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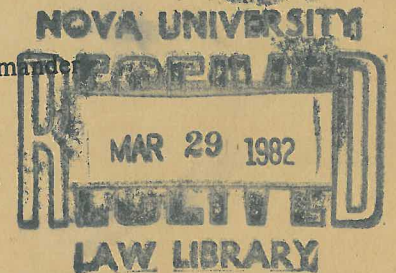
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# The Supreme Court in a New Role: From Negative Naysayer to Affirmative Commander\*

Arthur S. Miller\*\*

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## I

Four major milestones mark the almost two centuries of Supreme Court activity. The first three are the 1803 power-grab in *Marbury*,<sup>1</sup> the invention of “substantive” due process after the Civil War,<sup>2</sup> and the abdication of the Justices as ultimate economic policymakers in the 1930s and '40s.<sup>3</sup> The fourth, and possibly the most significant, is now clearly evident. Since 1958<sup>4</sup> the Court at times has been an *affirmative commander* as well as a *negative naysayer*. On occasion, the Justices tell other government officers what they *must* do to have their actions jibe with the fundamental law, rather than what they *cannot* do. The Court has become a commander. This article outlines that portentous development.

At the outset, I recognize the semantic problem: a naysaying decision can be considered to mean that the Justices chose affirmatively to pursue certain values. For example, by striking down a statute—say, one providing for minimum wages and maximum hours in employ-

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\* Copyright 1981 by Arthur S. Miller. This article is an adaptation of a chapter to appear in the author's forthcoming book, *ORACLE IN THE MARBLE PALACE: POLITICS AND THE SUPREME COURT*, to be published in 1982 by Greenwood Press.

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1. *Marbury v. Madison*, 5 U.S. (1 Cranch) 137 (1803).

2. Recounted in A. MILLER, *THE SUPREME COURT AND AMERICAN CAPITALISM* 50-62 (1968). See also J. COMMONS, *LEGAL FOUNDATIONS OF CAPITALISM* (1924); McCloskey, *Economic Due Process and the Supreme Court: An Exhumation and Reburial*, 1962 SUP. CT. REV. 34.

3. The turning point came in *West Coast Hotel Co. v. Parrish*, 300 U.S. 379 (1937), and in *National Labor Relations Bd. v. Jones & Laughlin Steel Co.*, 301 U.S. 1 (1937).

4. The new posture of the Court first became explicit in *Cooper v. Aaron*, 358 U.S. 1 (1958).

ment—the Court in the 1890-1937 period could be said to have made a “must do” pronouncement on corporate rights and to have furthered business expansion even at the expense of the working class. The semantic problem exists, but my point is different. The Justices in recent years have begun openly and expressly to command, by issuing opinions couched in language of affirmative duty laid upon political officers. In these instances, there is no need to infer a command (as in the employment decisions); it is flatly stated in plain language.

This is a constitutional revolution of the first water. Although it was not announced as such, the Court moved in an entirely new direction without fanfare. It tried to make the new posture appear a mere variation on what had gone before; the Court was doing only what judges had long done. That is far from true; nothing quite like it has been seen in American history (nor in the history of any other nation). The Justices became a *de facto* council of elders. By asserting the right and the power to say what the law *is* (as in *Marbury*) they have, through time and because of widespread acceptance, become able to say what the law *should* be. Rather than being “mere umpires,” they now are able to be, in Justice William Brennan’s words, “law-makers—a coordinate branch of government.”<sup>5</sup> The implications of this development have not yet been seen; there is little reason to think that the Court will not attempt to carve out an even larger role for itself in the future.

There is another way of looking at this development. During the heyday of what I have called the Constitution of Rights or of Quasi-Limitations,<sup>6</sup> the Court chose to emphasize certain rights of personhood which it attached to economic collectivities. It did so by denying the government the power to intervene into economic matters. The Justices spoke in terms of individualism and of *laissez-faire*. Today there is at least tacit recognition that the basic unit of society is the group. Conse-

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5. *Richmond Newspapers, Inc. v. Virginia*, 448 U.S. 555, 595 (1980) (concurring opinion).

6. In my book, *supra* note \*, I posit that the United States has had four constitutions: the Articles of Confederation, the Document of 1787, as amended (herein called the Constitution of Rights or of Quasi-Limitations), the Constitution of Powers, and the Constitution of Control. See A. MILLER, *DEMOCRATIC DICTATORSHIP: THE EMERGENT CONSTITUTION OF CONTROL* (1981) for further discussion.

quently, a concept of status is emerging in constitutional law.<sup>7</sup> The task of the Court is to effect the nexus, within the scope of constitutional values which they identify and articulate for and by themselves, between the individual and the groups (including the nation-state itself) of a bureaucratized society. This means that the Court has collectivized constitutional law. One aspect of such collectivism is the propensity, by no means always employed, to issue decrees couched in language of affirmative command. The Justices are attempting to preserve the values of individualism in a group-dominated nation. In order to do that, they have had to invent new ways of looking at old problems. They know that in some manner the stability of "the system" depends on siphoning off social discontent. Since those in positions of authority, both public and private, are not likely to police themselves, and are unlikely to alter the system even minimally, the Court steps in and does so. In doing that, the Justices act as surrogates for those who benefit most from the system.

One example will suffice to illustrate the point. In *Green v. School Board*,<sup>8</sup> a 1968 decision involving school desegregation, the unanimous Court used language of duty: "Brown II [the second, implementing decision of *Brown v. Board of Education*] was a call for dismantling of well-entrenched dual systems tempered by an awareness that complex and multifaceted problems would arise which would require time and flexibility for a successful resolution. School boards such as respondent [in *Green*] then operating state-compelled dual systems were nevertheless *clearly charged with an affirmative duty . . . to convert to a unitary system in which racial discrimination would be eliminated root and branch.*"<sup>9</sup>

No prior court opinion contained language charging administrative officers with "an affirmative duty" to do something. Thus *Green* went far beyond the traditional decisions of the Supreme Court. An express command aimed at school officials, *Green* meant that the Justices had openly entered the political arena, overtly taking part in the travail of society. The movement was from adjudication (settling only the dis-

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7. See Phillips, *Status and Freedom in American Constitutional Law*, 29 EMORY L.J. 3 (1980).

8. 391 U.S. 430 (1968).

9. *Id.* at 437-38 (emphasis added).



putes of the parties at bar) to legislation (stating rules for the public at large or at least for those similarly situated to the parties in court). It was a constitutional revolution of the first magnitude. There were forerunners to *Green*, to be sure, but none used the express words "affirmative duty."<sup>10</sup>

The Court makes no pretense in such decisions. In philosophic terms, the Justices have become telocratic; they openly admit as much. The rules of law they promulgate are instrumental, i.e., goal-seeking, while most Americans have long believed that the United States is nomocratic, i.e., rule-governed. That belief, that basic myth, has now become more than threadbare; it simply is not true. In constitutional matters the emperor has no clothes.<sup>11</sup> A government of laws, not of men, has never characterized the United States. (To the extent it does so today, it hampers rather than helps the resolution of public-policy problems.)<sup>12</sup> Telocracy, furthermore, has always been apparent in the Court's work; the real question is which purposes it was pursuing. There are, however, two major differences between yesteryear and today. First, the Court is now openly and outwardly purposive; and second, it has broadened the reach of its decisions to cover many more people.

The Justices choose constitutional questions to decide, not to further the interests of the litigants, but to develop the general law. Chief Justice Fred Vinson reminded lawyers in 1949 that "you are, in a sense, prosecuting or defending class actions; . . . you represent not only your clients, but tremendously important principles, upon which are based the plans, hopes and aspirations of a great many people throughout the country."<sup>13</sup> In a true class action, one plaintiff actually

10. For recent discussion, see J. BASS, UNLIKELY HEROES 308-09 (1981).

11. Cf. Kurland, *Ruminations on the Quality of Equality*, 1979 B.Y.U.L. REV. 7, 8: "[W]e are repeatedly told by the courts that the current egalitarianism which they are helping to impose derives from the Constitution. That, I think, is arrant nonsense. It is not being taken from the Constitution, it is being put into it." See also Forrester, *Are We Ready for Truth in Judging?*, 63 A.B.A.J. 1212 (1977).

12. "[I]n 1960-80 America became a nation of laws instead of men. The country had previously thrived by being exactly the opposite, although its lawyers wrote books pretending it wasn't." 277 THE ECONOMIST (London), No. 7165, Dec. 27, 1980, at 22, col. 3.

13. Quoted in H. HART & H. WECHSLER, THE FEDERAL COURTS AND THE FEDERAL SYSTEM 1404 (1953). See also Harlan, *Manning the Dikes*, 13 RECORD 541, 551

sues in his own name and on behalf of others similarly situated. In *Brown v. Board of Education*<sup>14</sup> for example, the immediate litigant, Miss Linda Brown of Topeka, Kansas, brought suit more for a general principle than for specific, immediate relief. (Immediate relief, of course, was also sought, but was not the primary motivation.) Vinson's remark was an oblique acknowledgment of the Court as legislator, for often "others similarly situated" do not even know of the lawsuit. Surely that was true in the Abortion Cases<sup>15</sup> and in the controversial *Miranda*<sup>16</sup> ruling (concerning the rights of a person caught up in administration of the criminal law). Although the Court has recently moved to tighten use of class actions,<sup>17</sup> Vinson's point is that *all* constitutional cases permit judges to rule generally while appearing to do so only specifically. They are, thus, "backdoor" class actions,<sup>18</sup> and therefore not subject to the statutory and decisional limitations imposed on true class actions. The Justices, not being logicians, have no difficulty in stating a general rule from the context of one particular case. The lesson here should be obvious: the Justices, speaking generally, set their own rules, both in the procedure to be followed and in the substance (the rules) to be applied. They have constitutional *carte blanche* and can go as far as the political process permits them to go.

## II

By fits and starts, with some Sisyphean back-pedaling, the members of the High Bench are overtly pursuing their ideas of justice. They

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(1958) (the Court chooses its cases "in the interests of the law, its appropriate exposition and enforcement, not in the mere interest of the litigants.") (quoting C.J. Hughes, S. REP. NO. 711, 75th Cong., 1st Sess., 39 (1937)). I have elaborated on the point in Miller, *Constitutional Decisions as De Facto Class Actions: A Comment on the Implications of Cooper v. Aaron*, 58 U. DET. J. URB. L. 573 (1982).

14. 347 U.S. 493 (1954).

15. *Roe v. Wade*, 410 U.S. 113 (1973); *Doe v. Bolton*, 410 U.S. 179 (1973). For analysis, see Miller & Barron, *The Supreme Court, the Adversary System, and the Flow of Information to the Justices: A Preliminary Inquiry*, 61 VA. L. REV. 1187 (1975), reprinted in A. MILLER, *THE SUPREME COURT: MYTH AND REALITY* ch. 8 (1978) [hereinafter cited as Miller & Barron].

16. *Miranda v. Arizona*, 384 U.S. 486 (1966).

17. *E.g.*, *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156 (1974).

18. For brief discussion, see Miller & Barron at 1193.

do not seem to be bound by pre-existing rules.<sup>19</sup> The consequence, as might be expected, is obvious: ideas of justice, of good public policy, differ among the nine Justices. I do not suggest this is a new situation, but some Justices now openly admit that they are law-makers and must at least try to accommodate the conflicting interests of a pluralistic society. That they are far from successful in the latter goal is revealing testimony of the shortcomings of pluralism itself as a form of political order.

The differences between the outward attitude of Justices of yesteryear and those of today are suggested by the following episodes, the first related by Judge Learned Hand about Justice Holmes and the second personal to myself. Said Hand: "Remember what Justice Holmes said about 'justice.' I don't know what you think about him but on the whole he was the master craftsman of our time; and he said, 'I hate justice,' which he didn't quite mean. What he did mean was this. I remember once when I was with him; it was on a Saturday when the Court was to confer. It was before he had a motorcar, and we jogged along in an old coupe. When we got to the Capitol, I wanted to provoke a response, so as he walked off I said to him, 'Well, sir, good-bye. Do justice!' He turned quite sharply and he said, 'Come here, come here.' I answered, 'Oh, I know, I know.' He replied, 'That is not my job. My job is to play the game according to the rules'."<sup>20</sup>

Holmes had the nineteenth-century view. (It is interesting to compare that episode with his 1873 candid acknowledgment that the rules were not neutral.)<sup>21</sup> He simply did not care about trying to help rectify some of the injustices of the world. "Savage, harsh, and cruel," as Professor Grant Gilmore described him,<sup>22</sup> he was quite willing as a Justice on the Supreme Court to aid "the rich and powerful [to] impose their

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19. See Kurland, *supra* note 11; Forrester, *supra* note 11. Cf. R. BERGER, GOVERNMENT BY JUDICIARY (1977).

20. Quoted in M. MAYER, THE LAWYERS 490 (1967) (paperback ed. 1968).

21. See Comment, *The Gas-Stokers' Strike*, 7 AM. L. REV. 582 (1873), discussed in Tushnet, *The Logic of Experience: Oliver Wendell Holmes on the Supreme Judicial Court*, 63 VA. L. REV. 975, 1029-31 (1977). See also Tushnet, *Truth, Justice, and the America Way: An Interpretation of Public Law Scholarship in the Seventies*, 57 TEX. L. REV. 1307 (1979).

22. G. GILMORE, THE AGES OF AMERICAN LAW 49 (1977).

will on the poor and weak.”<sup>23</sup> His was a harsh and gloomy universe; and although he knew quite well that playing the game “according to the rules” gave judges great leeway, he was unwilling to make the mental leap into considerations of justice and fair play.

The modern, albeit publicly unacknowledged, conception is that of Justice Hugo L. Black, a man whose cosmology made him an inheritor of the ideals of the Enlightenment. He saw in the Court—not consistently, to be sure, but often—a means whereby something more than the nebulous Holmesian rules could be employed. In 1959, I had an opportunity to speak with him in his chambers in the Marble Palace. The room was piled high with books, almost cascading off his desk, most of which dealt with philosophy and history and economics rather than with law as a technical doctrine. Black, a gracious man, spent an hour discussing the work of the Court and his role. With some reluctance, I finally got up to leave, for he obviously was a busy and hard-working man. As we walked to the door, I turned and shook his hand, and asked a final question: “What, sir, do you conceive your basic task to be?” I don’t know what I expected, but what came back was this: his eyes blazed, his right hand shot into the air, and without hesitation he fervently said, “To do justice!”

It would be wrong, of course, to infer too much about either episode. Black’s answer to my question, nonetheless, does seem to epitomize the Court’s new jurisprudence, the open desire, not always followed, to do justice or achieve fairness in individual cases—and thus to promulgate a general norm (or norms) of justice as fairness. It is not an invariable practice. At times some members of the present Supreme Court proceed in the opposite direction.

Justice William Rehnquist is perhaps Holmes’ intellectual heir in his attitude.<sup>24</sup> Consider in this connection *Rummel*,<sup>25</sup> decided by a bare 5-4 majority in 1980. In an opinion written by Rehnquist, a Texas law was upheld that made a life sentence mandatory when a person was convicted of three felonies. Texas’ criminal law is notoriously harsh. Rummel’s three offenses involved a total sum of \$229.11 (forgery,

23. *Id.*

24. For Justice Rehnquist’s views, see Rehnquist, *The Notion of a Living Constitution*, 54 TEX. L. REV. 693 (1976). For early discussion of Rehnquist’s ideology, see Shapiro, *Mr. Justice Rehnquist: A Preliminary View*, 90 HARV. L. REV. 293 (1976).

25. *Rummel v. Estelle*, 445 U.S. 263 (1980).

wrongful use of a credit card, and not fulfilling an air-conditioning contract). The life sentence, Rehnquist concluded, was not a cruel and unusual punishment proscribed by the Eighth Amendment. Maintaining that he was proceeding according to the rules and that the relevant rule was the Texas law, Rehnquist forgot (or simply ignored the fact) that the rule—the Texas law—was the very question at issue.

Most Justices today do not pretend, as did Rehnquist, that constitutional law is a game to be played—in Holmes' words—"according to the rules." Unabashedly making law, they often seem to strain for the "just" result. The problem is that no one, on the High Bench or elsewhere, has yet produced a workable definition of justice in the context of Supreme Court law-making. Hence sharp splits develop on the Court, as in *Rummel*, and as in the well-known decision concerning Allan Bakke's application for admission to the University of California medical school.<sup>26</sup> The school had a policy of preferential admissions for blacks and other disadvantaged people. When *Bakke* got to the Marble Palace, the Justices again narrowly split, and produced a Solomonic decision: Bakke would be admitted to the school, but race could be used as one of the criteria for future admissions. The net result was that white Americans (represented by Bakke) as well as black Americans (the disadvantaged generally) were each given at least a partial victory. My point is not to argue the pros and cons of *Bakke*, but to suggest that it, and others, reveal a marked propensity even in the Burger Court to follow Justice Black's *cri de coeur*: "Do justice!"

By no means is telocracy, avowedly pursuing a given goal and doing justice, publicly admitted by the High Bench. The pretense still exists that Holmes' prescription of nomocracy prevails. A failure to see through the pretense, accepting at face value what the Justices say in their opinions, impairs detection of reality and at times leads learned scholars into serious errors of judgment. Bertrand de Jouvenel, the well-known French political theorist, is an example:

Nomocracy is the supremacy of the law; telocracy is the supremacy of purpose. Modern institutions [i.e., Western] were developed around the central concept of law. Individual security is assured if the citizens are not exposed to arbitrary acts of the government,

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26. *University of Cal. Regents v. Bakke*, 438 U.S. 265 (1978).

but only to the application of the law, which they know. . . . The guarantees of such a regime are precious. But institutions of a judicial type are not [designed] for action.<sup>27</sup>

He went on to say that what “distinguished contemporary government is its vocation for rapid social and economic progress. . . . Once government activity has a relatively precise goal, the regime’s inspiration is telocratic and political forms necessarily reflect this.”<sup>28</sup>

De Jouvenel was not speaking of the Supreme Court of the United States, but his views are nonetheless relevant. They display a faith in nomocracy, in “the supremacy of law.” That supremacy, however, has never existed in the United States (or elsewhere).<sup>29</sup> He doubtless was correct in describing contemporary government, but surely he erred in asserting that it was a new development. Telocracy is novel only in the express acknowledgement of it by all branches of government. Law in America since the earliest colonial days has been instrumental, i.e., goal-seeking or telocratic. Professor Morton Horwitz’s conclusions about the common law are equally accurate for constitutional law:

By 1820 the legal landscape in America bore only the faintest resemblance to what existed forty years earlier. While the words were often the same, the structure of thought had dramatically changed and with it the theory of law. Law was no longer conceived of as an eternal set of principles expressed in custom and derived from the natural law. Nor was it regarded primarily as a body of rules designed to achieve justice only in the individual case. Instead, judges came to think of the common law as equally responsible with legislation for governing society and promoting socially desirable conduct. The emphasis on law as an instrument of policy encouraged innovation and allowed judges to formulate legal

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27. de Jouvenel, *quoted in Kelly, Who Needs A Theory of Citizenship?*, 108 *DAEDALUS* No. 4, at 21, 25 (Fall 1979).

28. *Id.*

29. In making this statement, I am referring in the main to the highest levels of government, although it must be noted that most administrators have some discretion. For a statement by a knowledgeable Washington lawyer, see C. HORSKY, *THE WASHINGTON LAWYER* 68 (1952).

doctrine with the self-conscious goal of bringing about social change.<sup>30</sup>

That statement, particularly the last sentence, describes remarkably well what the Supreme Court and other courts have been doing for at least a generation.

The change, thus, is not from nomocracy to telocracy, but in the recent open avowal of pursuit of social goals by officers in all segments of government. Congress, for example, by enacting the Employment Act of 1946,<sup>31</sup> expressly called for policies that furthered the economic well-being of the people. Other statutes have delegated authority to agencies and bureaus to help fulfill that very purpose. The President's annual budget and economic messages to Congress are a conscious effort to tinker with the economy for telocratic purposes. And the Supreme Court has had a major role in the new (open) posture—first, by validating new powers of Congress in socio-economic affairs (the so-called constitutional revolution of the 1930s); and second, by rendering decisions that are themselves telocratic. "It is of the very nature of a free society," Justice Felix Frankfurter once maintained, "to advance in its standards of what is deemed reasonable and right."<sup>32</sup> Today, it is deemed reasonable and right, even necessary, for all branches of government to pursue social welfare ends. The pretenses of the past have been cast aside. Law has become obviously instrumental. To be sure, disagreement occurs (at this writing, for example, in the details of President Ronald Reagan's economic programs); but it, at least outwardly, is about means rather than ends. Very few dispute that government has some role to play in socio-economic affairs; even the Reagan "supply-side" economics is being promoted as a means of helping all of the people (not just the affluent, who would be the immediate beneficiaries).

The legal theory for the new posture was suggested many years ago by Leon Duguit: "Any system of public law can be vital only so far as it is based on a given sanction to the following rules: First, the hold-

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30. M. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1780-1860*, at 30 (1977).

31. 60 Stat. 23 (1946). For discussion, see E. ROSTOW, *PLANNING FOR FREEDOM* (1958).

32. *Wolf v. Colorado*, 338 U.S. 25, 27 (1949).

ers of power cannot do certain things; second, there are certain things they must do.”<sup>33</sup> Formal constitutional law from 1789 to 1937 evolved for the most part around the “cannot do” of that formulation, making the Constitution one of “rights” or of “limitations.” Since 1937, the “must do” aspect has been slowly emerging.

When the Court validated the New Deal in the 1930s and ‘40s, it confirmed, rather than wrought, a revolution in American government. The High Bench caught up with the political branches of government. Each branch became an active participant in the travail of society. At first, the Justices were not fully aware of what they were doing; but the new form of government—the emergence of an operative Constitution of Powers<sup>34</sup>—quickly made it evident that not even judges could stay aloof from or forever block the tides of social change sweeping through the nation. Writing in 1908, Woodrow Wilson perceived the need for a common purpose among those who govern. Once it is conceded, as surely it must be, that courts are an integral part of the governing process, then his comment is particularly apt: “Government is not a body of blind forces; it is a body of men, with highly differentiated functions, no doubt, in our modern day of specialization, but with a common task and purpose. Their cooperation is indispensable, their warfare fatal.”<sup>35</sup> Although Wilson was speaking of the President and Congress, his observation fits the Supreme Court as well. Judges are not so much independent from other branches of government as they are cooperators with them. Rather than being separate and apart, they stand squarely in the mainstream of politics. And that is so whether their actions lend legitimacy to politicians’ goals, or quietly enable the political process to continue, or even impede some actions of political officers by declaring those invalid. Judges have an ongoing political function to perform.

An understanding of the flow of constitutional decisions, from the Supreme Court and elsewhere, requires inquiry into trends of doctrinal development in both the formal and the operative Constitutions. Trend analysis involves starting in the past, discussing interim developments, and projecting into the future. That can be done on several levels: the

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33. L. DUGUIT, *LAW IN THE MODERN STATE* 26 (H. Laski trans. 1919).

34. So labelled by E. CORWIN, *A CONSTITUTION OF POWERS IN A SECULAR STATE* (1951).

35. W. WILSON, *CONSTITUTIONAL GOVERNMENT IN THE UNITED STATES* 56-57 (1908).



evolution of specific constitutional principles, the structure of government itself, and the relationship of government *vis-a-vis* the citizenry. The last is our present focus.

The fundamental trend, as has been said, is from ostensible nomocracy to avowed telocracy. In politics, the change is from the negative, nightwatchman State to the positive State; in economics, it is from laissez-faire to regulation "in the public interest," and in law, the rule of law has been redefined from a seemingly static system of immutable principles to a dynamic, open-ended stream of decisions. Each change merits discussion, not separately but together.

Less than a half-century ago the American people crossed over one of the great constitutional watersheds of their history. In what was aptly termed a constitutional revolution, judicial approval was accorded to what most people wanted: governmental intervention in socio-economic affairs so as to provide—at least, attempt to provide—minimum economic security. The positive State came into existence under a third operative fundamental law—the Constitution of Powers. Government overtly became responsible for more than minimum internal order and external security; it assumed obligations of a social-service or welfare nature.

Whether the new commitments of government can long endure is by no means certain. Its politics, seemingly settled in the post-World War II period, are becoming unravelled. That may be attributed to the slowing down, even cessation, of economic growth, to the depletion of natural resources, and to the rising demands of people in the former colonial areas of the world. It comes as no surprise that our welfare programs precipitate tensions verging on violence. We are witnessing, in John Kenneth Galbraith's terms, the "revolt of the rich against the poor"<sup>36</sup> as a type of counter-revolution to the increasingly insistent demands of the underclass (both in the United States and elsewhere). Professor Lester Thurow has labelled the new politics "the zero-sum society,"<sup>37</sup> by which he means that in a slow or no-growth economy any important economic benefit for one segment of society requires a concomitant sacrifice elsewhere. Hence the zero-sum game: it is one in which all cannot win. "In the past," Thurow says, "political and eco-

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36. Galbraith, *How to Get Ahead*, N.Y. REV. OF BOOKS 12, 14 (July 19, 1979).

37. L. THUROW, *THE ZERO-SUM SOCIETY* (1980).

conomic power was distributed in such a way that substantial economic losses could be imposed on parts of the population. . . . Economic losses were allocated to particular powerless groups rather than spread across the population. These groups are no longer willing to accept losses and are able to raise substantially the costs for those who wish to impose losses upon them.”<sup>38</sup> The groups include blacks and other ethnic minorities, workers, women and consumers. But business interests remain powerful; the result is a creeping political paralysis. Whether and how that Gordian knot of the American political economy can be cut may well be the central constitutional question of the day.

Galbraith and Thurow, without doubt, are correct. Their message is well worth pondering, for what they say is that the telocracy that has characterized government for the past several decades may no longer be possible. The economic pie is shrinking; of that there can be no real question. Even so, whatever the outcome of struggles already begun and certain to continue, the commitment of government to general economic security remains. Congress still sets the broad policy guidelines, their administration is left to the bureaucracy, and the judiciary cooperates. How long that posture will continue is uncertain. One thing, however, seems sure: there will be no reversion to the *status quo ante*, to the Golden Age of the 1945-1970 period. Americans are entering the age of limits, of frugality, of scarcity. The ecological trap is closing. There can be little doubt that the next decade and beyond will be “a harsher, more exacting, and more perilous age.”<sup>39</sup>

Telocratic goals pursued by government may well have to change. I do not propose to discuss the point further, save in the context of Supreme Court decision-making. The social milieu is being rapidly altered. Does that mean that the instrumentalism of the Justices, so evident since 1937, will be altered so that different goals are pursued? Can human dignity, defined as the realization of basic human needs, survive and be enhanced in a “steady-state” economy? Can, in other words, the Court help effect the transition from the now-defunct Golden Age to “the lean years”<sup>40</sup> with a minimum of stress on existing

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38. *Id.* at 12.

39. P. DUIGNAN & A. RABUSHKA, *THE UNITED STATES IN THE 1980s* at xxxix (1980).

40. *See* R. BARNET, *THE LEAN YEARS* (1980).

institutions and expectations? These are the problems that now face all governmental officers, including those in the Temple on the Hill, problems with which they will continue to be concerned as the future unfolds. No quick technological fix, nor any other similar remedy, is available. We are in for it, deeply and irretrievably; and it behooves all who care—and only saints and fools do not—to help in the extrication of humankind from the crisis of crises—the climacteric—it now confronts. Judges cannot be immune from that effort.

The problem emerges at the very time that the Rule of Law, historically nomocratic, is being redefined to encompass a telocratic dimension. Constitutional law was traditionally procedural, telling government how it must deal with the citizenry. It has now taken on enough of a goal- or purpose-seeking aspect to conclude that nomocracy is no longer an adequate conception of the role of law and legal institutions. This is not to say that none of the traditional view remains; of course it does. But it must operate side-by-side with the new instrumentalism. The United States, thus, has assumed the task, vastly more difficult than merely enforcing a law known to all (the orthodoxy), of deciding what the law ought to be and of making desirable changes.<sup>41</sup>

Perhaps the clearest expression of the new Rule of Law came in 1959, in the Declaration of Delhi of the International Congress of Jurists (a group of lawyers from countries outside the Soviet bloc of nations): “The International Congress of Jurists . . . recognizes that the Rule of Law is a dynamic concept for the expansion and fulfillment of which jurists are primarily responsible and which should be employed not only to safeguard and advance the civil and political rights of the individual in a free society, but also *to establish social, economic, educational and cultural conditions under which his legitimate aspirations and dignity may be realized.*”<sup>42</sup> To the extent that the spirit, if not the letter, of the Declaration is accepted, (and it is by a wide range of American governmental programs) the Rule of Law has come to mean,

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41. See Knight, *On the Meaning of Justice*, in JUSTICE 1 (NOMOS VI: YEARBOOK OF THE AMERICAN SOCIETY FOR POLITICAL AND LEGAL PHILOSOPHY)(C. Friedrich & J. Chapman eds. 1963).

42. INTERNATIONAL CONGRESS OF JURISTS, THE RULE OF LAW IN A FREE SOCIETY 3 (N. Marsh ed. 1960) (emphasis added). See Thorson, *A New Concept of the Rule of Law*, 38 CAN. B. REV. 239 (1960).

in Aristotle's terms, *distributive* justice as well as *corrective* justice. Government, as Duguit said, "must do" certain things of an affirmative nature.

How, if at all, has the Supreme Court responded to that version of the Rule of Law? The Justices, in the first place, have not announced any spectacular shift in so many words. However, when some of their recent decisions are viewed in terms of effects, of social consequences, rather than as examples of doctrinal exegesis, it may be said that the Court has indeed accepted at least some parts of the new Rule of Law. Furthermore, it has contributed to the settlement of some immediate aims of Americans. Yves Simon once observed that in a democratic society, "deliberation is about means and presupposes that the problem of ends has been settled."<sup>43</sup> The Justices have contributed to developing consensuses on such troublous matters as race relations,<sup>44</sup> abortion,<sup>45</sup> the church-state relationship,<sup>46</sup> the immersion of the nation in world affairs,<sup>47</sup> and other critical public policy issues.<sup>48</sup> I do not suggest that they have solved them. They have not. In those and other areas, the Justices have moved to catch the conscience of the American people, and thus to stimulate and keep alive a continuing seminar on vital constitutional matters. If democracy means anything, it means a continuing dialogue among the citizenry on matters of public concern. The Justices both lead and participate in that dialogue.

The precise turning point to constitutional telocracy can be identified in Chief Justice Charles Evans Hughes' 1937 opinion in a minimum-wage case, *West Coast Hotel Co. v. Parrish*.<sup>49</sup> To Hughes, liberty meant "liberty in a social organization" which used the law to ward away the evils of industrialization. From being a limitation on governmental power, the due process clauses of the formal Constitution became at least an invitation, and perhaps a command, for political ac-

43. Y. SIMON, *PHILOSOPHY OF DEMOCRATIC GOVERNMENT* 123 (1951).

44. *E.g.*, *Brown v. Board of Educ.*, 347 U.S. 483 (1954) and progeny.

45. *E.g.*, *Roe v. Wade* 410 U.S. 113 (1973) and progeny.

46. *E.g.*, *Engel v. Vitale*, 370 U.S. 421 (1962).

47. *E.g.*, *Dames & Moore v. Regan*, \_\_\_ U.S. \_\_\_, 101 S. Ct. 2972 (1981).

48. Not that the Court has escaped criticism. Far from it. More than 20 bills were introduced in Congress in 1981 aimed at cutting down Supreme Court power. See Miller, *The Supreme Court Under Fire*, Miami Herald, June 28, 1981, at 4E, col. 1.

49. 300 U.S. 379, 391 (1937).

tion to ameliorate human distress. The command, if such, was couched in discreet terms, and the idea lay dormant for almost twenty years. Not until 1955, in the second, implementing decision in *Brown v. Board of Education*, did the Justices screw up their courage to tell the other government officers: "Do this." In that instance, the command was to integrate black children into public schools "with all deliberate speed."

Hughes' opinion in *Parrish* permitted government to actively further the cause of the disadvantaged—that is, to use law purposively. It also, as Professor Edward S. Corwin phrased it, changed the due process clauses from limitations on legislative power to "an actual instigation to legislative action of a leveling character."<sup>50</sup> At what point does an "instigation" become a command? There is no way to answer that question. At some time, however, between 1937 and 1955, a new perception of their role was accepted by the Justices.

The *Parrish* decision, with others, permitted the birth of what I call the (third) Constitution of Powers, for the Court had constitutionalized massive interventions into the political economy by Congress and state legislatures. That third fundamental law still remains as part of the operative Constitution; it is a layer on the palimpsest that is the Document of 1787. It was not that the (second) Constitution of Rights (of Quasi-limitations) was completely shunted aside and supplanted; it now had to share top billing with the third Constitution. (A fourth fundamental law—the Constitution of Control is now becoming visible.)<sup>51</sup>

### III

It is—"an axiom of statesmanship," Henry George once observed, "that great changes can best be brought about under old forms."<sup>52</sup> So with the formal words of the Constitution: they remain the same, but only as a facade, beneath which lies a radically different living reality.

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50. E. CORWIN, *LIBERTY AGAINST GOVERNMENT* 161 (1948) (emphasis omitted).

51. See A. MILLER, *DEMOCRATIC DICTATORSHIP: THE EMERGENT CONSTITUTION OF CONTROL* (1981); Miller, *Reason of State and the Emergent Constitution of Control*, 64 *MINN. L. REV.* 585 (1980).

52. H. GEORGE, *PROGRESS AND POVERTY* 404-05 (1879).

The emergence of a Constitution of Powers meant that structural changes came without amendment of the Constitution of Rights. Two of them are well known: the shift in the federal system toward a consolidation of national power, and increased flow of power within the general government toward the presidency (and the bureaucracy). Nor was this a sudden development. Much of American history evidences the low beginnings of both changes. By 1950 it had become clear beyond doubt that both were permanent alterations in the allocation of governmental powers. (That is so despite some recent attempts, as in the 1976 decision in *National League of Cities v. Usery*,<sup>53</sup> to resurrect historical federalism.)

I do not propose to discuss either federalism or the rise of executive hegemony here. My interest lies in what has happened and is happening to the Supreme Court. The Justices have moved on several fronts to meet the challenges of the modern era. They have not remained quiescent, but have become active participants in the arena of politics. Examples are easily found: racial segregation; apportionment in state legislatures (and in the U.S. House of Representatives); the rights of women, aliens, children and illegitimates; administration of the criminal law. Taken together, they tend to validate, at least partially, McGeorge Bundy's comment that "The fundamental function of the law is to prevent the natural unfairness of society from becoming intolerable."<sup>54</sup> The core of many recent decisions of the Court is the equality principle, writ large, and a concept of justice as fundamental fairness.

Under its new jurisprudence, the Supreme Court acts as a commander, not in the sense of having enforcement power of its own (which it does not), but by stating norms that purportedly bind the entire nation. By becoming a commander, and getting away with it, the Justices have assumed an even larger role. What that might be is suggested elsewhere.<sup>55</sup> Suffice it for now to state that the Court as legislator is now well, if not fully, accepted. People throughout the United States look to the Temple on the Hill for guidance, if not for ultimate

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53. 426 U.S. 833 (1976).

54. Quoted in M. MAYER, *supra* note 20, at 516.

55. See, e.g., Miller, *In Defense of Judicial Activism*, in SUPREME COURT ACTIVISM AND RESTRAINT (S. Halpern & C. Lamb eds.) (to be published in 1982); A. Miller, *supra* note \*, ch. 11.

resolution, in some of the more troublous problems they confront. Anguished protests come, of course, from those whose oxen have been gored by the very idea of the Court as commander, protests not unlike those suffered by Chief Justice Marshall. They too will fade away. The Justices' position as a necessary constituent of government is too solidified to be altered. The Court is needed, badly needed, by the fragmented and alienated populace trying to navigate the white rapids of the climacteric of humankind lying dead ahead. I do not suggest, now or later, that the Court can or will do this alone. That, of course, is a manifest impossibility. But the Justices can light a candle rather than standing aside and cursing the darkness of the coming Age of Frugality.

#### IV

The new judicial posture built in the last generation or so revolves around the concept of "positive freedom." To explain it requires reference to a long forgotten English philosopher, Thomas Hill Green, who wrote in the latter part of the nineteenth century. To him, the notion of positive freedom reflected the rediscovery of the community as a corporate body of which both institutions and individuals were a part, so that the idea of collective well-being or the common good would underlie any claim to private right. Ponder that idea for a moment. Can there be much doubt that claims to private right do give way, under modern law and policy, to ideas of collective well-being? The community has indeed been rediscovered. It may be seen in the rise of the State to pre-eminence, in the successful assertions of national security as justifications for governmental action, in invocations of the public (or national) interest by successive Presidents, in the "entitlements" that more and more Americans consider to be their right. In all these, and more, the notion of individual autonomy has been supplanted by an inchoate collectivism. Despite much rhetoric to the contrary, few dispute the need for the change, and fewer would wish to revert to the storied days of individualism, (which existed more in myth than in reality). It should be remembered that individualism, far from being inherent in the human experience, is a latter-day phenomenon, no older than the French Revolution. Even as a theory or philosophy it is now either dead or dying both in social affairs and in law. The autonomous man does not exist as such.

The development is reflected in American constitutionalism in the newly-emergent concept of status rights which derive from one's membership in a group (or groups) and not from some inherent, metaphysical notion of personhood.<sup>56</sup> An "indivisible" nation pledges "liberty and justice to all." That may be a mere slogan, a symbol, but we must always remember that, as Holmes said and Frankfurter often repeated, "we live by symbols."<sup>57</sup> The symbol today is of collective well-being, of welfare if you will. Green gave the philosophical basis for positive government: social insurance programs that provide the economic means for more people to be free (if they wish). The duty of government in this conception is not so much to maximize individual liberty as an end in itself, but rather "to insure the conditions for at least a minimum of well-being—a standard of living, of education, and of security below which good policy requires that no considerable part of the population shall be allowed to fall."<sup>58</sup> Analysis of governmental programs since the 1930s shows how closely they approximate that requirement. And one need only refer to the Declaration of Delhi<sup>59</sup> to see how some legal thinking coincides with Green's. It must be remembered, however, that Green wrote at a time when the economic growth seemed to make his proposals possible. The history of most of this century is also one of economic growth. Modern governmental programs were created during an age of abundance, well before the incipient age of frugality, and thus well before Thurow's zero-sum society became apparent. That, of course, makes the task of today's government immensely more difficult. It is a task, furthermore, that has lately encountered serious intellectual opposition from neo-conservatives generally and from such articulate wishful thinkers as philosopher Robert Nozick and economist George Gilder.<sup>60</sup> Both Nozick and Gilder want to create what they fancy was the world of yesteryear—a free market, non-statist society—or failing that, to move toward that end. That they cannot and will not succeed should be obvious to all.

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56. See Phillips, *supra* note 7.

57. For Holmes, see O. HOLMES, COLLECTED LEGAL PAPERS 270 (1920); for Frankfurter, see H. HIRSCH, THE ENIGMA OF FELIX FRANKFURTER 148 (1981).

58. G. SABINE, A HISTORY OF POLITICAL THEORY 676 (1937).

59. See text accompanying note 42 *supra*.

60. See R. NOZICK, ANARCHY, STATE, AND UTOPIA (1974); G. GILDER, WEALTH AND POVERTY (1981).



No one in government, certainly no Justice, has ever openly avowed that Green was the patron saint of the Constitution of Powers. Indeed, it would have been odd had anyone done so. Green was an obscure academic scribbler, little known outside of England. His ideas, however, have percolated through other, perhaps lesser minds to be seized by men of action who never heard of him and who had no interest in abstract ideas as such. But unquestionably Green's views on freedom as a social, not individual, right are dominant. He wished to reunite the individual with the social order of which he is a member, and without which his existence has no meaning. Green saw that individualism was running its course, a temporary phenomenon limited in time and space to a few centuries and the Western world. He also knew that organizations—the collective body, including the nation itself—were the new order. Therefore, the individual's freedom is, paradoxically to some, protected by legal and other institutions that can only be provided by the community. We have thus outlived the Robinson Crusoe myth. "When we speak of freedom as something to be so highly prized," asserted Green, "we mean a positive capacity of doing or enjoying something worth doing and enjoying, and that, too, something that we do or enjoy in common with others. We mean by it a power which each man exercises through the help or security given him by his fellow men, and which he in turn helps to secure for them."<sup>61</sup> In a phrase, that is a formula for benevolent collectivism—precisely where Americans are now, at least in the ideal. The ideal, to be sure, has not been achieved for many; with the incipient age of frugality, perhaps even fewer will achieve it.

Has the Supreme Court lived up to Green's conception? Only indirectly, as the following examples illustrate. Taken together, the Court's decisions display a marked tendency toward overt telocracy on implicit Green lines. Their numbers may be small, but they are of fundamental significance, both because they reveal beyond doubt a new and significant role of the Justices and because they are the principal targets of the Court's modern critics. To generalize, these illustrations show that the Court is willing for the first time in American history to give con-

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61. T. GREEN, WORKS: MISCELLANIES AND MEMOIR 371-72 (1888). See Phillips, *Thomas Hill Green, Positive Freedom and The United States Supreme Court*, 25 EMORY L.J. 63 (1976).

stitutional protection to some members of certain “discrete and insular” minorities.<sup>62</sup> Thus, the Constitution has been extended substantially, but still not completely to “We, the people . . .,” the opening words of the Preamble.

### *Race Relations*

The Negro problem, Gunnar Myrdal maintained in his classic *An American Dilemma* (1940), is really a problem in the hearts of white Americans. Except for a brief period, from about the mid-1940s to the late 1960s, whites have been quite willing to keep blacks in either a formal or an informal caste system. When slavery was abolished by the Thirteenth Amendment, the First Reconstruction began. It met an early death, first in politics and then by judicial decrees limiting Congress’ power to enforce the Civil War amendments. In the infamous *Plessy v. Ferguson* decision of 1896,<sup>63</sup> the Justices legitimated a caste system, wrapping it in the sugar-coating of “separate but equal,” even though everyone knew that blacks were in fact separate and unequal. Under the operative Constitution, blacks were kept “in their place.” Peonage was widespread, a form of bondage scarcely distinguishable from slavery.

That could not last, at least in formal law. No nation that trumpets itself as a democracy with “equal justice for all”<sup>64</sup> can indefinitely keep a large part of the populace submerged in a status providing little hope, except for an occasional fortunate escapee, of a better future. But last it did until the Second World War. The United States, like Great Britain, could hardly conscript men to fight, and at times die, in the name of freedom and democracy, only to return them to ghettos at the end of hostilities. Nor could blacks be further denied an opportunity for education and thus for fuller participation in American life. Moreover, blacks not called into service could not be denied employment in war industries; this led to President Roosevelt’s executive order barring ra-

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62. The term comes from the *Carolene Products* case and Justice Stone’s famous footnote therein. *United States v. Carolene Prods.*, 304 U.S. 144, 153 n.4 (1938). For discussion, see J. ELY, *DEMOCRACY AND DISTRUST* 76 (1980).

63. 163 U.S. 537 (1896).

64. This is the slogan carved deeply in the facade of the Supreme Court building in Washington, D.C.

cial discrimination in employment.<sup>65</sup> FDR, a true Machiavellian, made a virtue out of necessity.<sup>66</sup>

The main breakthroughs for improving the status of America's "untouchables" came in the Supreme Court—in the *White Primary Cases*,<sup>67</sup> in *Shelley v. Kraemer*,<sup>68</sup> and then in *Brown v. Board of Education*.<sup>69</sup> The facade of constitutional law has not been the same since. Others taking their cue from black Americans made the Court an object of pressure-group tactics. The reach of the equality principle has been extended to other areas. The Supreme Court, supposedly dispassionate, became compassionate. Men, women, and children, with little or no political influence, found through the judiciary a way to redress longfelt grievances. Federal appeals Judge J. Skelly Wright said it well: After pointing out that "great social and political problems [are better] resolved in the political arena," he went on to say "there are social and political problems which seem at times to defy such resolution. In such situations, under our system, the judiciary must bear a hand and accept its responsibility to assist in the solution where constitutional rights hang in the balance."<sup>70</sup> We have already mentioned that the Justices used express language of affirmative duty in the late 1960s in an effort to eliminate racial discrimination root and branch. What remains for blacks is not the principle found in the formal Constitution, but one based on cases and the operative Constitution. The Court may promulgate a general norm—a rule of law—but unless it is accepted and obeyed by people generally it tends to become, if not a dead letter, less and less significant.

Until they decided that discriminatory motive or intent was not only important but had to be proved by those alleging discrimination, the Justices had been remarkably consistent in furthering the cause of human dignity for black Americans. The basic change, subtle but important, surfaced in 1976 but was underscored in 1980 in *City of Mo-*

65. For discussion, see Miller, *Government Contracts and Social Control: A Preliminary Inquiry*, 41 VA. L. REV. 27 (1955).

66. N. MACHIAVELLI, *THE DISCOURSES*, Book I, Sec. 9: "A republic or a prince should ostensibly do out of generosity what necessity constrains them to do."

67. *E.g.*, *Smith v. Allwright*, 321 U.S. 649 (1944).

68. 334 U.S. 1 (1948).

69. 347 U.S. 483 (1954).

70. *Hobson v. Hansen*, 269 F. Supp. 401, 517 (D.D.C. 1967).

*bile v. Bolden*.<sup>71</sup> In *Bolden*, black citizens of Mobile, comprising one-third of the city's population, argued that their vote was unconstitutionally diluted because of the city's at-large system of electing the three city commissioners who governed the city. The system, established in 1911, kept blacks from effective political participation. Six separate opinions were filed; Justice Potter Stewart, speaking for a plurality, rejected the claims. Adverse action on an identifiable group was not enough, said Stewart; there must be proof that a challenged action was undertaken "at least in part 'because of', not merely 'in spite of', its adverse effects upon an identifiable group."<sup>72</sup> Professor Aviam Soifer ably summed up the implications:

It is as if in 1980 black citizens no longer constitute a discrete and insular minority. A black citizen's constitutional claim will not prevail unless he can demonstrate precise intentional discrimination against himself as an individual or some specific and intentional official discriminatory treatment of blacks. Otherwise, the promise of the fourteenth and fifteenth amendments, and the civil rights revolution, has either been satisfied or is properly left to the politicians. As we enter the 1980s, it is presumed that we all compete fairly. When no bad guys can be connected to evil discriminatory deeds, the Court apparently simply assumes that we all enjoy equal and fair opportunity.<sup>73</sup>

The *Bolden* decision, then, made the Court, as Justice Thurgood Marshall said in dissent, an accessory to the perpetuation of racial discrimination. His point is well taken. How could Stewart and others who upheld the Mobile system not have seen what should be obvious to all?

The meaning, for black Americans, seems clear beyond doubt: the formal Constitution is merging with the operative fundamental law. Under both, the blacks are slowly reverting to second-class citizenship. Under the living law of American constitutionalism, the promise of *Brown v. Board of Education* and progeny has not been realized. Ghettos remain and unemployment among blacks is highest in the nation.

71. 446 U.S. 55 (1980).

72. *Id.* at 71 n.17. See Soifer, *Complacency and Constitutional Law*, 42 OHIO ST. L.J. 383 (1981).

73. Soifer, *supra* note 72, at 389. See Miller, *The Court and Racial Bias*, Miami Herald, May 24, 1981, at 1E, col. 1.

Blacks do not receive, as in Mobile, their fair share of city services. As for unemployment, one study concluded: "These data fail to provide support for the popular belief that there has been a significant increase in the proportion of middle and upper-income Black families in recent years. If anything, these findings suggest that the proportion of such families may in fact have declined, that the economic gains of many blacks may have eroded under the combined effects of inflation and recession."<sup>74</sup> Many whites want to believe the contrary, but the facts do not bear them out. While a larger number of blacks have been able to gain economic and social rewards, most do not, and they are joined by ever-increasing numbers of Hispanics and poor whites.

The social consequences may well be considerable. Will blacks and other disadvantaged groups long acquiesce to a condition of operative *apartheid* and a growing willingness of the Supreme Court to uphold it? Justice Marshall ended his dissent in *Bolden* with a warning that may be prophetic: He said that a "superficial tranquility" created by "impermeable" and "specious" requirements that discriminatory intent must be proven may be short-lived. "If this Court," he concluded, "refuses to honor our long-recognized principles that the Constitution 'nullifies sophisticated as well as simple-minded modes of discrimination,' it cannot expect the victims of discrimination to respect political channels of seeking redress."<sup>75</sup> Indeed, it cannot. When political avenues are barred and the Supreme Court does not respond, is there any way victims can peacefully work within "the system"? None is apparent.

I do not wish to push the point further at this time. It is enough now to say that the Court's new posture—issuing commands of affirmative duty—poses difficult and as yet unanswered questions. But for blacks at least, the Court's stance is by no means a one-way street. The public at large may not disagree with the Court as commander; but scholars, commentators, and judges themselves have not answered many questions. Where does the Court get its constitutional right to issue general rules? How will the rules be enforced? Is the President, constitutionally charged with the duty of assuring that the laws are

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74. Hill, *The Illusion of Black Progress*, 9 Soc. POL'Y, No. 3, 14, 24 (1978). See Miller, *Brown's 25th: A Silver Lining Tarnished With Time*, 3 DISTRICT LAW. No. 5, —, 22 (1979).

75. 446 U.S. at 141.

faithfully executed, also under a duty to “execute” the decisions of the Court? Are Supreme Court decisions of the same rank as a statute so far as Article VI of the Constitution is concerned (making the Constitution, laws and treaties the supreme law of the land, binding judges in every state)?

As for the President, if he has a duty to execute judicial decrees, is it merely moral or political; or does it go further, carrying the implication that someone can go into court to make him enforce a judicial decision? Recall that in *Cooper v. Aaron*,<sup>76</sup> the Court maintained that its decisions are “the law of the land.”<sup>77</sup> If that means what it says, then a Supreme Court decision is akin to a statute under Article VI, and the logical implication is that the President must enforce the decision. Even though the writ of the Court can now run against the President (as in the *Nixon Tapes Case*),<sup>78</sup> no one has yet tried to trigger the Court to order the President to carry out that duty. The short answer to the question is that, at best, it is an unsettled constitutional question; at worst, no one can get the Court to act.

Another question is this: if the Court decision is “law,” can someone, not a litigant before the Court, be held in contempt of court for not obeying the asserted general norm? The immediate litigants certainly can, for the Court’s statement of a general norm is a specific decree aimed at them. Legal theory, however, does not at present make it a crime, nor does it make a person defying the Court subject to contempt charges, even though he may be within the scope of the actual or “backdoor” class-action ruling. To illustrate: if the Court holds that prayers cannot be recited in public schools in a case coming from Ohio, by no means would school officials be subject to contempt punishment for not adhering to it in Montana.

Nor does legal theory yet meet the challenge of federal judges acting as administrators. For example, in his sweeping mental hospital and prison rulings in Alabama,<sup>79</sup> Judge Frank Johnson in effect established

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76. 358 U.S. 1 (1958).

77. 358 U.S. at 18. To my knowledge, this was the first time that the Court said that in explicit terms. The decision, thus, marks the point of departure for the new jurisprudence of the Court. It is unique, in that it is the only opinion in Supreme Court history that was individually signed by all nine Justices.

78. *United States v. Nixon*, 418 U.S. 683 (1974).

79. These are the well-known decisions in *Wyatt v. Stickney*, 325 F. Supp. 781

himself as *de facto* head of both systems, telling state officials to rectify admitted grievances on pain of emptying the hospitals and jails. Those decisions pose crucial questions about the power of federal judges, but are beyond the scope of this essay. Suffice it to note that Johnson's orders are the logical extension of the role of the Supreme Court as commander.

As the Justices continue their open acknowledgment of their new role, those and other questions will have to be answered. Judicial power has been enhanced. Perhaps, however, mounting criticism of the Supreme Court and an increasing awareness of the intractability of many questions may cause the Justices to pull back. They have done so, as noted above, in some cases involving black Americans, but not in others such as the Solomonic decision in *Bakke* and the decisions sustaining "affirmative action" in employment cases.<sup>80</sup> The Court is developing a new constituency—the "great unwashed" of the populace. Whether that new base of support will allow the Court to strike out and recognize claims for human dignity depends, however, upon whether those who are the ultimate (albeit hidden) beneficiaries of judicial action—the elites of the nation—are sufficiently acute to perceive that human rights decisions are in their interests also. On that score one should not be sanguine. What Gandhi called his greatest problem—the hardness of heart of the educated—is matched, perhaps exceeded, by the inherent inability (bordering on stupidity) of many of the moneyed and propertied to realize where their long-range interests can best be served.

In final analysis, what the Court can or cannot do for blacks and others depends on the social milieu. I have written elsewhere that the ecological trap is closing and that Americans will be fortunate if they are able to escape realization of Arnold Toynbee's doleful forecast. "In all developed countries," he asserted in 1975, "a new way of life—a severely regimented way—will have to be imposed by ruthless, authori-

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(M.D. Ala. 1971), and *Pugh v. Locke* 406 F. Supp. 318 (M.D. Ala. 1976). See Johnson, *In Defense of Judicial Activism*, 28 EMORY L.J. 901 (1979) for a statement of Judge Johnson's judicial philosophy. See also Chayes, *The Role of the Judge in Public Law Litigation*, 89 HARV. L. REV. 1281. For discussion of the *Wyatt* case, see J. LIEBERMAN, *THE LITIGIOUS SOCIETY* 115-128 (1981).

80. *E.g.*, *Fullilove v. Klutznick*, 448 U.S. 448 (1980).

tarian government.”<sup>81</sup> We can hope Toynbee was wrong, but there can be little question that the world is moving rapidly toward a steady-state economy; two centuries of unprecedented technological and economic development are drawing to a close. Those two centuries—almost exactly the life span of the American republic—have left an indelible mark on the mind of modern Americans. Many still believe in the inevitability of continuing progress, although few take the trouble to define that ambiguous word. The Justices and the politicians will have to operate in a social context well described by economist E. J. Mishan:

Modern economic growth, and the norms and attitudes it establishes, have produced a highly complex industrial and urban organization, albeit one that is increasingly vulnerable largely because the spread of affluence, the diffusion of the products and processes of technology, and the sheer rapidity of change, have combined, unavoidably, to undermine the influence of the complex of institutions and myths that invested all preindustrial civilizations with stability and cohesion. The existing libertarian order in the West is no longer rooted in a consensus that draws its inspiration from a common set of unquestioned beliefs. The legitimacy of all its institutions is perpetually under assault. Social order is visibly disintegrating.<sup>82</sup>

In some respects, Mishan is confirming Lester Thurow’s idea of the zero-sum society. There is a factor, not mentioned by either, which when added shows that the ecological trap is not only closing but is producing a high potential for social tension, even violence. That factor is simply this: when the expectations of a significant group of people, e.g., black Americans, are raised so that many believe the rhetoric of democracy and equality, and when those expectations are dashed as they have been for blacks, not only is the political order in disarray (as Thurow says) but the economic system cannot meet their demands (Mishan and Thurow). The result is a high probability of violence, which in turn produces harsh repressive measures.

The challenge for all American political institutions is obvious: to

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81. A. MILLER, *DEMOCRATIC DICTATORSHIP: THE EMERGENT CONSTITUTION OF CONTROL* 151 (1981), quoting Toynbee.

82. E. MISHAN, *THE ECONOMIC GROWTH DEBATE: AN ASSESSMENT* 265 (1977).



develop another common set of unquestioned beliefs. It is here that the Court can be of substantial help. Of course, the Justices cannot do it alone. But if the disintegration of the social order that Mishan perceives is to be halted and turned around, the Justices cannot shirk participating in the task. The same sort of attitude that permitted the Supreme Court in 1954 to grasp the nettle of racial discrimination should prevail for other polycentric social questions. Americans should demand no less from the black-robed justices who work in the Temple on the Hill.

### *Legislative Reapportionment*

To repeat: *Brown* and progeny, both judicial and legislative, successfully altered the formal Constitution and, during America's Golden Age, the operative Constitution, because an economy of abundance characterized the United States. With economic growth slowing or even ending, the consensus that held the nation together since 1945 is falling apart. The spinoffs from *Brown* and the legislative reapportionment cases,<sup>83</sup> have made this disintegration both possible and inevitable. The black vote, insofar as blacks vote in a bloc, becomes of great importance in political campaigns (particularly for the presidency). The apportionment decisions, mandating one person/one vote, came precisely when whites began to flee to the suburbs from the large cities. Not by mere chance did Raoul Berger, among others, single out *Brown* and *Baker v. Carr*,<sup>84</sup> the key apportionment decision, for particularly harsh criticism.<sup>85</sup> *Baker* and its aftermath, buttressed by the Voting Rights Act of 1965,<sup>86</sup> made bloc-voting crucial in key cities. People long bereft of political power could now make their weight felt, particularly in presidential elections where the Electoral College is still used. (The College works only because of widespread acceptance of the no-

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83. *E.g.*, *Reynolds v. Sims*, 377 U.S. 533 (1964); *Wesberry v. Sanders*, 376 U.S. 1 (1964). *But see* *City of Mobile v. Bolden*, *supra* note 72, and articles cited in notes 72 and 73 *supra*.

84. 369 U.S. 186 (1962).

85. R. BERGER, *GOVERNMENT BY JUDICIARY* (1977). *See also* L. CRAGLIA, *DISASTER BY DECREE* (1976). Berger's book is the subject of a symposium in 6 *HASTINGS CONST. L.Q.* No. 2, at 403-662 (1979).

86. Pub. L. 89-110, 79 Stat. 437, (codified at 42 U.S.C. §§ 1971, 1973-1973p (1970)).

tion, not in accord with the intentions of the Framers, that electors vote in accordance with the popular vote.)

*Baker* emanated from an especially pernicious situation in Tennessee, where the state legislature, contrary to the Tennessee Constitution, had failed to reapportion the legislature for sixty years. That meant that voters in rural areas had a grossly disproportionate number of representatives. After several failed attempts to have the system declared unconstitutional, the practice became so bad as to offend a majority of the Justices. In 1962, they ruled that an equal protection violation had been presented. Two years later the Court went the full distance and decreed that voting districts had to be as nearly equal in population as possible, both for state legislatures and the federal House of Representatives.<sup>87</sup> The principle was subsequently applied to local governments.<sup>88</sup>

Again, a furor erupted, led by academic disciples of Justice Frankfurter, who thought the Court had not properly reasoned its decisions and had not exercised a proper amount of self-restraint.<sup>89</sup> Oddly, however, unlike the reception of *Brown*, the apportionment decisions have been placidly accepted by public and politicians alike. Frankfurter thought the voters in Tennessee could and should ask state politicians, in effect, to vote themselves out of office. Even a federal judge who was once a law professor should have known better. He carried his mistaken views about judicial self-restraint to absurd lengths. Another dissenting Justice, John M. Harlan, waxed even more choleric in 1964: he grumbled that the one person/one vote decisions “give support to a current mistaken view . . . that every major social ill in this country can find its cure in some constitutional ‘principle’, and that this Court should ‘take the lead’ in promoting reform when other branches of government fail to act. The Constitution is not a panacea for every blot upon the public welfare, nor should this Court, ordained as a judicial body, be thought of as a general haven for reform movements. . . . This Court . . . does not serve its high purpose when it exceeds its authority even to satisfy justified impatience with the slow workings of the political process.”<sup>90</sup>

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87. See cases cited in note 83 *supra*.

88. *Avery v. Midland County*, 390 U.S. 474 (1968).

89. *E.g.*, A. BICKEL, *THE SUPREME COURT AND THE IDEA OF PROGRESS* 167 (1970).

90. *Reynolds v. Sims*, 377 U.S. 533, 624-25 (1964) (dissenting opinion).

That statement, to speak gently, is simply not adequate. Not only did Harlan seek to differentiate a “judicial body” from the “political process,” which for the Supreme Court is at best fallacious, he also asserted that his colleagues had exceeded their authority. That simply is not true. Nowhere is it prescribed, in the Constitution, statutes, or rules of the Supreme Court itself, what the authority of the Court is. Since almost the beginning of the republic, that authority has been what the Justices say it is, and what, politically, they can get away with. Frankfurter and Harlan, furthermore, badly misread the social tea leaves in their impassioned dissents; people have accepted the Court’s rulings on reapportionment, whether reasoned or not. Ideally, it doubtlessly would be better if the political process were adequate to manifest long-denied needs. But at times it is not, as Harlan conceded. How, possibly, could he and Frankfurter have thought that politicians would reform themselves and voluntarily give up some of their power. Surely, Judge Wright’s statement<sup>91</sup> is closer to the realities of the constitutional order. For present purposes, the lesson of *Baker* and progeny is clear and unmistakable: they classically exemplify an affirmative constitutional duty imposed by judges upon the political branches of government. Since 1964 state legislatures have been restructured, at times after a direct command from a judge. Compliance has occurred. At this writing, another round of apportionments is taking place as a result of the 1980 census. The rotten boroughs of the nation have been easier to eradicate, therefore, than racial discrimination—a lesson to be pondered when one reflects on the political power of the courts.

The suggestion here is not that the products of state legislatures after reapportionment differ markedly from the past. It is far too simplistic to believe that legislators vote on a rural-urban split. The reapportionment decisions did little to cure the real ills of the political process. But the significance of *Baker* and subsequent decisions lies in the creation by the Justices of an affirmative duty on the part of politicians to do certain things, simply because the Justices so read the Constitution. That the Justices have prevailed is itself an important lesson in politics as the art of the possible, a lesson that surely can be applied elsewhere.

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91. See text accompanying note 70 *supra*.

*Other Examples*

No need exists to multiply the examples where the Justices have acted as commander. Sometimes their command is couched in permissive language, as in the 1980 decision allowing patents to be issued for the creation of new forms of life.<sup>92</sup> At other times, they are direct and pointed. *Miranda v. Arizona*<sup>93</sup> is an example of the latter. One of the most criticized of all recent decisions, *Miranda* set forth a code of conduct for officers to follow when someone is arrested. Affirmative duties thus were imposed on police officers throughout the nation, even though the lawsuit nominally concerned Miranda and the state of Arizona. Miranda was important to the ruling only because, as with divers others before and after him, he was necessary to trigger the mechanism of the Court.

Another example is the well-known and controversial rulings in the *Abortion Cases*,<sup>94</sup> where the Court decreed that a woman had a right to an abortion limited only by the duration of her pregnancy. A trimester system was established, under which abortions could not be prevented during the first three months, while during the second three months a steadily increasing societal interest in the viability of fetuses made abortions regulable by the states. During the final three months, abortions were permissible only in extreme circumstances. Again, a set of general rules was promulgated; and again, the litigants were unimportant.

Judges in both federal and state courts caught the cue from the Supreme Court; they, too, occasionally issue commands. We have already mentioned Judge Frank Johnson's mind-boggling decrees, that since Alabama's treatment of mental patients and prisoners violated the Constitution, the appropriate remedy was complicated administrative procedures established by Johnson. In Boston, Judge Arthur Garrity declared the school system to be in receivership and ordered busing

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92. *Diamond v. Chakrabarty*, 447 U.S. 303 (1980).

93. 384 U.S. 436 (1966).

94. I happen to believe that these cases, *supra* note 15, were decided correctly; and that those who criticize the Court, particularly Blackmun, J., for the reasoning in the opinion miss the mark. Other parts of the book from which this article is derived develop in some detail the idea of reason and its application in judicial decisionmaking.

to achieve racial integration.<sup>95</sup> As for the states, an outstanding example came in New Jersey, where its supreme court ordered the legislature to enact a financing scheme to improve schools on pain of having them closed by court order.<sup>96</sup>

I do not suggest that Judges Johnson and Garrity or the New Jersey Supreme Court have been able to translate their bare-bones orders into operational reality. There is a long, long road between judicial decision and full compliance. What is important for present purposes is to see the growing willingness of judges to actively intervene in politics and to command obedience to judicial decrees. One can agree with Professor Nathan Glazer that “the courts truly have changed their role in American life” and have reached deeper into the lives of people than “they ever have in American history.”<sup>97</sup> But one need not—one should not—agree with Glazer when he maintains that this is “against the will of the people.”<sup>98</sup> Some people perhaps, but certainly it is the people themselves, many of them new types of litigants (the poor, the disadvantaged, women, etc.), who are energizing the judiciary. Impotent politically, these people see judges as their final hope. Given this, activist judges may be the final desperate hope of a crumbling system of American constitutionalism for salvation from its own inequities and inconsistencies. The litigants believe the incessant rhetoric about democracy and the rule of law; they call upon an oligarchic judiciary to further democratic ends. That may be a paradox, but it is the truth.

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95. *Morgan v. Kerrigan*, 379 F. Supp. 410 (D. Mass. 1974); *aff'd* 509 F.2d 580 (1st Cir. 1976); *cert. denied, sub nom., White v. Morgan*, 426 U.S. 935 (1976).

96. *Robinson v. Cahill*, 118 N.J. Super. 223, 287 A.2d 187 (Super. Ct. Law Div. 1972), *cert. denied*, 414 U.S. 976 (1973), *modified*, 62 N.J. 473, 303 A.2d 273 (1973); 119 N.J. Super. 40, 289 A.2d 569 (Super. Ct. Law Div. 1972), *cert. denied*, 414 U.S. 976 (1973), *modified*, 62 N.J. 473, 303 A.2d 273 (1973); 67 N.J. 35, 335 A.2d 6 (1975); 67 N.J. 333, 338 A.2d 193 (1975); 69 N.J. 133, 351 A.2d 713 (1975), *cert. denied*, 423 U.S. 913 (1975); 69 N.J. 449, 355 A.2d 129 (1976), 70 N.J. 155, 358 A.2d 457 (1976), *modified*, 70 N.J. 464, 360 A.2d 400 (1976).

97. Glazer, *Towards an Imperial Judiciary*, 41 PUB. INTEREST 104, 106 (1975).

98. *Id.* For criticism, see Miller, *Judicial Activism and American Constitutionalism: Some Notes and Reflections*, in CONSTITUTIONALISM 333 (Nomos XXI, J. Pennock & J. Chapman eds. 1979).

## IV

The Court as commander requires affirmative cooperation from other governmental officers. The Justices can pronounce, but they cannot administer. Even federal judges in lower courts, such as Johnson and Garrity, find detailed administration beyond their capacities. So judges must trust the good will of politicians to carry out their decrees. That means litigants, too, must trust the good will of politicians. No doubt it would be better were that not true. Many officers who should administer the law of the land as stated by the Court, do not; they are reluctant and often defiant. Even with the best of intentions, which doubtless many have, administrators also must contend with possible public disapproval.

That has an important effect. The Supreme Court interprets the Constitution but politicians, bureaucrats and lower-court judges interpret the Court. Those entrusted with administration oftentimes apply obscure commands. In so doing, they have considerable discretion. This has long been known, but seldom analyzed in depth. Few have inquired into the extent of compliance with the Supreme Court's rulings. Judicial opinions do not enforce themselves. In a widely-quoted statement, Bishop Hoadly said: "Whoever hath an absolute authority to interpret any written or spoken laws, it is he who is truly the lawgiver, to all intents and purposes, and not the person who first spoke or wrote them."<sup>99</sup> The Justices may have "absolute authority" to interpret the Constitution, but those interpretations must be transmuted into operational reality by literally tens of thousands of other governmental officers who were not before the bar of the Court.

Compliance, thus, often is chancy, especially so when Court opinions are written in opaque language. The Justices, moreover, cannot possibly predict all of the factual situations that might arise in which their general norms are applied. Nor can they expect those who are affected by administrative actions to be aware of what the Court has said. Ambiguity in pronouncement plus uncertainty in application makes for uneven administration. Even in the best of circumstances, lawyers are adept at distinguishing cases, showing that factual situa-

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99. *Quoted in* W. LOCKHART, Y. KAMISAR & J. CHOPER, *CONSTITUTIONAL LAW: CASES-COMMENTS-QUESTIONS* 1 (5th ed. 1980).

tions differ in significant ways, to evade even unambiguous judicial decrees. Furthermore, constitutional decisions tend to produce new claims and thus new litigation, with the net result that constitutional law has become a lawyer's paradise—a fertile area for more and more work for more and more attorneys. The truly fundamental principles of American constitutionalism are being lost in a swamp of thousands of judicial rulings; the Supreme Court alone has produced some 450 fat volumes of reports, all of which are kept in law libraries and computerized files.

To summarize, freedom in the United States is as much positive as negative in nature. For a person to have freedom *to* participate and *to* attain goals central to the concept of human dignity he must have freedom both *from* the arbitrary exercise of governmental power and *from* inadequate social conditions that make it unlikely he can achieve that level. Courts do help, albeit imperfectly, in dispensing justice. Their fundamental task now is to help create something wholly new: a Constitution of Human Needs.<sup>100</sup>

Why judges, some may ask? The short answer is that, as political as well as judicial officers, they cannot avoid the swirls and currents engulfing the body politic. Why not legislators and administrators, including the President? The short answer is that the system of governance established by the Constitution is not suited to the demands of our era. It worked well, by hindsight at least, during the nineteenth and first part of the twentieth centuries. Today, however, politics are in disarray. Serious students speak of the "ungovernability of democracy."<sup>101</sup> History since 1789 has seen a steadily expanding franchise and the rise of decentralized groups that dominate the government, at times even challenging the State's claim to sovereignty. The name for the political order is pluralism. In theory, people form groups, and out of the clashes between them something called the public or national interest is supposed to evolve. That is a romantic conception of politics, far from reality (although some use it to argue that the Supreme Court should have a lesser role). Political pluralism is Adam Smith economics writ large

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100. In a forthcoming book, tentatively entitled *GETTING THERE FROM HERE: TOWARD A CONSTITUTION OF HUMAN NEEDS*, I am developing this idea in some detail.

101. *E.g.*, Professor Samuel Huntington. See Huntington, *The United States*, in M. CROZIER, S. HUNTINGTON & J. WATANUKI, *THE CRISIS OF DEMOCRACY* 59 (1975).

and transferred to politics. It is no more valid there than in economics. Why judges? Because there is no alternative, if the American system of constitutionalism is to be saved.

I am not suggesting, of course, that the Court as commander is always followed. Far from it. Recent decisions, such as *Haig v. Agee* and *Dames & Moore v. Regan*<sup>102</sup> display a tendency on the part of the present Justices to defer to the political branches of government. That posture of deference, of judicial self-restraint, runs counter to the thesis propounded in this article. Nevertheless, most members of the Court today were on the bench when *Roe v. Wade* was decided; of greater importance, there is no evidence that the Justices will not impose affirmative duties in appropriate situations. Certainly, it is true that they have not repudiated the theory of *Cooper v. Aaron*<sup>103</sup>—that their decisions are “the law of the land”—nor of *Reynolds v. Sims*.<sup>104</sup> The Justices have more than an umpire’s function, as Justice William Brennan noted in 1980:

Under our system, judges are not mere umpires, but, in their own sphere, lawmakers—a co-ordinate branch of *government*. While individual cases turn upon controversies between parties, or involve particular prosecutions, court rulings impose official and practical consequences upon members of society at large. Moreover, judges bear responsibility for the vitally important task of construing and securing constitutional rights. . . .

The interpretation and application of constitutional and statutory law, while not legislation, is lawmaking, albeit of a kind that is subject to special constraints and informed by unique considerations. Guided and confined by the Constitution and pertinent statutes, judges are obliged to do discerning, exercise judgment, and prescribe rules. Indeed, at times judges wield considerable authority to formulate legal policy in designated areas.<sup>105</sup>

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102. *Haig v. Agee*, 101 S. Ct. 2766 (1981); *Dames & Moore v. Regan*, 101 S. Ct. 2972 (July 2, 1981). In the same vein, see *Rostker v. Goldberg*, 101 S. Ct. 2646 (1981).

103. 358 U.S. 1, 18 (1958).

104. 377 U.S. 533 (1964).

105. *Richmond Newspapers, Inc. v. Virginia*, 448 U.S. 555, 595 and n. 20 (1980) (concurring opinion).



In that extraordinary statement, Brennan acknowledged what I have argued in this article. First, general principles are inferred from one particular situation, even though that is logically impossible; individual cases impose official and practical consequences upon members of society at large. Second, the Court is indeed, at times, an affirmative commander; it can formulate legal policy.

While several problems of the new role of the Supreme Court have been outlined above, the essential question, which Court critics tirelessly repeat, goes to the legitimacy of the Court as commander. If, as the late Professor Alexander Bickel wrote, "*Brown v. Board of Education* was the beginning,"<sup>106</sup> surely it is accurate to say that we have not yet seen the end of judicial lawmaking. The form it will take, the issues that will be involved, may be difficult to predict; but the position of power of the fourth major development in Supreme Court history is not one that will soon be abdicated.<sup>107</sup>

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106. A. BICKEL, *THE SUPREME COURT AND THE IDEA OF PROGRESS* 7 (1970).

107. Cf. White, J., dissenting in *Miranda v. Arizona*:

The Court has not discovered or found the law in making today's decision, nor has it derived it from some irrefutable sources; what it has done is to make new law and new public policy in much the same way that it has . . . in interpreting other great clauses of the Constitution. This is what the Court historically has done. *Indeed, it is what we must do and will continue to do until and unless there is some fundamental change in the constitutional division of governmental powers.*

384 U.S. at 531 (emphasis added).

# The Pan American World Airways-National Airlines Merger and The Airline Deregulation Act of 1978: A History and Analysis

Steven A. Stinson\*

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## Introduction

Fifteen months after Texas International Airlines surprised the commercial aviation community by announcing it had purchased 9.2 percent of the common stock of National Airlines,<sup>1</sup> the Civil Aeronautics Board [C.A.B.] unanimously approved not only Texas International's merger application, but also the subsequently-filed Pan American World Airways-National Airlines merger application.<sup>2</sup> Before the C.A.B. decision, Texas International agreed to sell its 2.9 million shares of National Airlines stock to Pan American for a pre-tax profit of \$45,780,000.<sup>3</sup> On January 7, 1980, the merger became effective,<sup>4</sup> giving Pan American the domestic route system it had sought for 34

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1. Wall St. J., July 11, 1978, at 2, col. 2.

2. Texas International-National Acquisition Case/Pan American Acquisition of Control of, and Merger with National, Docket Nos. 33112, 33283, CAB Order Nos. 79-12-163, 79-12-164, 79-12-165 (October 24, 1979).

3. Palm Beach Post Times, July 29, 1979, § A, at 24, col. 1. As of October 19, 1979, Texas International had sold Pan American 38% of its holdings in National for after-tax profits of \$19.3 million. Pan Am had further paid Texas International three million dollars for an option to purchase the remaining 1.3 million shares at \$50 per share. Texas International eventually sold Pan Am all of its National stock and realized the expected profit. See *A Plucky Challenge to Eastern's Shuttle*, Bus. Wk., Sept. 22, 1980, at 71; *A New Air War*, TIME, Sept. 22, 1980, at 72.

4. Application of Pan American World Airways, Inc. for Acquisition of Control of, and Merger with, National Airlines, Inc., Docket No. 33283, CAB Order No. 80-1-125 (Jan. 18, 1980).

years.<sup>5</sup> Eastern Air Lines spent \$3.4 million in its unsuccessful attempt to acquire National,<sup>6</sup> but after unfavorable decisions from both an administrative law judge<sup>7</sup> and the full C.A.B.,<sup>8</sup> dropped out. Tiny Air Florida also was unsuccessful in its limited merger application.<sup>9</sup> Ironically, the new Pan Am has continued to have problems since the merger, losing \$126.9 million from air transport operations in its first year of combined operations<sup>10</sup> and another \$217.6 million during the first six months of 1981.<sup>11</sup>

This article will examine what the Miami Herald termed the "biggest and most complex airline merger case ever," in which National Airlines became the "world's most wanted airline."<sup>12</sup> The multi-faceted National Airlines case is not only significant in itself; but because it came at a time when the United States commercial aviation industry was undergoing great change, primarily due to the drastically altered

5. For a recent history of Pan American, see R. DALEY, AN AMERICAN SAGA - JUAN TRIPPE AND HIS PAN AMERICAN EMPIRE (1980).

6. *Eastern to Halt Pursuit of National*, AV. WK. & SPACE TECH., Oct. 8, 1979, at 29.

7. Application of Eastern Air Lines, Inc. for Approval of Acquisition of Control of National Airlines, Inc., Docket No. 34226 (June 14, 1979) (initial decision of Administrative Law Judge Richard J. Murphy).

8. Application of Eastern Air Lines, Inc. for Approval of Acquisition of Control of National Airlines, Inc., Docket No. 34226, CAB Order No. 79-12-74 (Dec. 17, 1979)(dismissing the application).

9. Wall St. J., Feb. 22, 1979, at 29, col. 1. Air Florida, unlike the other applicants, was only seeking permission to acquire National's international routes and four of its wide-bodied DC-10's. *Id.*

10. PAN AMERICAN WORLD AIRWAYS, INC. 1980 ANNUAL REPORT 1 (1981). Actually Pan Am showed a net income of \$80.3 million, but this was from the gain of some \$294 million it showed from the sale of its office building in New York City. *Id.*

11. Merzer, *Pan Am Eyes Shifting Base to S. Florida*, Miami Herald, Aug. 15, 1981, § A, at 1, col. 5. Pan Am international operations were particularly hard hit by the astronomic rise in world-wide fuel prices and competition from foreign government-supported flag carriers as well as American carriers encouraged by the passage of the International Air Transportation Competition Act of 1979, Pub. L. No. 96-192, 94 Stat. 35 (amending 49 U.S.C. § 1301 *et seq.*).

12. Baron, *Now Stockholders Get Their Turn in National Fight*, Miami Herald, May 13, 1979, § F, at 1, col. 5. One reason other airlines were interested in National was that the asset value of its undervalued stock was between \$60-\$75 per share. Therefore, even a purchase price of \$50 a share would be a bargain, particularly in view of National's low debt load. *Id.*

regulatory climate, it illustrates the effects of that change.

The C.A.B. initially signalled the pending deregulation,<sup>13</sup> which was greatly expanded and codified in the Airline Deregulation Act of 1978<sup>14</sup> [A.D.A.]. The A.D.A. changed the public interest test which the C.A.B. used to make decisions under antitrust statutes,<sup>15</sup> delineated the burden of proof for opponents and proponents of a merger,<sup>16</sup> set time limits for C.A.B. approval<sup>17</sup> and limited the reviewing power of the President.<sup>18</sup> It also included labor-protective provisions for workers adversely affected by the A.D.A.,<sup>19</sup> and provided for eventual elimination of the C.A.B.<sup>20</sup>

After a brief overview of general merger and anti-trust law and philosophy, this article reviews pre-A.D.A. airline mergers under the 1938 and 1958 Aviation Acts.<sup>21</sup> Next the 1978 A.D.A. is discussed. The various proposed mergers with National are analyzed, beginning with brief histories of each of the airlines involved and a chronology of merger and post-merger events. Finally the various administrative law

13. *C.A.B. End Set in Air Deregulation*, N.Y. Times, Nov. 7, 1978, § 1, at 79, col. 1.

14. Airline Deregulation Act of 1978, Pub. L. No. 95-504, 92 Stat. 1705 (amending 49 U.S.C. § § 1301 *et seq.*). A partial legislative history of the Act may be found in 1978 U.S. CODE CONG. & AD. NEWS 3737. For an earlier Senate Report by the Senate Judiciary Subcommittee chaired by Senator Edward M. Kennedy, the Airline Deregulation Act's chief sponsor, *see* SUBCOMM. ON ADMINISTRATIVE PRAC. & PROC., SENATE COMM. ON THE JUDICIARY, 94TH CONG., 1st SESS., CIVIL AERONAUTICS BOARD PRACTICES AND PROCEDURES (Comm. Print 1975) (hereinafter C.A.B. PRACTICES AND PROCEDURES).

15. 49 U.S.C. § 1302(a) (1976 & Supp. 1979).

16. 49 U.S.C. § 1378(b)(1) (1976 & Supp. 1979). Opponents of a merger have the burden of proof as to the anticompetitive effects and proponents have the burden of proof that it meets significant transportation conveniences and needs, which may not be met by less anticompetitive means.

17. 49 U.S.C. § 1490 (Supp. III 1979).

18. 49 U.S.C. § 1461 (1976 & Supp. III 1979). In international cases, the President must base his decision solely upon foreign relations or national defense criteria and not upon economic or carrier selection criteria.

19. 49 U.S.C. § 1552 (Supp. III 1979). *See* text accompanying notes 164-76 *infra*.

20. 49 U.S.C. § 1551 (Supp. III 1979). *See* text accompanying note 70 *infra*.

21. Civil Aeronautics Act of 1938, Act of June 23, 1938, ch. 601, 52 Stat. 973 and Federal Aviation Act of 1958, Pub. L. No. 85-726, Aug. 23, 1958, 72 Stat. 731.

judges' decisions and Board orders related to the National merger attempts are discussed and compared with other post-A.D.A. merger decisions.

## Background

### *Federal Regulation of Big Business*

In response to the huge trusts and corporations established in the last quarter of the nineteenth century by the so-called robber barons,<sup>22</sup> the United States Congress passed the Sherman Antitrust Act<sup>23</sup> in 1890. In 1914 the Clayton Act<sup>24</sup> was passed in an effort to strengthen

22. 54 AM. JUR. 2d *Monopolies, Restraints of Trade and Unfair Trade Practices* (hereinafter *Monopolies*) § 1 (1971), which principally cites *Standard Oil Co. v. United States*, 221 U.S. 1 (1911) and *United States v. duPont de Nemours & Co.*, 351 U.S. 377 (1956).

23. 15 U.S.C. §§ 1-7 (originally enacted as Act of July 2, 1890, ch. 647, 26 Stat. 209). See generally 54 AM. JUR. 2d *Monopolies* §§ 1-108 (1971); 58 C.J.S. *Monopolies* §§ 17-25 (1948). Basically, 15 U.S.C. section 1 deals with means of monopolizing and section 2 deals with the results to be achieved. Section 1 states in part: "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal." 15 U.S.C. § 1. Section 2 states:

Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any person or persons, to monopolize any part of trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a misdemeanor, and, on conviction thereof, shall be punished by fine not exceeding fifty thousand dollars, or by imprisonment not exceeding one year, or by both said punishments, in the discretion of the court.

*Id.* § 2.

24. The Clayton Act can be found at 15 U.S.C. § § 12, 13, 14-19, 20, 21, 22-27, and 44, and at 29 U.S.C. § § 52-53. (originally enacted as Act of Oct. 15, 1914, ch. 323, 38 Stat. 730). See generally 54 AM. JUR. 2d *Monopolies* §§ 109-139 (1971); 58 C.J.S. *Monopolies* § 26 (1948). Rather than being broad and general like the Sherman Act, the Clayton Act concentrates on certain specified practices that Congress believed were anticompetitive and permitted economic concentration, but which the various courts had held to be outside the coverage of the Sherman Act. 54 AM. JUR. 2d, *Monopolies* § 1096 (1971). Among the proscribed practices are: discrimination in price, services or facilities (15 U.S.C. § 13) sale on agreement not to use goods of competitors (§ 14); with various exceptions, acquisition of stock in one corporation by another corporation (§ 18); interlocking directorates in certain situations (§ 19); purchases by

the Sherman Act. While the Antitrust Division of the Justice Department is responsible for federal enforcement of the various federal anti-trust laws,<sup>25</sup> private individuals may also bring suits and seek treble damages.<sup>26</sup> But the current political climate is once again favoring big business; "bigness in business does not necessarily mean badness."<sup>27</sup> Thus, a number of extremely large corporate mergers have taken place in the last several years.<sup>28</sup>

### *Pre-Deregulation Airline Mergers*

The early history of the American commercial aviation industry is inexorably tied to that of the United States Post Office. The latter provided funds for airport and airway development and subsidized airmail contracts. The four big airlines before the Pan Am merger, United, American, T.W.A. and Eastern, can all trace their present prominence to this early period.<sup>29</sup> Under the Black-McKellar Act,<sup>30</sup> during an in-

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common carriers in case of interlocking directorates (§ 20). Private individuals or corporations who are hurt by the above activities may obtain treble damages and reasonable attorney fees (§ 15) or may sue for injunctive relief (§ 26). Also a judgment obtained by the Government under this Act may be used as prima facie evidence of an antitrust violation in a private suit. (§ 16).

25. UNITED STATES GOVERNMENT MANUAL 1978-1979, at 352-53.

26. 15 U.S.C. § 15 states in part: "Any person who shall be injured in his business or property by reason of anything forbidden in the Antitrust Laws may sue therefore. . . ."

27. Alexander, Beckwith & Ungeheuer, *Reaching for Conoco's Riches*, TIME, July 27, 1981, at 50, quoting Attorney General William French Smith. For a sampling of the Reagan philosophy, compare R. BORK, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF (1978) with MONOPOLY POWER AND ECONOMIC PERFORMANCE (3d ed. E. Mansfield 1974); RALPH NADER'S STUDY GROUP REPORT ON REGULATION AND COMPETITION: THE MONOPOLY MAKERS (M. Green ed. 1973).

28. Strout, *Merger Action Boom Going Full Steam*, Palm Beach Post, Aug. 2, 1981, § FF, at 2, col. 1. The author noted that first quarter 1981 merger bids were a record \$17.5 billion and that 1980 had previously set a record with mergers of \$44.3 billion. The largest, Dupont-Conoco at 7.3 billion dollars, took place in 1981. *Id.*

29. C.A.B. PRACTICES AND PROCEDURES, *supra* note 14, at 29-35 and 195-215. In 1938, when the Civil Aeronautics Act became effective, these four airlines accounted for 82.5% of all revenue passenger miles flown and in 1972 they still accounted for 60% of all revenue passenger miles flown. *Id.* at 6. See also A. LOWENFIELD, AVIATION LAW, § 1 (1972). For a recent and comprehensive history of commercial aviation in the United States, see C. SOLBERG, CONQUEST OF THE SKIES: A HISTORY OF

terim period from 1934 to 1938, the Interstate Commerce Commission worked with the Post Office Department to regulate airmail contracts. The Black-McKellar Act also established a five member Federal Aviation Commission to study commercial aviation and make recommendations to Congress.<sup>31</sup> The eventual result of these recommendations was the passage of the Civil Aeronautics Act of 1938.<sup>32</sup> Twenty years later Congress passed the similar, but expanded, Federal Aviation Act of 1958.<sup>33</sup>

During the forty years the C.A.B. functioned prior to deregulation, mergers reduced the original sixteen domestic trunk lines to ten.<sup>34</sup> Local service carriers, which first came into existence after World War II, were reduced through mergers from nineteen to nine.<sup>35</sup> Between 1938 and 1973, eight domestic trunkline merger applications were denied or disapproved and fifteen applications resulted in eventual mergers. Others were withdrawn or dismissed.<sup>36</sup>

Lucile Sheppard Keyes, an economist who has written much on the subject of economic deregulation of commercial aviation, traced the

#### COMMERCIAL AVIATION IN AMERICA (1979).

30. Act of June 12, 1934, ch. 466, 48 Stat. 933. This Act provided competitive bidding for airmail contracts, curtailed the Postmaster General's discretion in letting contracts, placed a ceiling on total airmail route miles authorized, gave responsibility for contract modifications to the I.C.C., outlawed aviation holding companies and limited the number of contracts each airline could have. C.A.B. PRACTICES AND PROCEDURES, *supra* note 14, at 206-07.

31. Act of June 12, 1934, ch. 466, 48 Stat. 933. The Commission reported back with 102 recommendations, including the establishment of an independent regulatory agency. President Roosevelt, however, favored extending the authority of the I.C.C. to cover aviation. The legislation was stalled for three years in Congress because of the inability to decide whether to use the I.C.C. or establish an independent agency. Finally the concept of an independent agency won and the legislation quickly went forward. C.A.B. PRACTICES AND PROCEDURES, *supra* note 14, at 208.

32. Act of June 23, 1938, ch. 601, 52 Stat. 973. *See generally* C. RHYNE, CIVIL AERONAUTICS ACT ANNOTATED (1939).

33. Act of August 23, 1958, Pub. L. No. 85-726, 72 Stat. 731. The economic regulation provisions were continued practically verbatim; among others, provisions relating to the Federal Aviation Administration were added.

34. C.A.B. PRACTICES AND PROCEDURES, *supra* note 14, at 6.

35. *Id.* at 6 and 222.

36. *Id.* at 252.

history of U.S. airline mergers, dividing it into four periods.<sup>37</sup> During the first period from 1938 through the late forties, the C.A.B. maintained a strongly competitive attitude. This was followed by a period running through the mid-fifties, during which the Board actively encouraged mergers, approving several mergers with considerable anticompetitive effects. The third period, from the mid-fifties through the late sixties, saw the approval of only one airline merger, that under the "failing business" doctrine. This was followed by a four-year period which saw the approval of four merger proposals, each improving the financial stability of at least one of the airlines.<sup>38</sup>

Oren T. Chicamoto analyzed the various factors considered by the C.A.B. in pre-deregulation merger applications.<sup>39</sup> While the Board stated that mergers would be considered on a case by case basis without reference to precedents,<sup>40</sup> it nevertheless considered common factors under §408 of the 1958 Act. In determining whether the proposed merger would be in the public interest, the Board balanced benefits, such as efficiency and economy, route integration and improved services,<sup>41</sup> against disadvantages, such as diversion from competing carri-

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37. Keyes, *Notes on the History of Federal Regulation of Airline Mergers*, 37 J. AIR L. & COM. 357 (1971).

38. *Id.* at 357. During the first period the C.A.B. proclaimed its pro-competitiveness in its decisions denying merger approval: United Air Lines Transport Corp., Acquisition of Western Air Express Corp., 1 C.A.B. 739 (1940) and American Airlines, Inc., Acquisition of Control of Mid-Continent Airlines, Inc., 7 C.A.B. 365 (1946). A significant change in policy was announced by the C.A.B. during the second period: CIVIL AERONAUTICS BOARD, ANNUAL REPORT 2 (1950). The one merger approved under the "failing business doctrine" during the third period was the takeover of Capital by United. United-Capital Merger Case, 33 C.A.B. 307 (1961). Only three of the four mergers approved during the fourth period were consummated. Frontier and Central; Pacific, West Coast and Bonanza; Allegheny and Lake Central were the three local service mergers which were approved. The Northeast and Northwest merger was approved but the transfer of the previously approved Miami to Los Angeles route was not immediately approved and Northwest withdrew. Keyes, *supra* note 37.

39. Chicamoto, *Domestic Mergers in the Airline Industry: C.A.B. Approval and Antitrust*, 11 HAWAII B.J. 3 (1974). See also Travers, *An Examination of the C.A.B.'s Merger Policy*, 15 KAN. L. REV. 227 (1967); Crooker, *Airline Mergers in the 1970's*, 39 J. AIR L. & COM. 143 (1973); Reid & Mohrfeld, *Airline Size, Profitability, Mergers and Regulation*, 39 J. AIR L. & COM. 167 (1973).

40. Chicamoto, *supra* note 39, at 7-8.

41. *Id.* at 8-10.



ers, competitive balance after merger and the intent of the general antitrust laws.<sup>42</sup> Additionally, other factors were examined: the reasonableness of the proposed purchase price, protective labor conditions for employees of both carriers, the applicant's guilt of prior and present antitrust violations, and the overall effect of the proposed merger on local service carriers.<sup>43</sup>

The United States Supreme Court has provided analytical tools for the Board, such as the "failing business" doctrine, to sanction a merger that would otherwise be quite anticompetitive.<sup>44</sup> The doctrine of primary jurisdiction has often been invoked by various courts, including the Supreme Court, to permit C.A.B. examination and judgment on purported antitrust violations within its jurisdiction.<sup>45</sup> This doctrine was expanded considerably by the Court in *Pan American World Airways vs. United States*<sup>46</sup> and in *Hughes Tool Company vs. Trans World Airlines*<sup>47</sup> where the Court held that in addition to any express exemptions, there was an implied exemption from general antitrust statutes, based on the Board's primary jurisdiction under the Federal Aviation Act of 1958.

### Airline Deregulation Act of 1978

Various reasons have been espoused to explain the rapid and unprecedented congressional movement toward deregulation of the commercial aviation industry: Public and political antipathy against government regulation in general; discontent with burdensome regulatory schemes and agencies such as the Occupational Safety and Health

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42. *Id.* at 10-16.

43. *Id.* at 16-18.

44. United Capital Merger Case, 33 C.A.B. 307 (1961). The Board specifically cited *International Shoe Co. v. Federal Trade Comm'n*, 280 U.S. 291 (1929), the initial case in which the Supreme Court adopted the failing business doctrine to uphold such a potentially anticompetitive merger.

45. See generally Coultas, *The Doctrine of Primary Jurisdiction: Determination of Express and Implied Immunity from the Antitrust Laws*, 39 J. AIR L. & COM. 559 (1973); Annot., 38 L. Ed. 2d 796 (1974); 2 AM. JUR. 2d *Administrative Law* § 788-97 (1962).

46. 371 U.S. 296 (1963). See Note, *Civil Aeronautics Board Held to Have Exclusive Jurisdiction to Grant Injunctive Relief Against Acts Allegedly in Violation of Antitrust Laws*, 63 COLUM. L. REV. 923 (1963).

47. 409 U.S. 363 (1973).

Act,<sup>48</sup> and the agency it spawned; economic factors affecting the industry, such as wildly escalating fuel costs, excess capacity afforded by new wide-body jets and the success of intra-state carriers; the nearly unanimous academic and public opinion that regulation could only lead to greater inefficiency and higher fares for the traveling public; and a growing coalition of politicians and academic and governmental economists that started deregulation through C.A.B. regulations and introduced and supported legislation until they were successful.<sup>49</sup>

Certainly one of the most significant and pervasive sections of the A.D.A. is that declaring Congressional policy.<sup>50</sup> With respect to interstate and overseas air transportation, ten factors replaced the original six.<sup>51</sup> These factors, considered to be in the public interest and in accordance with public convenience and necessity, are:

1. maintenance of safety as the highest priority in air commerce;
2. prevention of any deterioration in presently established safety procedures;

48. 29 U.S.C. §§ 651 *et seq.*

49. Thornton, *Deregulation: The C.A.B. and Its Critics*, 43 J. AIR L. & COM. 641 (1977); Callison, *Airline Deregulation-Only Partially a Hoax: The Current Status of the Airline Deregulation Movement*, 45 J. AIR L. & COM. 961 (1980); Kellener, *Deregulation and the Practicing Attorney*, 44 J. AIR L. & COM. 261 (1978). During the three year period that deregulation was being debated in the Congress, it was also being debated in the journals; *see, e.g.*, Brenner, *Need for Continued Economic Regulation of Air Transport*, 41 J. AIR L. & COM. 793 (1975); Callison, *Airline Deregulation-A Hoax?*, 41 J. AIR L. & COM. 747 (1975); Levine, *Alternatives to Regulation: Competition in Air Transportation and the Aviation Act of 1975*, 41 J. AIR L. & COM. 703 (1975); Thayer, *And Now 'The Deregulators': When Will They Learn?* 43 J. AIR L. & COM. 661 (1977). For a legislative history, *see* C.A.B. PRACTICES AND PROCEDURES, *supra* note 14; Styles, *Commuter Airlines and the Airline Deregulation Act of 1978*, 45 J. AIR L. & COM. 685 n.1 (1980) (listing pre-A.D.A. hearings).

50. 49 U.S.C. § 1302(a) (1976 & Supp. 1979).

51. In summary, the six original factors were: 1) Encourage and develop the air transportation system, 2) Regulate air transportation in such a way as to assure the highest degree of safety and foster sound economic conditions, 3) Promote adequate, economical and efficient service without unjust discrimination, preferences or unfair competition, 4) Maintain necessary competition to assure the sound development of the air transportation system, 5) Promote air safety, 6) Promote, encourage and develop civil aeronautics. FEDERAL AVIATION ACT OF 1958, § 102. Congress readopted these factors as the six factors to be considered in the area of foreign air transportation. 49 U.S.C. § 1302(c) (1976 & Supp. 1979).

3. availability of a variety of adequate, efficient and low-priced services without using unfair or deceptive practices, while encouraging fair wages and equitable working conditions;
4. maximum reliance on competition in the market place;
5. development and maintenance of a sound, responsive and prompt regulatory climate, which adapts to the country's needs;
6. development of services in major urban centers through secondary and satellite airports where possible;
7. prevention of unfair, deceptive, predatory or anticompetitive practices and avoidance of unreasonable concentration, excessive market domination and monopoly powers;
8. maintenance of a comprehensive and convenient system of scheduled airline service for small communities;
9. development of the air transportation system by relying on actual and potential competition;
10. encouraging new carriers to enter the system, encouraging established carriers to enter new markets and strengthening small carriers.<sup>52</sup>

The subsequent International Air Transportation Competition Act [I.A.T.C.A.] of 1979<sup>53</sup> deleted the A.D.A.'s six foreign air transportation factors, merging them with those for interstate and overseas air transportation, and added two extra factors for all three types of air transportation:<sup>54</sup>

11. promote, encourage and develop civil aeronautics and a viable, privately owned United States air transport industry;
12. strengthen the competitive position of U.S. commercial aviation to assure at least equality with foreign carriers and to maintain and increase profitability in foreign air transportation.

The procedures for a merger proposal are governed by 49 U.S.C. § 1378. Subpart A, generally unchanged, lists those consolidations, mergers and acquisitions that are unlawful, unless approved by the C.A.B.<sup>55</sup> The Board's decision process has been outlined:

52. *Id.* § 1302(a).

53. Pub. L. No. 96-192, 94 Stat. 35 (amending 49 U.S.C. §§ 1301 *et seq.*). A partial legislative history of this act may be found at 1980 U.S. CODE CONG. & AD. NEWS 54.

54. 49 U.S.C. § 1302(a) (1976 & Supp. 1979).

55. *Id.* § 1378(a). The section providing presumption of control of an air carrier

Unless, after a hearing, the Board finds that the transaction will not be consistent with the public interest or that the conditions of this section will not be fulfilled, it shall, by order, approve such transaction, upon such terms and conditions as it shall find to be just and reasonable and with such modifications as it may prescribe, except the Board shall not approve such transaction—

(A) if it would result in a monopoly or would be in furtherance of any combination or conspiracy to monopolize or to attempt to monopolize the business of air transportation in any region of the United States; or

(B) the effect of which in any region of the United States may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint of trade, unless the Board finds that the anticompetitive effects of the proposed transaction are outweighed in the public interest by the probable effect of the transaction in meeting significant transportation conveniences and needs of the public, and unless it finds that such significant transportation conveniences and needs may not be satisfied by a reasonably available alternative having materially less anticompetitive effects.

The party challenging the transaction shall bear the burden of proving the anticompetitive effects of such transaction, and the proponents of the transaction shall bear the burden of proving that it meets the significant transportation conveniences and needs of the public and that such convenience and needs may not be satisfied by a less anticompetitive alternative.<sup>56</sup>

Thus, the Board must base its determinations on three distinct tests: (1) the Sherman Act test, (2) the Clayton Act test and (3) the public interest and convenience test.<sup>57</sup>

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where 10% or more of its stock is owned by any person remains unchanged. *Id.* § 1378(f) (1976). If one or more of the parties to the transaction come within the purview of the C.A.B., an application must be filed with the Board with copies sent to the Attorney General and Secretary of Transportation. The Board must notify the applicant(s) and others with a substantial interest in the proceedings of the manner in which the Board will proceed. *Id.* § 1378(b)(1) (1976 & Supp. 1979).

56. *Id.*

57. The relationship or order of these three tests is a significant issue discussed in both the TXI-Pan Am decision and the Eastern decision. *See* text accompanying notes 105-109 and 112-115 *infra*.

Interlocking relationships of officers, directors, or stockholders with controlling interests in air carriers, common carriers or a person "substantially engaged in the business of aeronautics" are still unlawful, unless approved by the C.A.B. as being in the public interest.<sup>58</sup> Pooling and other agreements between domestic and foreign air carriers are subject not only to a public interest test, but also to an anticompetition test.<sup>59</sup> Mutual aid agreements are treated separately.<sup>60</sup> They may only be approved if they are limited to cover sixty percent of an air carrier's direct operating expenses, do not start for thirty days after the beginning of the labor strike, last no longer than eight weeks and the air carrier agrees to binding arbitration under the provisions of the Railway Labor Act, if the union so requests.<sup>61</sup>

The President of the United States still has final authority with respect to foreign air transportation; his approval is necessary whenever the merger is between carriers flying international routes. However, the A.D.A. limits his power to national defense and foreign relations con-

58. 49 U.S.C. § 1379 (1976 & Supp. 1979).

59. *Id.* § 1382. Under the A.D.A. the agreements are simply referred to as "possible cooperative working arrangements," without further defining them. *Id.* § 1382(a)(1) (Supp. 1979). Previously such agreements were delineated:

agreement. . . for pooling or apportioning earnings, losses, traffic, service, or equipment, or relating to the establishment of transportation rates, fares, charges, or classifications, or for preserving and improving safety, economy, and efficiency of operation, or for controlling, regulating, preventing, or otherwise eliminating destructive, oppressive, or wasteful competition, or for regulating stops, schedules, and character of service, or for other cooperative working arrangements.

*Id.*; FEDERAL AVIATION ACT OF 1958, § 412. Procedures for reviewing such agreements are statutorily outlined including prior notification to certain Cabinet officers before approval, so written comments may be filed or hearings requested. 49 U.S.C. § 1382(b) (1976 & Supp. 1979). Delineation of burdens of proof are also included. *Id.* § 1382(c)(2)(B) (Supp. 1979).

60. *Id.* § 1382(e). Mutual aid agreement is defined as any contract or agreement between air carriers which provides that any such air carrier will receive payments from the other air carriers which are parties to such contract or agreement for any period during which such air carrier is not engaging in air transportation, or is providing reduced levels of service in air transportation, due to a labor strike.

*Id.* § 1382(e)(3)(A).

61. *Id.* § 1382(e)(2).

siderations. He may not disapprove upon the basis of economic or carrier selection considerations.<sup>62</sup>

The A.D.A. also changed 49 U.S.C. § 1384, retitled Antitrust Exemptions.<sup>63</sup> The antitrust exemption is no longer automatic with the C.A.B.'s approval of the transaction. Before antitrust exemption may be given, the Board must specifically find exemption is required in the public interest.<sup>64</sup> A 1980 amendment to this section now provides that the Board *shall* by order exempt any person "to the extent necessary to enable such person to proceed with the transaction specifically approved . . . and transactions necessarily contemplated by such order."<sup>65</sup>

To preclude deliberate stalling tactics by the Board, the A.D.A. set specific time limits for Board decisions; for Section 1378 applications, the final order must be rendered within six months.<sup>66</sup>

62. *Id.* § 1461(a) (1976 & Supp. 1979). In his letter of December 22, 1979, approving the Pan American-National merger, President Carter noted his limited review power. Letter from President Carter to C.A.B. Chairman Marvin Cohen dated Dec. 22, 1979, reprinted at Texas International-National Acquisition Case/Pan Am-Acquisition of and Merger with National, Docket Nos. 33112 & 33283, C.A.B. Order Nos. 79-12-163, 79-12-164, and 79-12-165 (Oct. 24, 1979).

63. 49 U.S.C. § 1384 (1976 & Supp. 1979):

In any order made under section 1378, 1379 or 1382 of this title, the Board *may*, as part of such order, exempt any person affected by such order from the operations of the "antitrust laws" set forth in subsection (a) of section 12 of Title 15 to the extent necessary to enable such person to proceed with the transaction specifically approved by the Board in such order and those transactions necessarily contemplated by such order, except that the Board may not exempt such person unless it determines that such exemption is required in the public interest.

*Id.* (emphasis added).

64. *Id.* In the Texas International/Pan American-National merger case, the Board was asked to grant antitrust exemption to the proposed mergers, but after analyzing the A.D.A. and the arguments presented specifically declined to do so. Texas International-National Acquisition Case/Pan American Acquisition of Control of, and Merger with National Acquisition Case, Docket Nos. 33112 & 33283, C.A.B. Orders 79-12-163, 79-12-164 and 79-12-165 (October 24, 1979). *See also* Beane, *The Antitrust Implications of Airline Deregulation*, 45 J. AIR L. & COM. 1001 (1980).

65. 49 U.S.C. § 1384 as amended by section 27 International Air Transportation Competition Act of 1979, Pub. L. No. 96-192, 94 Stat. 35, 47-48. It would appear that the amendment goes a long way towards an automatic exemption again.

66. 49 U.S.C. § 1490 (Supp. 1979).

In another significant section, the A.D.A. established an employee protection program for employees who had been employed by a certificated air carrier for four years as of the beginning of the A.D.A. and who were deprived of either employment or compensation as a result of bankruptcy or "major contraction"<sup>67</sup> "the major cause of which is the change in regulatory structure provided by the A.D.A."<sup>68</sup> Monthly assistance payments may be made until the protected employee finds other employment or for 72 months maximum. Relocation assistance may also be provided. After their own furloughed employees have been called back, certificated carriers have a duty to hire protected employees before hiring any non-protected employee similarly qualified.<sup>69</sup>

Most significant are the A.D.A.'s sunset provisions prescribing a three-phase termination of C.A.B. authority, with complete phase-out on January 1, 1985, unless Congress intervenes. Board authority to pass on mergers ceases on January 1, 1983, and is transferred to the Department of Justice.<sup>70</sup>

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67. *Id.* § 1552(h)(4) defines "major contraction" as being "a reduction of at least 7½ percent of the total number of full time employees of an air carrier within a 12 month period." *Id.* However, the C.A.B. may also determine that it is a major contraction if less than 7½ percent. Strikers are not to be included. *Id.*

68. 49 U.S.C. § 1552(h)(2) (Supp. 1979). However, this program is limited to the first 10 calendar years occurring after October 28, 1979, the date that the A.D.A. became effective. *Id.*

69. *Id.* § 1552. For an interesting history and explanation of this provision and similar provisions for railroad employees, see Ris, *Government Protection of Transportation Employees: Sound Policy or Costly Precedent?*, 44 J. AIR L. & COM. 509 (1979). The historical reasons for labor protective provisions in the railroad industry have not necessarily been present in the commercial aviation industry. In fact until the A.D.A., Congress did not mandate such provisions as it had in the railroad industry; the C.A.B. nevertheless administratively applied them starting in 1950 in United-Western Acquisition of Air Carrier Property, 11 C.A.B. 701 (1950).

70. 49 U.S.C. § 1551 (Supp. 1979). The Board is also required to make a comprehensive review of its activities and present this review to the Congress no later than January 1, 1984. It is to recommend to Congress whether it should be continued in existence after 1985 and what changes should be made to further the goals of the A.D.A. The A.D.A. lists in great detail the elements and factors to be considered during the comprehensive review. *Id.* It was reported that the Transportation Department would support legislation which would move the sunset date up from 1985 to 1982. *Transportation Department Backs Early C.A.B. Sunset*, AV. WK. & SPACE TECH. Apr. 7, 1980, at 32.

Ironically the A.D.A. preempted to the federal government all authority over rates, routes or services of certificated carriers.<sup>71</sup> Liberalized route application procedures and awards were provided the A.D.A.,<sup>72</sup> including an automatic market entry program<sup>73</sup> and a means to obtain unused authority.<sup>74</sup> Carriers obtained flexibility in rate changes; a "standard industry fare level"<sup>75</sup> was established between city-pairs and carriers could adjust their fare no more than 5% upward or 50% downward from this level without C.A.B. authority.<sup>76</sup> In 1980 I.A.T.C.A. established a similar "standard foreign fare level" and

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71. 49 U.S.C. § 1305 (Supp. 1979). This is ironic because one of the primary reasons advanced in support of deregulation was the economic and regulatory success of intrastate carriers operating under California and Texas state authorities. *See Note, Is Regulation Necessary? California Air Transportation and National Regulatory Policy*, 74 YALE L.J. 1416 (1965); Means & Chasnoff, *State Regulation of Air Transportation: The Texas Aeronautics Commission*, 53 TEXAS L. REV. 653 (1975).

72. 49 U.S.C. § 1371 (1976 & Supp. 1979). Among other provisions in this lengthy section, the C.A.B. is authorized to establish simplified procedural rules for route applications. *See generally The Line Forms Here for Air Routes*, BUS. WK., Nov. 6, 1978, at 66; *Deregulation Spurs Airport Problems*, AV. WK. & SPACE TECH., Nov. 3, 1980, at 55; Tinnin, Alexander & Hannifin, *Fasten Your Seat Belts*, TIME, Aug. 4, 1980, at 47; Marbach, Buckley, *et al. Silver Lining in the Air*, NEWSWEEK, Aug. 24, 1981, at 52.

73. 49 U.S.C. § 1371(d)(7) (Supp. 1979). Basically this section provides that each certificated air carrier may apply for (and generally will be automatically given) route authority for one city pair during the first thirty days of 1979, 1980 and 1981. If the Board either determines that the air carrier is not fit, willing and able to provide such non-stop service or that the air carrier is not the *only* air carrier to be given that particular city pair under the automatic market entry program, it may reapply for another city pair within the first one hundred and twenty days of the year. *Id.*

74. *Id.* § 1371 (d)(5)(A) (Supp. 1979). Basically an air carrier must provide a minimum of five round trips per week between two points or city pairs for which it has route authority for at least thirteen weeks during any twenty-six week period or any other air carrier may apply for such unused route authority thirty days after the end of the twenty-six week period. *Id.*

75. 49 U.S.C. § 1482(d)(6)(A) (1976 & Supp. 1979) which is defined as the "fare level in effect on July 1, 1977, for each interstate or overseas pair of points, for each class of service, existing on that date. . . ." Semiannually the Board will make adjustments proportional to the percentage change "in the actual operating cost per available seat mile for interstate and overseas transportation combined." *Id.* § 1482(d)(6)(B).

76. *Id.* § 1482(d)(4).



range of reasonableness for foreign fare adjustments.<sup>77</sup> Subsidized "guaranteed essential air transportation" for those small communities that have lost all air service as a result of deregulation was also provided.<sup>78</sup> Finally, the A.D.A. amended the 1957 Guaranty of Loans for Purchase of Aircraft and Equipment Act to encompass guaranties for "charter air carriers," "commuter air carriers," and "intrastate air carriers."<sup>79</sup>

## Proposed National Mergers

### *Description of the Airlines*

To more clearly understand this complicated merger, it is necessary to briefly examine and compare each of the five airlines involved. Prior to the merger each of the five airlines was in a different stage of development and was practically, if not theoretically and legally, a different category of air carrier.<sup>80</sup> Each of the four courtiers had a differ-

77. *Id.* § 1482(j)(6). See generally *Is the U.S. Sabotaging Its International Airlines?*, Bus. Wk., Jan. 26, 1981, at 74.

78. 49 U.S.C. § 1389 (Supp. 1979).

79. 49 U.S.C. § 1380.

80.

ITEM (1978)	NAL	PAN AM	EAL	TXI	AF
Employees	8,040	26,964	35,899	2,949	500
Equipment					
Total planes	55	95	257	28	7
Wide-bodied jets	15	43	41	---	---
Passengers enplaned	6,983* (11)**	8,675 (10)	37,819 (2)	3,987 (19)	498 (na)
Revenue	7,892,599*	21,054,983	25,183,415	1,560,554	181,000
Passenger Miles	(10)**	(6)	(4)	(16)	(na)
Passenger Revenue (\$)	587,782* (10)**	1,631,798 (6)	2,150,577 (3)	158,185 (19)	15,350 (na)
Profits (\$)	18,309*	118,801	67,257	12,850	132
Assets (\$)	452,952*	2,048,303	1,908,556	95,200	11,474

ent reason for wanting to merge with National.

National, the smallest of the domestic trunklines, first began flying in 1934, carrying the mail between St. Petersburg, Florida, and Daytona Beach, Florida. By 1970 National's routes generally ran from Florida to Washington and New York City, and from Florida across the southern tier of states to California. It was awarded the Miami-London transatlantic route in 1970, and has since steadily expanded into Europe. Prior to the merger it flew from Florida to London, Paris, Amsterdam and Frankfurt.<sup>81</sup> Its stock was undervalued.<sup>82</sup>

Pan American World Airways was unique among United States airlines because, for all practical purposes, it was strictly an international airline. It too traced its roots to Florida. On October 28, 1927, it first flew from Key West, Florida, to Havana, Cuba. In 1947 the company provided the first scheduled around-the-world service.<sup>83</sup> In 1974, it was thought Pan Am would follow Penn-Central into bankruptcy, but this was avoided by better management procedures and elimination of excess management personnel.<sup>84</sup> More recently the airline faced two problems; increasing international competition from other American airlines and continued competition from foreign airlines, such as Air

\*Add 000

\*\*Rank among ATA carriers

AIR FLORIDA SYSTEM, INC., 1978 ANNUAL REPORT (n.d.); EASTERN AIR LINES, INC., 1978 ANNUAL REPORT (1979); NATIONAL AIRLINES, INC., 1978 ANNUAL REPORT (n.d.); PAN AMERICAN WORLD AIRWAYS, INC., 1978 ANNUAL REPORT 1978; AIR TRANSPORT ASSOCIATION OF AMERICA, AIR TRANSPORT 1979 (1979); Cook, *Lorenzo the Presumptuous*, FORBES, Oct. 30, 1978, at 115; Baron, *New Aircraft, Increased Traffic Push Air Florida into the Black*, Miami Herald, Nov. 18, 1978, § B, at 4, col. 1; BARRON'S, Oct. 10, 1977, at 39; PAN AMERICAN WORLD AIRWAYS, INC., THE PAN AMERICAN MERGER (n.d.).

81. NATIONAL AIRLINES, INC., NATIONAL AIRLINES HISTORY, (n.d.).

82. See note 12 *supra*; Russell, *They're Just Wild About National*, N.Y. Times, Dec. 24, 1978, § C, at 1, col. 4.

83. For histories of Pan American World Airways, Inc., see R. DALEY, AN AMERICAN SAGA: JUAN TRIPPE AND HIS PAN AM EMPIRE (1980); C. SOLBERG, CONQUEST OF THE SKIES: A HISTORY OF COMMERCIAL AVIATION IN AMERICA (1979); PAN AMERICAN WORLD, INC., THE FIRST 50 YEARS OF PAN AM-THE STORY OF PAN AMERICAN WORLD AIRWAYS, INC. FROM 1927 TO 1977 (n.d.); PAN AMERICAN WORLD AIRWAYS, INC., ANNUAL REPORT 1979 (1980).

84. See generally *Pan Am: In the Black-For-Now*, BUS. WK., Sept. 5, 1977, at 52; Cook, *Pan American: Coming Home*, FORBES, Oct. 16, 1978, at 47; Griffiths, *Pan Am Cutback Geared to Profits*, AV. WK. & SPACE TECH., Sept. 18, 1978, at 34.

France, Alitalia and Lufthansa, which are owned and/or heavily subsidized by their respective governments.<sup>85</sup> Increased American competition reduced Pan Am's domestic feeder traffic. Thus Pan Am was desirous of obtaining its own domestic system more quickly and less expensively than building one from scratch. Pan Am expected that National would best connect Pan Am's transpacific, transatlantic and Latin American operations, and enable better utilization of equipment since Pan Am peaked during the summer tourist season and National peaked during Florida's winter season.<sup>86</sup>

Eastern Air Lines, as its name implies, generally concentrated its route system in the eastern United States, with major hubs at Miami, Atlanta, Washington and New York. It also served Eastern Canada, Mexico and the Caribbean. Eastern was the second largest domestic trunkline in the United States before the Pan Am-National merger.<sup>87</sup> Eastern's present president, Colonel Frank Borman, appears to be bringing the company out of a severe financial crisis, which saw it lose nearly ninety million dollars in 1975.<sup>88</sup> Two major problems appeared to face the proposed Eastern-National merger. One was the fact that the two airlines were major competitors on the important northeast-Florida routes. The other was the resultant size of the combined company.<sup>89</sup>

Texas International (TXI), originally known as Trans-Texas Air-

85. PAN AMERICAN WORLD AIRWAYS, INC., THE PAN AM-NATIONAL MERGER (n.d.); ANNUAL REPORT 1979 20 (1980) and Pan American World Airways, Inc., S.E.C. Form 10-K (1978) (S.E.C. file # 103532) (1979). For a description of state ownership characteristics of various I.A.T.A. airlines, see generally P. HAANAPPEL, RATEMAKING IN INTERNATIONAL AIR TRANSPORT - A LEGAL ANALYSIS OF INTERNATIONAL AIR FARES AND RATES 37-39 (1978).

86. ANNUAL REPORT 1979, *supra* note 68; Hice, *Pan Am-National Merger: Where Will All the People Fit?*, FLORIDA TREND, Apr. 1980, at 150. Union seniority and meshing problems have prevented the cross-utilization of equipment that was expected. *Id.* See also text accompanying notes 165-69 *infra*.

87. Pan Am replaced Eastern in second place, behind United, when the merger became effective. Hobson & Golden, *Merged Pan Am Slashes Fares*, Miami News, Jan. 7, 1980, § A, at 1, col. 1. See generally R. SERLING, FROM THE CAPTAIN TO THE COLONEL - AN INFORMAL HISTORY OF EASTERN AIRLINES (1980); E. RICKENBAKER, RICKENBAKER - AN AUTOBIOGRAPHY (1967).

88. EASTERN AIRLINES, INC., GROWTH, CHALLENGE CHARACTERIZE EASTERN AIRLINES FIRST 50 YEARS (1979).

89. See text accompanying notes 143-47 *infra*.

ways, was a small local service airline. In 1967 it was rescued from a crippling debt load of over twenty million dollars by two Harvard M.B.A.'s, Frank Lorenzo and Robert Carney, who were able to recapitalize the company through innovative and aggressive management, turning it into one of the industry's most exciting companies. Texas International's daring in trying to gain control of National brought the company at least forty-five million dollars in profits on the sale of its National stock.<sup>90</sup> After realizing the profit from the sale of its stock to Pan Am, Texas International sought to acquire T.W.A. and currently has C.A.B. approval to acquire Continental Airlines.<sup>91</sup>

Until the A.D.A. Air Florida was strictly an intrastate carrier. Deregulation and an infusion of new capital permitted the once struggling airline to expand its route system to the Northeast, the Caribbean, Central America and Europe.<sup>92</sup> Like the other so-called National-merger losers, Air Florida has grown and prospered more than the "new" Pan Am.

### *Chronology of Events*

While this article focuses on the airline regulatory process, it is important to realize that concurrent with the C.A.B. hearings there was a massive corporate scramble on other fronts, involving the Securities and Exchange Commission and the shareholders of the involved corporations. These are here summarized.<sup>93</sup>

Texas International Airlines set this incredible chain of events in motion on July 10, 1978 when it announced it had already purchased 9.2% of National's common stock. On August 22, 1978 Pan American World Airways joined in battle against Texas International, also seeking C.A.B. approval for its proposed merger with National Airlines. Shortly thereafter Pan American and National executed a definitive merger agreement. The C.A.B. consolidated these two merger applications, but later refused to consolidate Eastern Airlines' application, when, on December 11, 1978, it likewise indicated an interest in acquiring its chief rival on the East Coast-Florida market. Throughout,

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90. See note 3 *supra* and accompanying text.

91. See text accompanying notes 148-62 *infra*.

92. AIR FLORIDA SYSTEM INC., AIR FLORIDA BACKGROUND (n.d.).

93. For a full chronology, see Appendix A.

Air Florida's only interest was the acquisition of National's international routes and four of its DC-10's.

Meanwhile, on October 28, 1978, President Carter signed into law the A.D.A., which not only deregulated the domestic airline industry, but also significantly changed the rules for airline mergers. Later I.A.T.C.A. was also enacted, much to Pan American's detriment.

Eventually an auction system was proposed and accepted by National's shareholders, which would permit five rounds of bidding between Pan American and Eastern, should each obtain C.A.B. approval. The Texas International, Pan American and Eastern applications were all rejected by the respective administrative law judges. Finally the full Board approved both Texas International's and Pan American's merger applications, despite the fact that Texas International had informed the Board it had already agreed to sell its National stock to Pan American for a handsome profit. Throughout the summer of 1979 Pan American increased its ownership of National.

In September 1979 the full C.A.B. tentatively rejected Eastern's merger application and shortly thereafter Eastern dropped out of contention.

President Carter formally approved the Pan American-National merger in December 1979 and the merger became effective in January 1980. Since the merger, management problems, labor seniority meshing problems, continued and expanded deregulation, high fuel costs and the economy in general have all combined to raise the spectre of possible bankruptcy. First the airline sold its New York City headquarters to raise badly needed cash, then its profitable InterContinental Hotel subsidiary. Only time will tell whether Pan American World Airways will realize the expected benefits from its merger with National Airlines and even whether the "new" Pan Am will survive.

### C.A.B. Decisions

Although not the first merger decision after the adoption of the A.D.A. merger tests,<sup>94</sup> the C.A.B. decision in the Texas International/

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94. The C.A.B.'s first affirmative decision created Republic Airlines from North Central and Southern. Since the two airlines served different regions of the United States, there was little, if any, anticompetitive effect on the airline industry. Thus the Board opinion offered no real analysis or rationale. North Central-Southern Merger

Pan American-National Case<sup>95</sup> gives the greatest expository insight into the Board's interpretation of the A.D.A. merger provisions. Handed down one year after the adoption of the A.D.A., this lengthy opinion approved both the proposed acquisition of National by Texas International and the proposed acquisition and merger of National with Pan American, despite contrary recommendation by the administrative law judge.<sup>96</sup> This Board opinion is analyzed and compared with the earlier decision by Administrative Law Judge William Dapper. The initial decision of Administrative Law Judge Richard Murphy recommending denial of the Eastern-National acquisition application,<sup>97</sup> the decision of Administrative Law Judge John Vittone recommending approval of the second Continental-Western merger,<sup>98</sup> and the C.A.B. decision accepting such recommendation are also discussed below.<sup>99</sup> The latter Continental-Western decisions are examined because they shed some light on the C.A.B.'s earlier decision denying the first Continental-Western merger application<sup>100</sup> and because they show the changes in the domestic airline industry since deregulation and the effect those

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Case, Docket Nos. 33136 & 34430, C.A.B. Order Nos. 79-6-7 & 79-6-8 (May 15, 1979). For discussion and analysis of the first five merger/acquisition cases under the A.D.A., see Keyes, *A Preliminary Appraisal of Merger Control Under the Airline Deregulation Act of 1978*, 46 J. AIR L. & COM. 71 (1980).

95. Texas International-National Acquisition Case/Pan American Acquisition of Control of, and Merger with National Acquisition Case, Docket Nos. 33112 & 33283, C.A.B. Order Nos. 79-2-163, 79-12-164, 79-12-165 (Oct. 24, 1979) (hereinafter TXI/Pan Am-National Order).

96. Texas International-National Acquisition Case/Pan American Acquisition of Control of, and Merger with National Acquisition Case, Docket Nos. 33112 & 33283 (Decision of Administrative Law Judge William H. Dapper, Apr. 5, 1979) (hereinafter TXI/Pan Am-National Judge Decision).

97. Application of Eastern Air Lines, Inc. for Approval of Acquisition of Control of National Airlines, Inc. Docket No. 34226 (Decision of Administrative Law Judge Richard J. Murphy, June 14, 1979) (hereinafter Eastern-National Judge Decision).

98. Continental-Western Merger Case, Docket No. 38733 (Decision of Administrative Law Judge John M. Vittone, Feb. 6, 1980) (hereinafter Continental-Western Judge Decision).

99. Continental-Western Merger Case, Docket No. 38733, C.A.B. Order Nos. 81-6-1 & 81-6-2 (Mar. 31, 1981) (hereinafter Second Continental-Western Order).

100. Continental-Western Merger Case, Docket No. 33465, C.A.B. Order No. 79-9-185 (Sept. 27, 1979) (dismissing application) (hereinafter First Continental-Western Order).

changes have had on the C.A.B.'s consideration of merger applications.

### *Preliminary Decisions*

Under the Federal Aviation Act of 1958, the C.A.B. initially determined whether the proposed merger, consolidation or acquisition was consistent with the public interest. The Board was further required to disapprove proposals that would result in a monopoly or monopolies.<sup>101</sup> In the first post-A.D.A. decision, Administrative Law Judge Saunders commented upon the C.A.B.'s view of its antitrust role under the 1958 Act: "Under this interpretation of the prior law, the Board's antitrust resolve was erratic; and with the broad discretion afforded by the 'public interest' test, antitrust policy was often ignored."<sup>102</sup>

With the adoption of the A.D.A. Congress specifically intended to subject proposed airline mergers or acquisitions to the same antitrust standards to which other mergers are subject, with the proviso that if the proposed merger failed the Sherman and Clayton Act tests, it might nevertheless be approved if it passed the public interest test and "no reasonably available less anticompetitive alternative"<sup>103</sup> existed.

101. *Hughes Tool Co. v. Trans World Airlines, Inc.*, 409 U.S. 363 (1973). Federal Aviation Act of 1958, Pub. L. No. 85-726, tit. IV, § 408, 72 Stat. 767 as amended, stated (before the A.D.A.):

Unless after such hearing, the Board finds that the consolidation, merger, purchase, lease, operating contract, or acquisition of control will not be consistent with the public interest or that the conditions of this section will not be fulfilled, it shall by order approve such consolidation, merger, purchase, lease, operating contract, or acquisition of control, upon such terms and conditions as it shall find to be just and reasonable and with such modifications as it may prescribe: Provided, that the Board shall not approve any consolidation, merger, purchase, lease, operating contract, or acquisition of control which would result in creating a monopoly or monopolies and thereby restrain competition or jeopardize another air carrier not a party to the consolidation, merger, purchase, lease, operating contract or acquisition of control. . . .

102. *North Central-Southern Merger Case*, Docket No. 33136 at 23 (Decision of Administrative Law Judge Saunders, Feb. 9, 1979).

103. A.D.A. Legislative History, *supra* note 14, at 3789.

The intent of the new section 408 of the proposed legislation is to insure that, in light of deregulation, mergers in the air carrier industry will be tested by the antitrust standards traditionally applied by the courts to unregulated industries. However, under the new section 408, even if a merger

The public interest tests under the A.D.A. are similar to those under Section 102(a) of the Bank Merger Act of 1966.<sup>104</sup>

Because of substantial change in Section 408 of the Aviation Act,<sup>105</sup> which effectively altered the entire antitrust philosophy and tests applied to the airline industry, the Board and the two administrative law judges dealing with the various National merger cases had to determine the section's intent and application. The two issues were: first, whether the public interest test was separate from the antitrust analysis or whether the antitrust analysis was only an important part of the overall public interest test;<sup>106</sup> and second, what criteria or factors should be considered for the public interest test.<sup>107</sup> Judge Dapper,

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does not meet the antitrust standards of the Sherman and Clayton Acts it may nonetheless be approved if it meets 'significant transportation needs of the community to be served,' and if there is no 'reasonably available less anticompetitive alternative' to the merger. These latter tests only apply if a merger or similar transaction does not meet the Sherman and Clayton standards. The 'public interest' standard in section 408(b) of the Federal Aviation Act of 1958 is retained in the new section, but the standard must now be interpreted in light of the intent of Congress to move the airline industry rapidly toward deregulation. The foundation of the new airline legislation is that it is in the public interest to allow the airline industry to be governed by the forces of the marketplace. Consistent with the premise, mergers of air carriers should be governed by the same standards that are applied to mergers of other firms.

The Sherman and Clayton Acts are more fully explained at notes 23-24 *supra*.

104. 12 U.S.C. § 1828(c) (1976 & Supp. 1979). See generally 54 AM. JUR 2d *Monopolies* §§ 198-205. Accord, TXI/Pan-Am-National Judge Decision at 40, and Eastern-National Judge Decision at 21.

105. 49 U.S.C. §§ 1301-1504 (1976 & Supp. 1979).

106. TXI/Pan Am-National Judge Decision at 40-45. Pan Am, TXI and the Department of Justice all took the position that if the proposed acquisitions or mergers passed both the Clayton Act Test and the Sherman Act Test, that there was no need to subject them to the public interest tests. The factors listed in section 12(a) of the Bank Merger Act would only come into play if the antitrust tests are not passed. National and others contend that even if the proposed mergers pass the antitrust tests, they could still be disapproved if they fail to pass the public interest test. *Id.* It would appear that the first position is supported by the Legislative History, which states: "These latter tests (public interest tests) *only apply* if a merger or similar transaction *does not meet* the Sherman and Clayton Act Standards." A.D.A. Legislative History, *supra* note 14, at 3789 (emphasis added).

107. TXI/Pan Am-National Judge Decision at 40-45.



whose Texas International/Pan Am-National decision provided the first interpretation of Section 408, concluded that antitrust analysis was only an important part of the overall public interest standard, and that the factors for public interest listed in Section 102(a) of the A.D.A. should be considered, but were not exhaustive.<sup>108</sup> Specifically:

The analysis proceeds as follows: a determination is made concerning whether a proposed merger is anticompetitive or not (The Clayton Act Test). If the conclusion is that the transaction is not anticompetitive then other public interest factors are evaluated. The antitrust and other public interest factors are then weighed and balanced against each other and an ultimate determination is made. Thus, the merger may pass muster under antitrust criteria but offend overriding public interest considerations on the other hand. In that event the merger must be disapproved. Finally, if the merger fails under the antitrust criteria it may still be approved pursuant to section 408(b)(1)(B) if it meets significant transportation needs.<sup>109</sup>

Applying this analysis, Judge Dapper concluded with respect to each airline that the proposed transactions were violative of the Clayton Act test,<sup>110</sup> applying the public interest test as applied under the Bank Merger Act of 1966, he concluded that neither airline had met its burden of proof in establishing that such a merger would meet "significant transportation conveniences and needs of the public."<sup>111</sup>

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108. *Id.* at 43.

109. *Id.*

110. *Id.* at 82-91.

111. *Id.* at 114-127. TXI's principal argument was that it was a more aggressive and better-managed company than National, that subsequent to the merger TXI's low cost fares could be introduced system-wide and overall management would be improved to the benefit of the consumer. Judge Dapper declined to accept this thesis. He also noted several negative factors that he considered: 1) a long period of cross-ownership would have detrimental effects on National; 2) TXI might lose its citizenship because of the foreign debenture device it used to raise money for the acquisition; 3) approval of this acquisition would be a signal that might cause other acquisitions or mergers; 4) it would be better for the consumer if TXI expanded internally rather than acquired another airline externally and 5) TXI violated section 408 when it initially acquired more than 10% of National stock without Board approval. *Id.* at 82-91. Likewise, Judge Dapper disagreed with Pan Am's main contention that it would be in the public interest to permit Pan Am to rapidly acquire a domestic feeder system and thereby

Several months later, Judge Murphy in the Eastern-National case determined that there were three separate tests to be considered under the A.D.A.: 1) the public interest test, 2) the Sherman Act Test and 3) the Clayton Act Test.<sup>112</sup> He concluded that *each* of the three tests must be passed for approval, rather than the alternative propositions Judge Dapper considered. Thus, even though he concluded that the proposed acquisition would “not be inconsistent with the public interest,”<sup>113</sup> and that it would pass the Sherman Act Test,<sup>114</sup> because it failed the Clayton Act Test, he recommended disapproval.<sup>115</sup>

### *C.A.B. Decision in the Texas International/Pan Am-National Merger Application*

In October 1979 the full C.A.B. interpreted for the first time the applicability and interrelationship of the various tests under Section 408 of the A.D.A. First the Board decided that the public interest standard was separate and independent from the antitrust standard. However the Board refused to read subsection 7, condemning monopolies and other anticompetitive acts, out of the public interest factors of section 102(a). Despite including antitrust or anticompetitive factors in the public interest test, the Board noted that the effect would be the same as pre-A.D.A. analysis using the Clayton Act Test and the Bank Merger Act of 1966, since the Clayton Act envisaged a broad inquiry, subsuming this independent public interest inquiry.<sup>116</sup> In making a determination under the Clayton Act, the Board decided that a “functional analysis” of the acquisitions, taking into account the “structure, history and performance of the industry,” was more appropriate than “static statistical analyses of market shares and concentration ra-

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support its position as the primary U.S. flag carrier, rather than require it to slowly build such a domestic feeder system. The Judge also listed three negative public interest factors: 1) the merger would be inconsistent with U.S. international aviation policy which supports more international competition, 2) internal growth is preferable and 3) approval would trigger other mergers. *Id.* at 114-127.

112. Eastern-National Judge Decision at 5-6, 12.

113. *Id.* at 21.

114. *Id.* at 59.

115. *Id.* at 62.

116. TXI/Pan Am-National Order at 58-60.

tios."<sup>117</sup> The Board ultimately disagreed with Judge Dapper, determining that there were no anticompetitive problems with either merger or acquisition, other than on the United States-London market,<sup>118</sup> and further found that both applications were in the public interest, subject to labor protective provisions.<sup>119</sup>

In the Board's functional Clayton Act analysis, it agreed with Judge Dapper that the "product market" was "scheduled air transportation."<sup>120</sup> Actually Judge Dapper had more narrowly defined the applicable product market as "scheduled passenger air transportation between a specific origin point and a specific destination point."<sup>121</sup>

Looking first at the Texas International proposal, Judge Dapper determined the applicable geographic markets were those city-pairs where Texas International and National actually competed, those where one of the two airlines actually operated and the other might be a potential entrant and those where both airlines might be potential entrants.<sup>122</sup> Although the Board agreed that city-pairs deserved analysis, it deemphasized the importance of statistical market share analysis relative to such city-pairs. It based its Clayton Act determination upon a historical, structural and prospective analysis of the industry, particularly in view of deregulation.<sup>123</sup> Specifically, Judge Dapper determined

117. *Id.* at 6 and 59.

118. *Id.* at 3-7. *See* text accompanying note 138 *infra*.

119. TXI/Pan Am-National Order at 3-7.

120. *Id.* at 10.

121. TXI/Pan Am-National Judge Decision at 52-55 citing *Brown Shoe Co. v. United States*, 370 U.S. 294 (1962), Judge Dapper stated, "In that proceeding, the Court stated that the key factor in identifying the product market was the 'reasonable interchangeability of use or the cross elasticity of demand between the product itself and substitutes for it.'" TXI/Pan Am-National Judge Decision at 53. It would appear that the difference in terminology between Judge Dapper and the Board shows the Board's emphasis upon a more functional analysis, partially occasioned by the changed competitive conditions brought about by the A.D.A.

122. *Id.* at 57.

123. TXI/Pan Am-National Order at 12-16, citing *United States v. General Dynamics*, 415 U.S. 486 (1974).

We believe the Judge erred in not accepting TXI's invitation to make a thorough examination of this market. . . . Under this functional approach the likely effect on performance should be examined as well as surface structural changes. . . . We believe that we should apply antitrust law functionally and in the light of the recent and ongoing deregulation of

there would be a substantial and continuing two-firm concentration ratio in the Houston-New Orleans market should the proposed merger be approved, which would violate the Clayton Act.<sup>124</sup> Skeptical about market shares analysis in general, the Board decided Texas International's rapid market growth and Southwest Airlines' ability to enter the market with apparent ease belied the conclusions drawn by Judge Dapper.<sup>125</sup> The Board concluded that the loss of National in this market would not be anticompetitive.<sup>126</sup>

Courts have divided potential competition into "perceived" and "actual" potential competition.<sup>127</sup> Judge Dapper examined sixteen city-pairs radiating from Houston or New Orleans and determined that either National or TXI would be an actual potential competitor, having deconcentrating effects upon the markets they entered.<sup>128</sup> Disagreeing with this conclusion, the Board noted the Judge's underlying assumption, that "concentration gives rise to poor competitive performance," is legally challengeable.<sup>129</sup> Concluding that none of these southern tier markets faced any anticompetitive challenge from the proposed acquisition, the Board decided that no commercial (or special) barriers would prevent other airlines from entering these markets, should the acquisition be approved.<sup>130</sup> It emphasized the changed conditions under the A.D.A.:

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the airline industry. The case law just reviewed reveals a reemphasis of the Supreme Court's belief that a thorough review of competitive circumstances is advisable.

TXI/Pan Am-National Order at 16.

124. TXI/Pan Am-National Judge Decision at 62-70.

125. TXI/Pan Am-National Order at 17-19.

126. *Id.* at 19.

127. TXI/Pan Am-National Judge Decision at 71:

An actual entrant is a company which does not serve the relevant market. However, it has the 'available feasible means' for entering the relevant market other than by acquisition; and those means offer a 'substantial likelihood of producing deconcentration in that market or other significant procompetitive effects.' A perceived potential entrant is a company which does not serve the relevant market. However, it is perceived by the competitors in the relevant market as likely to enter that market if anticompetitive practices develop.

128. *Id.* at 75-80.

129. TXI/Pan Am-National Order at 23.

130. *Id.* at 20-31.

A more general examination of entry conditions must begin with the recognition that the most significant barrier to competitive entry in the domestic system was a regime of restrictive licensing and that has been eliminated by the passage of the A.D.A. In implementing its provisions we have adopted a policy of granting widespread authority to all fit applicants, and of allowing substantial freedom to reduce fares and engage in price competition.<sup>131</sup>

In considering the Pan Am application, the administrative law judge chose five city-pairs where National was actually operating and where Pan Am was an actual potential competitor. He concluded, based upon the high concentration ratios and the competitive effect Pan Am's entry into these markets would have, the proposed merger would violate the Clayton Act in all such markets.<sup>132</sup> Rejecting his recommendation, the Board again decided it was necessary to go beyond market share and concentration ratios, and determined all five markets were substantial markets that would draw other capable competitors should the merger be approved.<sup>133</sup>

Internationally, city-pairs are not as important because consumers are more price sensitive and less time sensitive, willing to substitute destinations and origins when economically advantageous. The airline industry and C.A.B. have recognized this unique situation. Thus both Judge Dapper and the Board concluded, with respect to the Pan American-National merger, that the United States-Western Europe market should be the applicable international market, with United States-London as a sub-market.<sup>134</sup>

With respect to the United States-Western Europe market, Judge Dapper determined that National and Pan Am were actual competitors in a concentrated market, that National had become the third largest United States carrier crossing the Atlantic and moreover, was a vigorous competitor; therefore, its loss under the contemplated merger would be anticompetitive and violative of the Clayton Act.<sup>135</sup> The Board, on the other hand disagreed that National had been a vigorous competitor

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131. *Id.* at 27.

132. TXI/Pan Am-National Judge Decision at 110-114.

133. TXI/Pan Am-National Order at 55-57.

134. *Id.* at 32-34, 44-46, and TXI/Pan Am-National Judge Decision at 94-101.

135. TXI/Pan Am-National Judge Decision at 104-109.

and disagreed that the merger would have any effect on a healthy and increasingly competitive transatlantic market.<sup>136</sup> Further the Board noted:

Competitive conditions in the United States-Western Europe market have changed markedly in recent months, and we believe that as a result the reduction by one of the number of United States scheduled carriers will have little impact on competition. Over the past few years the United States government has promoted and encouraged liberalized entry in international aviation. The results of this effort are now being seen in the form of bilateral agreements with some European nations which permit United States carriers, unrestricted in number, to fly to virtually any major point (city) in those nations.<sup>137</sup>

The Board agreed with Judge Dapper's analysis of the United States-London submarket. Transferring National's Miami-London certificate would increase the Pan American market share and would be anticompetitive. Rather than veto the merger as the Judge recommended, the Board conditioned approval on the loss of the Miami-London route, making that route subject to separate route proceedings.<sup>138</sup>

Since the Board disagreed with the Judge on the public interest test, it approved both the Texas International and the Pan American applications.<sup>139</sup> Before the A.D.A. such approval would automatically clothe the acquisition or merger with antitrust immunity. But the Board noted congressional policy had changed under the A.D.A. Immunity must now be specifically conferred by the Board, if the Board determines under section 414 of the A.D.A. that immunity is required

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136. TXI/Pan Am-National Order at 35-43.

137. *Id.* at 37. This decision was written before I.A.T.C.A. became law; this has further increased competition on the Transatlantic routes.

138. *Id.* at 44-54 and TXI/Pan Am-National Judge Decision at 109-110. Eventually the Board was forced to return the route permanently to the new Pan Am, because it was the only U.S. carrier that could continue to fly into Heathrow under the terms of amendments to the Bermuda II Treaty, imposed by the British. Russell, *London Run Is Pan Am's: CAB Cities Heathrow Flap*, Miami Herald, Apr. 8, 1980, § A, at 1, col. 3.

139. TXI/Pan Am-National Order at 3-7.

in the public interest. Additionally, the Board required the applicants to show the merger would not go forward without such immunity. Neither applicant made the showing; therefore, the Board declined to grant antitrust immunity.<sup>140</sup> Without such immunity it is conceivable that the merger may be subject to collateral attacks by the Government or other airlines, which could subject the resulting airline to treble damages and other penalties.<sup>141</sup>

Despite arguments that labor protective provisions were not justified under the philosophy of the A.D.A., the Board nevertheless conditioned its approval on acceptance of the standard labor protective provisions first enunciated in the Allegheny-Mohawk Merger Case.<sup>142</sup>

### *Other Post-A.D.A. Decisions*

No formal C.A.B. opinion was prepared in the Eastern-National merger case, because Eastern dropped out of competition after receiving the initial unfavorable Board opinion.<sup>143</sup> It is useful nevertheless to compare briefly the administrative law judge's initial decision in Eastern with the Board decision in the TXI/Pan Am-National Merger. Noting the vigorous actual competition between Eastern and National on the East Coast and Sun Belt Routes, Judge Murphy concluded the applicable geographical markets for the Clayton Act test were groups of routes (rather than city-pairs).<sup>144</sup> He placed much emphasis on market share and firm concentration ratios; and, despite misgivings engendered by *General Dynamics*, concluded those statistics, though generated prior to the A.D.A., proved the merger would be anticompe-

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140. *Id.* at 73-77.

141. See generally Beane, *The Antitrust Implications of Airline Deregulation*, 45 J. AIR L. & COM. 1001 (1980).

142. TXI/Pan Am-National Order at 65-69. See text accompanying notes 168-69 *infra*.

143. Application of Eastern Air Lines, Inc. for Approval of Acquisition of Control of National Airlines, Inc., Docket No. 34226, CAB Order No. 79-12-74 (Dec. 17, 1979) (dismissing the application).

144. Eastern-National Judge Decision at 22-32. The routes were: 1) New York-Florida Routes, 2) Washington-Florida Routes, 3) Intra-Florida Routes, 4) New York-Washington Routes and 5) Sun Belt Routes. With very little discussion, the Judge accepted the relevant product market as "scheduled passenger air transportation." *Id.* at 22.

titive.<sup>145</sup> After examining the effects of various barriers on potential competitors, it was his opinion that such barriers precluded entry by other airlines in four of the five markets; therefore, Eastern had failed to rebut the merger opponents' prima facie case.<sup>146</sup> Thus the proposed merger failed the Clayton Act test. Therefore even though it passed the Sherman Act test and the Public Interest test, Judge Murphy recommended disapproval.<sup>147</sup>

Both administrative law judges premised their decisions on traditional, historically-slanted market share analysis. They were less inclined to include the effects of the A.D.A.'s deregulatory philosophy. The Texas International/Pan Am-National Board decision, which came several months later, more willingly predicted the market and competitive effects of the year-old A.D.A.

Continental Airlines and Western Airlines have twice submitted joint applications for approval of proposed mergers. Even though the administrative law judge in the first application recommended approval, the full Board voted to disapprove.<sup>148</sup> It filed no formal opinion because the Continental Board of Directors withdrew from the merger agreement. In the Order Dismissing Application, the Board indicated the proposed merger would fail the Clayton Act test, since both airlines were aggressive actual competitors in at least twelve city-pairs and potential competitors in many other western cities.<sup>149</sup> Further, the Board expressed concern about barriers caused by crowded conditions at some Western United States airports which would bar potential competitors even in a deregulated situation.<sup>150</sup> Another factor was the possibility of

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145. *Id.* at 33-36 citing *United States v. General Dynamics*, 415 U.S. 486 (1974).

146. *Id.* at 37-51. While there were no regulatory barriers, and temporary but not insurmountable capital barriers, there were landing slot restrictions at some Eastern U.S. airports that might constitute barriers, and similar but less serious gate problems in Florida. Fuel sources were not a problem. But route efficiency and the marketability of the alternatives might constitute barriers in certain markets. Cumulatively there would be problems of entry in all but perhaps the Sun Belt market and therefore Eastern had not rebutted the prima facie case against it. *Id.*

147. *Id.* at 62.

148. See First Continental-Western Order.

149. *Id.* at 1.

150. *Id.* at 2.



duopolistic control by the new airline and United Airlines.<sup>151</sup> The Board did not accept some of the asserted public benefits,<sup>152</sup> and thus disapproved the application.

In instituting proceedings on the second case, the Board asked the parties and the administrative law judge to specifically address those concerns it voiced over the first application and to relate them to the foreseeable effects of the A.D.A.<sup>153</sup> Judge Vittone addressed five issues. First, evidence clearly showed competition in the airline industry nationwide was increasing.<sup>154</sup> Second, since the implementation of new routes under the A.D.A., competition between the two airlines had substantially declined.<sup>155</sup> But third, in those two city-pairs where the merger would cause decline in competition, there were sufficient potential competitors.<sup>156</sup> With respect to concentration Judge Vittone wrote:

Similarly I have concluded that the loss of one of the applicants upon the merger will not adversely affect the balance of perceived potential competition in the west. The structure of the air transportation industry has changed significantly since deregulation and the Western United States has been the scene of many such changes. Carriers traditionally confined to the east have entered western routes since deregulation. Mergers have strengthened the networks of formerly limited western carriers. . . . Concentration in the west is declining.<sup>157</sup>

Fourth, significant improvements had taken place to remove those barriers previously a problem.<sup>158</sup> Finally he determined that the resultant carrier and United would not be able to exert duopolistic control in light of deregulation.<sup>159</sup> Judge Vittone also extensively examined the

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151. *Id.*

152. *Id.* at 3.

153. Continental-Western Judge Decision at 1.

154. *Id.* at 9.

155. *Id.* at 9-11. Of the twelve original city-pairs where the two airlines were actual competitors, only four remained that were still served by both. One new city-pair had been added.

156. *Id.* at 12-19, 25.

157. *Id.* at 25.

158. *Id.* at 27-36.

159. *Id.* at 37-43.

relevant product markets.<sup>160</sup> He finally concluded the proposed merger would pass all three A.D.A. merger tests.<sup>161</sup> The Board adopted his decisions as its own.<sup>162</sup>

The Board's three decisions are best viewed and explained in light of geographic markets served by the various airlines involved in the mergers at the time the A.D.A. was passed. On the east coast there was National, Eastern and Delta; an Eastern-National merger would result in a duopoly between the resultant airline and Delta. In the vast western United States there was Continental, Western and United; a Continental-Western merger would result in a duopoly between the resultant airline and United.

But Texas International was largely a Texas-Mexico-southwestern United States local service carrier and Pan American was strictly an international carrier, while National was a small trunk line with some east coast, sun belt and transatlantic traffic. Its merger with either of the latter applicants would not result in the same potentially duopolistic market that the first Continental-Western merger or the Eastern-National merger would have caused. In the few years since the A.D.A., this potential for duopolistic control in a regional market has generally disappeared because of the liberalized route application proceedings.<sup>163</sup>

### *Labor Issues*

As previously mentioned, the A.D.A. established a ten year protection program to assist employees adversely affected by deregulation. Monthly payments for up to 72 months, relocation assistance and priority in hiring at any certificated airline, after that airline's furloughed employees have been called back, are the three major provisions.<sup>164</sup>

Nonetheless the Board prescribed labor protective provisions in the TXI/Pan National merger as a condition for merger approval.<sup>165</sup> The Board put all interested parties on notice that while special provisions would not be automatic in future mergers, until unions and labor con-

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160. *Id.* at 44-75.

161. *Id.* at 87.

162. Second Continental-Western Order.

163. 49 U.S.C. § 1371 (1976 & Supp. III 1979).

164. 49 U.S.C. § 1552 (Supp. III 1979).

165. TXI/Pan Am-National Order at 65-69 and Appendix III-Labor Protective Provisions.

tracts had an opportunity to adjust to the A.D.A., provisions would be applied as they had since 1950.<sup>166</sup> These provisions provide for the integration of seniority lists in a fair and equitable manner; the payment of displacement allowances or differential pay for a three year period, if an employee is adversely affected by the merger; a dismissal allowance equal to 60% of the average monthly compensation of the employee for anywhere from six to sixty months, depending on total length of service and relocation assistance for employees forced to move because of the merger.<sup>167</sup>

The Pan American-National merger caused many labor problems based on the different nature of the two airlines and on the different types of airplanes being used. Labor problems prevented management from using and mixing equipment in the most advantageous manner.<sup>168</sup> Eventually an arbitrator had to decide the integration method for pilots and flight engineers using a complex formula.<sup>169</sup>

In the second Continental-Western case, the administrative law judge found that even two years after the adoption of the A.D.A. most of the eleven labor agreements binding the applicants had been concluded or substantially delineated prior to the Board's National-Pan Am decision.<sup>170</sup> Thus the "notice" given in that decision did not prepare the parties for a merger free of labor protective provisions. The judge recommended provisions similar to those in the National-Pan Am

166. *Id.*

167. TXI/Pan Am-National Order at Appendix III-Labor Protective Provisions.

168. See, e.g., Feazel, *Labor Problems in Merger May Lead to Arbitration*, AV. WEEK & SPACE TECH., Apr. 21, 1980, at 26; *Meshing Problems for Pan Am and National*, BUS. WK., Jan. 21, 1980, at 56; *Union Issues Big Problem Facing Pan Am in National Merger*, Aviation Daily, Apr. 15, 1980, at 249 and *Teamsters Outline Problems in Pan Am-National Merger*, Aviation Daily, Apr. 16, 1980, at 261.

169. In Re: Merger of Pan Am and National Airlines Flight Deck Crew Member Seniority Lists, (Arbitrator Lewis M. Gill, Mar. 12, 1981) and In Re: Merger of Flight Deck Crew Member Seniority Lists. Pan Am and National Airlines, (Arbitrator Lewis M. Gill, May 5, 1981). Possibly inspired by a similar attempt by Continental employees to purchase a controlling interest of their airline's stock and thereby preclude a takeover attempt by Texas International, a group of Pan American employees unsuccessfully tried a similar approach with Pan American in an effort to install their own management. See *Continental's Crusade to Stop Frank Lorenzo*, BUS. WK., May 11, 1981, at 110; Merzer, *Group Seeks a Takeover of Pan Am*, Miami Herald, May 21, 1981, § A, at 1, col. 6.

170. Continental Western Judge Decision at 81.

decision.<sup>171</sup> The Board agreed with this analysis, and adopted the labor protective provisions in its order.<sup>172</sup>

A clearer picture of the future of these provisions was to have been supplied by the Texas International-Continental Acquisition Case,<sup>173</sup> where Texas International voiced opposition to the provisions. The C.A.B. instituted a proceeding to consider the costs and benefits of the provisions.<sup>174</sup> On the fourth day of the hearing, however, Texas International withdrew its opposition, citing conditions similar to those in the Continental-Western case.<sup>175</sup> Thus, since no evidence against the provisions would be presented, the judge recommended ending the hearings as useless.<sup>176</sup> He noted that the Board wished to stop using the provisions, but concluded that this was not the proper case for such a decision.<sup>177</sup>

### Conclusion

The Texas International/Pan Am-National Merger Case first interpreted the parameters of airline merger under the A.D.A. While the administrative law judges tended to use traditional analytical tools in their decisions, the C.A.B. took a broader view. Recognizing that the A.D.A. was meant to change the traditional patterns of growth in commercial aviation, the Board rejected only those mergers that would produce a duopoly of control in an area. As deregulation proceeds, competition should increase in all areas of the country, with the possibility of duopolistic control lessening everywhere. Perhaps the last years of C.A.B. control will approach the "decontrol" the A.D.A. aspires to. The limits to merger will be the pressures of economy, often difficult to predict. As in the Pan Am-National merger, an unsuccessful merger attempt may be more financially rewarding than a completed one. Only time will tell if Pan Am was the winner in its endeavors.

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171. *Id.* at 82.

172. Second Continental-Western Order at 16 and Appendix B.

173. C.A.B. Docket No. 39285 (1981).

174. Texas International-Continental Acquisition Case, Docket No. 39285, C.A.B. Order 81-3-100 (Jan. 3, 1981).

175. Texas International-Continental Acquisition Case, Docket No. 39285, at 2 (Partial Decision of Judge Kane, Jr., May 22, 1981).

176. *Id.* at 3.

177. *Id.* at 4-5.

## Appendix A

The following abbreviated citation form is used: A.W. = Aviation Week & Space Technology; B.W. = Business Week; M.H. = Miami Herald; N.Y.T. = New York Times; W.S.J. = Wall Street Journal.

- 7/10/78 TXI announces it bought 790,700 shares of NAL's 8.6 million shares of common stock between June 12, 1978, and July 7, 1978, for \$14,355,780.45 including brokers' commissions. It is considering the possibility of seeking control. N.Y.T., July 11, 1978, § D, at 1, col. 1, W.S.J., July 11, 1978, at 2, col. 2; A.W., July 17, 1978, at 28.
- 7/28/78 TXI files with C.A.B. to seek control of NAL. Also notifies S.E.C. of intent to buy not more than 25% of NAL common stock. Stock to go in voting trust. C.A.B. Bureau of Consumer Protection notifies TXI that such purchases would be a "knowing and willful" violation of Federal Aviation Act. TXI has no definite plans for the acquisition. N.Y.T., July 29, 1978, § A, at 23, col. 3; W.S.J., July 31, 1978, at 3, col. 4.
- 8/8/78 NAL asks C.A.B. to delay approving TXI request to purchase more NAL stock and also asks that TXI be forced to detail its takeover plan. N.Y.T., Aug. 9, 1978, § D, at 1, col. 6; W.S.J., Aug. 9, 1978, at 11, col. 3.
- 8/16/78 TXI's Netherlands Antilles financing subsidiary announces offering of \$25 million convertible subordinated debentures paying 7½% convertible into TXI common stock at the rate of one share per \$14.50 of debentures. Proceeds will be used to buy additional NAL stock. W.S.J., Aug. 8, 1978, at 35, col. 2; W.S.J., Aug. 17, 1978, at 29, col. 1.
- 8/22/78 Pan Am files application with C.A.B. for permission to merge with NAL. Announces that it has acquired 411,600 shares or 4.8% of NAL's stock. Offers \$35/share or approximately \$286 million for acquisition. Pan Am also asks that it be allowed to purchase up to 25% of NAL stock. A.W., Aug. 28, 1978, at 30; W.S.J., Aug. 24, 1978, at 3, col. 1; W.S.J., Aug. 25, 1978, at 2, col. 3.
- 8/25/78 C.A.B. enters order tentatively allowing TXI to purchase up to 25% of NAL common stock. Requires that all stock in excess of 10% be placed in a voting trust device, with stock

- to be voted in same proportion as all non-TXI held NAL stock. Recommends that all such stock be placed in voting trust. Thirty days for comments before order is confirmed. TXI-NAL Acquisition Case & Enforcement Investigation, Docket No. 33112, Order 78-8-150 (Aug. 25, 1978); *see also* W.S.J., Aug. 18, 1978, at 6, col. 4.
- 8/28/78 C.A.B. permits Pan Am to purchase up to 25% of NAL common stock on same conditions as TXI. TXI case assigned to administrative law judge. N.Y.T. Supp. Mat., Aug. 29, 1978, at 12; W.S.J., Aug. 29, 1978, at 4, 1.
- 8/29/78 TXI has purchased 1,553,300 shares or approximately 18.2% of NAL stock for a total acquisition cost of \$42,193,501. TXI also announces foreign debenture sale completed. A.W., Sept. 4, 1978, at 36; W.S.J., Aug. 31, 1978, at 27, col. 4.
- 9/5/78 U.S. Justice Department announces its intent to intervene and files Petition for Intervention with the C.A.B. W.S.J., Sept. 5, 1978, at 2, col. 3.
- 9/6/78 Directors of Pan Am and NAL hold merger discussions in Miami, Florida. W.S.J., Sept. 6, 1978, at 2, col. 2; W.S.J., Sept. 7, 1978, at 5, col. 5.
- 9/7/78 C.A.B. consolidates TXI and Pan Am merger cases. Pan Am announces that it has a definitive merger agreement with NAL whereby Pan Am would purchase NAL for \$41/share or about \$350 million and would rename NAL Pan American U.S.A. W.S.J., Sept. 8, 1978, at 6, col. 4; TXI-NAL Acquisition Case/Pan Am Acquisition Case, Docket Nos. 33112 and 32283, Order Consolidating Cases 78-9-24 (Sept. 7, 1978).
- 9/11/78 TXI announces it has bought an additional 165,000 shares at a price per share of \$34.08. TXI has 1,718,300 shares at a total cost of \$48,816,076.45 or \$28.41 per share. W.S.J., Sept. 11, 1978, at 12, col. 3.
- 9/14/78 TXI petitions C.A.B. to permit it to acquire control of NAL. Eventually TXI expects a complete amalgamation of the two carriers, but has no specific plans at present. W.S.J., Sept. 15, 1978, at 38, col. 5.
- 9/15/78 U.S. Justice Department urges C.A.B. to prohibit further purchases of NAL stock by either Pan Am or TXI. Pan

- Am discloses details of the Pan Am-NAL merger agreement and that it has lined up \$300 million of the \$350 million credit needed for the purchase. Pan Am also has acquired 1,614,000 shares of NAL stock or 18.9% for a total purchase price of \$55,406,297. A.W., Sept. 25, 1978, at 21-22; W.S.J., Sept. 18, 1978, at 10, col. 2; W.S.J., Sept. 19, 1978, at 34, col. 2.
- 9/25/78 TXI asked by NAL if it expects to make an offer better than Pan Am's. W.S.J., Sept. 26, 1978, at 1, col. 2.
- 9/29/78 Frank Borman, EAL President, states that EAL would have to seek merger if either Pan Am or TXI are permitted to merge with NAL. EAL urges C.A.B. to disapprove both mergers. A.W., Oct. 2, 1978, at 33.
- 10/16/78 Pan Am files documentation with C.A.B. B.W., Nov. 6, 1978, at 67.
- 10/20/78 C.A.B. approves continued use of voting trusts by TXI and Pan Am. TXI-NAL Acquisition Case/Pan Am Acquisition Case, Docket Nos. 33112 & 33283, Order 78-10-100 (Oct. 20, 1978).
- 10/24/78 President Carter signs the Airline Deregulation Act of 1978, PUB. L. NO. 95-504, 92 STAT. 1705 (amending 49 U.S.C. § 1301 *et seq.*); W.S.J., Oct. 25, 1978, at 2, col. 3.
- 10/31/78 Hearing before Judge Dapper begins and lasts until January 12, 1979. Exhibits and transcripts total over 12,000 pages. Opening briefs filed by 25 organizations. TXI-NAL Acquisition Case/Pan Am Acquisition Case, Docket Nos. 33112 & 33283, Decision at 5 & 7 (Apr. 5, 1978).
- 11/3/78 TXI purchases 76,500 more shares of stock at \$22.34/share for a total holding of 1,969,000 shares, or \$54.5 million. TXI has acquired 23% of NAL at a per share average of \$27.45. A.W., Nov. 6, 1978, at 34.
- 12/11/78 EAL announces that it too will seek approval to merge with NAL. EAL offers \$50/share or \$425 million for NAL. Criticized as a defensive move. Financing may be difficult because of a high debt-equity ratio. A.W., Dec. 18, 1978, at 29; B.W., Dec. 25, 1978, at 35; N.Y.T., Dec. 12, 1978, § D at 1, col. 6; W.S.J., Dec. 12, 1978, at 3, col. 1.
- 12/13/78 EAL files application for merger approval with C.A.B. and requests that case be consolidated with the other two NAL

- merger cases. EAL Acquisition Case, Docket No. 34226, Decision at 1 (June 14, 1979).
- 12/15/78 NAL management unsure what it will recommend to its stockholders relative to the EAL merger attempt. Before EAL offer, NAL planned to recommend the lower Pan Am offer. W.S.J., Dec. 18, 1978, at 17, col. 1.
- 12/21/78 Despite contrary recommendation by Judge Dapper, C.A.B. denies EAL Petition to Consolidate all NAL merger cases. W.S.J., Dec. 22, 1978, at 8, col. 1.
- 12/22/78 S.E.C. investigation into adequacy of TXI's and Pan Am's public disclosures reported. EAL not affected. N.Y.T., Dec. 23, 1978, § 1, at 29, col. 5; W.S.J., Dec. 26, 1978, at 7, col. 1.
- 12/29/78 EAL announces that Chase Manhattan Bank has agreed to provide \$100 million of \$425 million purchase price. W.S.J., Jan. 1, 1979, at 19, col. 4.
- 1/22/79 U.S. Department of Justice files brief with C.A.B. opposing both TXI and Pan Am merger proposal on antitrust grounds. D.O.J. argues such mergers would have anticompetitive effects and would violate standards set by the Airline Deregulation Act of 1978. U.S. Department of Transportation, on the other hand, files briefs supporting both airlines. W.S.J., Jan. 23, 1979, at 48, col. 1.
- 1/25/79 Pan Am proposes amendment to its offer which would allow bidding between EAL and Pan Am if they receive final approval to merge with NAL. N.Y.T., Jan. 27, 1979, § 1, at 29, col. 4; W.S.J., Jan. 29, 1979, at 18, col. 2.
- 2/8/79 NAL announces auction plan whereby Pan Am and EAL would have five rounds of bids in a 48 hour period with Pan Am always getting the final bid. EAL states that it is willing to forego C.A.B. antitrust immunity to expedite its merger effort with NAL. N.Y.T., Feb. 9, 1979, § D, at 5, col. 1; W.S.J., Feb. 9, 1979, at 2, col. 3.
- 2/20/79 TXI makes formal bid to NAL of consideration that would be worth at least \$50/share composed of cash, debt securities, equity securities or a combination. W.S.J., Feb. 20, 1979, at 4, col. 2.
- 2/21/79 Air Florida asks C.A.B. approval to purchase NAL international routes and four of its DC-10 series 30 airplanes at



- same price that the purchaser of domestic route pays. Air Florida urges that Pan Am be given domestic route and Air Florida be given the international route. W.S.J., Feb. 22, 1979, at 29, col. 1.
- 3/9/79 NAL rejects TXI offer and says that after merger NAL shares would not be worth \$50 each because of TXI financing arrangements. W.S.J., Mar. 12, 1979, at 2, col. 2.
- 4/5/79 Administrative Law Judge Dapper files opinion in which he finds that the application of TXI to merge with NAL should be denied, further finds that TXI has violated 49 U.S.C. § 1378 by acquiring control of NAL without prior C.A.B. approval and finally recommends that Pan Am's application also be denied. TXI-NAL Acquisition Case/Pan Am Acquisition Case, Docket Nos. 33112 & 33283, Decision (Apr. 5, 1978); *see also* W.S.J., Apr. 6, 1979, at 7, col. 3.
- 4/25/79 NAL tells shareholders in supplementary proxy material that they, in effect, would be loaning TXI the money with which to buy NAL. Both the U.S. Departments of Justice and Transportation tell the C.A.B. they oppose the acquisition bid of EAL because it would reduce competition. W.S.J., Apr. 26, 1979, at 2, col. 2.
- 5/2/79 Pan Am formally raises its merger offer to \$50/share. M.H., May 3, 1979, § C, at 7, col. 3.
- 5/16/79 NAL shareholders approve Pan Am's revised merger offer at annual meeting. They also approve the management recommended auction plan which would give Pan Am the final bid should the C.A.B. approve Pan Am and EAL merger. TXI merger offer is rejected. Palm Beach Post, May 17, 1979, § C, at 5, col. 3.
- 6/14/79 Administrative Law Judge Murphy finds that the EAL application for merger with NAL should be denied because it would substantially lessen competition. EAL Acquisition Case, Docket No. 34226, Decision (June 14, 1979). *See also* M.H., June 15, 1979, § A, at 1, col. 5.
- 7/10/79 C.A.B. unanimously enters a preliminary order instructing its staff to prepare a final order permitting both TXI's application to acquire and Pan Am's application to merge. Preliminarily the Board finds that neither application is in-

- consistent with the public interest or anticompetitive under the standards prescribed by 49 U.S.C. § 1378. Further the C.A.B. lifts its 25% limits on the purchase of stock by both carriers because it does not want to preclude either carrier from purchasing the NAL stock at its present, possibly lower price. TXI-NAL Acquisition Case/Pan Am Acquisition Case, Docket Nos. 33112 & 33283, Order (July 10, 1979); M.H., July 11, 1979, § A, at 1, col. 5.
- 7/21/79 C.A.B. turns down Continental-Western merger proposal despite recommendation of administrative law judge. Many on Wall Street see this as signal that the Eastern proposal will also be rejected because of similar anticompetitive factors. M.H., July 24, 1979, § C, at 4, col. 1; M.H., July 25, 1979, § A, at 12, col. 2; A.W., July 30, 1979, at 22.
- 7/23/79 Pan Am announces that it has bought 95,000 shares of National the preceding week and 900,000 shares today for total holdings of 3.1 million shares or 36% of NAL stock. M.H., July 24, 1979, § C, at 4, col. 5.
- 7/24/79 NAL's stock topped the N.Y.S.E. active list with 1,191,400 shares traded. Pan Am confirmed it was buying, but refused to reveal numbers. Nine large blocks of stock totaling 911,400 shares were sold today and assumption is Pan Am was the buyer. If true then Pan Am had at least 4 million shares of National or roughly 47% of the total stock. M.H., July 25, 1979, § A, at 12, col. 2.
- 7/26/79 Pan Am publicly acknowledges that it is the majority shareholder in NAL, having purchased 4,398,500 shares in all for a total purchase price of about \$186 million or a per share average price of \$42.25. Eastern owns only about 100 token shares. Speculation is that TXI would make about \$45 million for its shares. M.H., July 27, 1979, § A, at 1, col. 6.
- 7/29/79 Pan Am and TXI announce Pan Am will buy NAL stock owned by TXI for 3 million dollars plus \$50 per share. TXI will realize pre-tax profit of \$45,780,000 on the sale of 2.9 million shares and Pan Am will own 75.9% of NAL. Palm Beach Post Times, July 29, 1979, § A, at 24, col. 1.
- 7/30/79 TXI President Lorenzo informs C.A.B. by letter that TXI will sell stock to Pan Am. TXI-NAL Acquisition Case/Pan

- Am Acquisition Case, Docket Nos. 33112 & 33283, Decision 79-12-163; 79-12-164; 79-12-165 at 61 (Oct. 24, 1979).
- 8/10/79 NAL announces fiscal year profit of \$24.22 million or \$2.83 per share. Palm Beach Post Times, Aug. 11, 1979, § A, at 19, col. 5.
- 9/13/79 N.Y.S.E. halts trading in T.W. Corporation (T.W.A. parent company) stock. Trading rapid because of TXI attempt to acquire T.W.A. through purchase of 1.6 million shares. TXI attempt rebuffed by T.W. Corporation. A.W., Sept. 19, 1979, at 26; N.Y.T., Oct. 29, 1979, § D, at 1, col. 3.
- 9/27/79 Informal C.A.B. decision disapproves Eastern merger bid with National. Anticompetitive effects cited. A.W., Oct. 1, 1979, at 23.
- 10/5/79 Eastern announces it will halt its pursuit of NAL in view of the C.A.B. decision. A.W., Oct. 8, 1979, at 29.
- 10/24/79 Formal 77 page C.A.B. decision issued approving both Texas International and Pan Am merger applications and setting out the detailed rationale of the Board. TXI-NAL Acquisition Case/Pan Am Acquisition Case, Docket Nos. 33112 & 33283, Decision 79-12-163; 79-12-164; 79-12-165 (Oct. 24, 1979); A.W., Nov. 5, 1979, at 32; M.H., Oct. 30, 1979, § A, at 1, col. 1; N.Y.T., Oct. 30, 1979, § A, at 1, col. 4.
- 12/7/79 Hearings to begin on London-Miami service proposals. Eleven airlines, including Pan Am, Eastern and Air Florida had filed proposals. A.W., Dec. 3, 1979, at 31.
- 12/22/79 President Carter approves TXI and Pan Am merger proposals. Letter from President Jimmy Carter to C.A.B. Chairman Marvin Cohen dated December 22, 1979. M.H., Dec. 23, 1979, § A, at 1, col. 1; N.Y.T., Dec. 23, 1979, § 1, at 12, col. 2.
- 12/26/79 C.A.B. grants Pan Am exemption for Miami-London route until permanent route decision made. Pan Am Acquisition Case, Docket No. 33283, Order 79-12-166 (Dec. 26, 1979).
- 12/31/79 Pan Am net income for the last full year of operation before acquiring National was reported as \$76.128 million, which was down from the \$118.801 million net income

- from the year before. PAN AMERICAN WORLD AIRWAYS, INC., ANNUAL REPORT 1979 at 2 (1980).
- 1/7/80 Formal acquisition of National by Pan Am. B.W., Jan. 21, 1980, at 56.
- 1/18/80 National certificates of public convenience and necessity formally transferred to Pan Am. Pan Am Acquisition Case, Docket No. 33283, Order 80-1-125 (Jan. 18, 1980).
- 1/29/80 U.S.-Great Britain bilateral talks begin. Gatwick over Heathrow is seen as a major issue. A.W., Jan. 21, 1980, at 31.
- 2/15/80 International Air Transportation Competition Act of 1979 signed into law by President Carter. Deregulates international aviation to extent possible. PUB. L. NO. 96-192, 94 Stat. 35 (Feb. 15, 1980).
- 2/22/80 Administrative Law Judge Elias Rodriguez recommends Eastern get Miami-London route. M.H., Feb. 23, 1980, § A, at 1, col. 8.
- 3/5/80 U.S.-British bilateral agreement initiated. All new London service, whether British or American, to be through Gatwick. A.W., Mar. 17, 1980, at 26.
- 4/3/80 D.O.T. announces it would support legislation for C.A.B. sunset in 1982 rather than 1985. A.W., Apr. 7, 1980, at 32.
- 4/7/80 Full C.A.B. gives Pan Am the Miami-London route because Pan Am was the only route applicant that could continue to serve Heathrow Airport under bilateral agreement. A.W., Apr. 14, 1980, at 24; M.H., Apr. 8, 1980, § A, at 1, col. 8; Palm Beach Post, Apr. 8, 1980, § B, at 9, col. 5.
- 7/1/80 Pan Am will be unable to meet the deadline for a fully completed merger because of labor problems caused by merger. A.W., Apr. 21, 1980, at 26.
- 7/28/80 Pan Am announces that it had agreed to sell its 59 story headquarters building in New York City to Metropolitan Life Insurance Company for a total sales price of \$400 million. Airline will continue to occupy the 15% of the building it was using. B.W., Aug. 11, 1980, at 25; TIME, Aug. 11, 1980, at 50.
- 10/6/80 Pan Am announces that Teamsters unions have reached agreement as to the integration of seniority lists for certain

- ground personnel. A.W., Oct. 6, 1980, at 36.
- 10/26/80 Pan Am and National officially become one completely merged airline operating solely under the Pan Am name. A.W., Oct. 6, 1980, at 36; PAN AMERICAN WORLD AIRWAYS, INC., 1980 ANNUAL REPORT 5 (1981).
- 12/31/80 Sale of Pan Am building officially recorded, which resulted in a gain of \$294.4 million. The company also showed an operating *loss* of \$87.819 million, compared to an operating *income* of \$112.703 million for the previous year. Because of the gain on the sale of the building, the net income for the year was \$80.266 million versus \$76.128 million for the previous year. *Id.* at 27.
- 3/12/81 Arbitrator Lewis M. Gill issues Award in In Re: Merger of Pan Am and National Airlines Flight Deck Crew Member Seniority Lists and thereby resolves the seniority integration problems. *See also* A.W., Mar. 2, 1981, at 38.
- 4/7/81 Pan Am founder and former C.E.O., Juan Trippe dies. TIME, Apr. 13, 1981, at 81.
- 5/11/81 Arbitrator Lewis M. Gill issues 59 page Opinion in In Re: Merger of Flight Deck Crew Member Seniority Lists, Pan Am and National Airlines, to explain and support his earlier Award.
- 5/20/81 Former National pilots group announces intent to organize all Pan Am employees in an effort to buy the controlling interest in the company. M.H., May 21, 1981, § A, at 1, col. 1.
- 6/30/81 Revenue passenger miles for first half of 1981 down 9.1% over same period in 1980 and Pan Am has a \$217.6 million operating loss for the first six months of 1981 versus a total 1980 operating loss of \$126.9 million. A.W., July 20, 1981, at 27; M.H., Aug. 15, 1981, § A, at 5, col. 1.
- 7/7/81 William Waltrip appointed President of Pan Am to succeed William Seawell. Pan Am changes to a holding company, with three divisions, one of which is the airline. A.W., July 13, 1981, at 30; M.H., July 8, 1981, § A, at 1, col. 1; M.H., July 19, 1981, § F, at 1, col. 1.
- 7/14/81 Pan Am announces 10% reduction in operations and the reduction of the payroll by 3,000 jobs. Operations in New York City will only be at J.F.K., rather than there and at

- Newark and LaGuardia. M.H., July 15, 1981, § A, at 1, col. 1; M.H., July 19, 1981, § F, at 1, col. 1.
- 8/3/81 P.A.T.C.O. strikes and causes disruptions in flight schedules and causes further losses. TIME, August 17, 1981, at 14; NEWSWEEK, Aug. 24, 1981, at 52.
- 8/15/81 Miami Herald reports that well placed sources indicated Pan Am might move its headquarters back to the former National headquarters at the Miami International Airport to take advantage of all the unused space that is available and to further reduce operating expenses. M.H., Aug. 15, 1981, § A, at 1, col. 5.
- 8/20/81 Earlier this week Pan Am announced that its profitable Inter Continental Hotel subsidiary or division is for sale. Directors are assembled today to allegedly consider approximately \$500 million offer for the 83 hotel chain in 48 countries from Grand Metropolitan Ltd., a giant British liquor and hotel company. PALM BEACH POST, Aug. 21, 1981, § D, at 9, col. 4.
- 8/21/81 Pan Am agrees to sell Inter Continental Hotel Corp., subsidiary to Grand Metropolitan Ltd. of London for \$500 million. Sale to be consummated on September 30, 1981. A.W., Aug. 31, 1981, at 29.
- 9/1/81 C. Edward Acker, chief executive officer of Air Florida, becomes chairman and chief executive officer of Pan Am. Eli Timoner to replace Acker at Air Florida. A.W., Aug. 31, 1981, at 29.
- 9/7/81 Pan Am announces 67% unrestricted fare cuts on many domestic routes to increase traffic. A.W., Sept. 14, 1981, at 34.
- 9/11/81 Pan Am signs formal agreement with syndicate of banks led by Citibank for a \$200 million line of credit. Unions required to take 10% pay cut as condition of loan. A.W., Aug. 24, 1981, at 31.
- 10/5/81 Senate Commerce Committee drafts further C.A.B. sunset legislation, which would require the C.A.B. to cease to exist by April 1, 1983. Thereafter mergers to be handled by Department of Justice as with any other industry. A.W., Oct. 5, 1981, at 49.

10/12/81 President Reagan gives final approval to TXI takeover of control of Continental Airlines, Inc. TXI owns 50.3% of stock for which it paid \$96.6 million. B.W., Oct. 26, 1981, at 182.

## Tax-Free Fringe Benefits and Social Security: Is It Time to Change the Rules?

Gail Levin Richmond\*

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[I]f benefits were keyed to wages earned, there would be something of a check upon the demands which might be made as to amounts of pensions, and . . . the method in which benefits were made dependent upon wages earned would fit the benefits somewhat to the circumstances of life of the beneficiary, because presumably his way of living would be fixed by the wages he had been in the habit of receiving; and his benefit would be fixed upon the same basis.<sup>1</sup>

When then Assistant Attorney General Jackson made the above argument in defense of the social security system, economic conditions were vastly different from those faced by Congress and the Court in 1981. There was no minimum wage, although a twenty-five cent per hour minimum was subsequently enacted in 1938.<sup>2</sup> The act under attack in *Helvering v. Davis* provided for a tax of only one percent, levied on no more than \$3,000 of an employee's annual wages,<sup>3</sup> and its modest retirement benefits were hardly surprising.<sup>4</sup> Fringe benefits, the sub-

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1. Opening Argument of Robert H. Jackson before the Supreme Court of the United States in the case of *Helvering v. Davis*, 301 U.S. 619 (1937), reprinted in S. Doc. No. 71, 75th Cong., 1st Sess. 9 (1937).

2. Fair Labor Standards Act of 1938, ch. 676, § 6, 52 Stat. 1062, *upheld in United States v. Darby*, 312 U.S. 100 (1941).

3. Social Security Act, ch. 531, tit. VIII, §§ 801, 811(a), 49 Stat. 636, 639 (1935). Employers paid a like amount. *Id.* § 804, 49 Stat. 637.

4. Monthly benefits ranged from 1/2 of 1% of the first \$3,000 aggregate covered wages to 1/24 of 1% of wages exceeding \$45,000. The maximum benefit allowed was \$85 per month. *Id.* tit. II, § 202, 49 Stat. 623.

The minimum wage has always lagged behind the FICA wage base. In 1940, for example, the thirty cents per hour minimum wage yielded annual earnings of only



ject of this article, were of minor importance; indeed, the Revenue Act of 1936 virtually ignored them.<sup>5</sup>

Several events occurred in 1981 which, considered as a group, suggest a re-examination of the continuing validity of the argument quoted above. The Supreme Court in *Rowan Cos. v. United States*<sup>6</sup> invalidated a Treasury regulation imposing social security (FICA) tax on the value of meals and lodging furnished employees for the employer's convenience.<sup>7</sup> Congress excluded from income the use of an employer-provided day care center,<sup>8</sup> extended the time period during which employer-provided legal assistance plan benefits would be excludible,<sup>9</sup> and continued until 1984 the moratorium preventing the issuance of Treasury regulations governing the tax status of fringe benefits.<sup>10</sup> And, in a move that has proven highly controversial,<sup>11</sup> that body accepted a Reagan administration proposal to eliminate the minimum benefit paid recipients of social security pensions.<sup>12</sup> Such a re-examination is particu-

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\$600; the FICA wage base was then \$3,000; in 1981, the amounts involved were, respectively, \$6,700 and \$29,700.

5. The only "fringe benefit" excluded by that act was a rental allowance provided ministers of the gospel. Revenue Act of 1936, ch. 690, § 22(b)(6), 49 Stat. 1658. The 1936 Act repeated the broad language of the 1913 Act taxing "compensation for personal service . . . in whatever form paid . . ." Act of Oct. 3, 1913, ch. 16, § II(B), 38 Stat. 167; Revenue Act of 1936, ch. 690, § 22(a), 49 Stat. 1657.

6. 101 S. Ct. 2288 (1981), *rev'g* 624 F.2d 701 (5th Cir. 1980). *Rowan* invalidated Treas. Reg. § 31.3121(a)-1(f) (1956). Also invalidated was a comparable provision interpreting wages for purposes of the Federal Unemployment Tax Act (FUTA), Treas. Reg. § 31.3306(b)-1(f) (1956). Although the problem discussed also affects the computation of that tax, the \$6,000 wage base provided in I.R.C. § 3306(b)(1) limits its application in most instances.

7. These items are excluded from gross income by I.R.C. § 119.

8. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 124(e), Daily Tax Report, Aug. 3, 1981 (Supp.) (signed Aug. 13, 1981). This provision will be codified as I.R.C. § 129.

9. *Id.* § 802 (extending I.R.C. § 120 through 1984).

10. *Id.* § 801.

11. See, e.g., *House Panel Challenges Administration over Minimum Benefit Data*, Daily Tax Report, Sept. 10, 1981, at G-2.

12. Pub. L. No. 97-35, § 2201, 95 Stat. 830; *cf.* H.R. 4331, 97th Cong., 1st Sess. (1981). See also H.R. 4342, 97th Cong., 1st Sess. (1981).

larly timely since further cuts in social security benefits, including the percentage of pre-retirement income they will replace, are currently under study.<sup>13</sup>

### Development of the Income Tax Rules

Congress did not exclude any fringe benefits from taxation until 1921<sup>14</sup> and then acted very slowly in exempting additional benefits.<sup>15</sup> Thirty-three years later, the 1954 Code excluded only employee death benefits,<sup>16</sup> amounts received under employer-financed health and accident plans<sup>17</sup> (and the amounts paid to fund such benefits<sup>18</sup>), meals and lodging furnished for the employer's convenience,<sup>19</sup> and a minister's rental allowance.<sup>20</sup> Furthermore, legislative activity between 1954 and 1976 served primarily to reduce the favorable tax treatment granted certain benefits.<sup>21</sup> Only after the Treasury Department issued its 1975 Discussion Draft of proposed fringe benefits regulations<sup>22</sup> did Congress wake up and begin enacting exclusions.

Noting that "[t]he status of most other fringe benefits is not answered expressly by statute,"<sup>23</sup> the Treasury Department proposed

13. Daily Tax Report, May 12, 1981, at X-1; *The Battle over Repairing Social Security*, BUS. WEEK, Sept. 28, 1981, at 116; STAFF OF SENATE COMM. ON FINANCE, 97TH CONG., 1ST SESS., REPORT ON SOCIAL SECURITY FINANCING (Comm. Print 1981).

14. Revenue Act of 1921, ch. 136, § 213(b)(11), 42 Stat. 227, enacting present I.R.C. § 107 (rental allowance furnished to a minister of the gospel). This provision overruled the IRS position expressed in O.D. 862, 4 C.B. 85 (1921).

15. The IRS excluded several benefits on its own, however. *See, e.g.*, O.D. 265, 1 C.B. 71 (1919); L. Op. 1014, 2 C.B. 88 (1920); O.D. 514, 2 C.B. 90 (1920); O.D. 915, 4 C.B. 85 (1921).

16. I.R.C. § 101(b).

17. *Id.* § 105.

18. *Id.* § 106.

19. *Id.* § 119.

20. *Id.* § 107.

21. I.R.C. § 79, enacted in 1964, limited an exclusion previously granted by the Treasury Department. *Compare* Revenue Act of 1964, Pub. L. No. 88-272, § 204, 78 Stat. 36, with Treas. Reg. § 1.61-2(d)(2), T.D. 6272, 1957-2 C.B. 21.

22. 40 Fed. Reg. 41,118 (1975) (proposing Treas. Reg. § 1.61-16) [hereinafter cited as 1975 Discussion Draft].

23. *Id.* at 41,119.

three exclusion categories. Many benefits would be excluded because they arose from the employer's business and the employer incurred no substantial additional costs in providing them; examples included stand-by travel privileges for flight attendants and employee discounts on merchandise.<sup>24</sup> Other benefits, such as bodyguards provided the president of a multinational company, qualified under a nine-item "facts and circumstances" test.<sup>25</sup> Finally, an exclusion was proposed for any benefit "so small as to make accounting for it unreasonable or administratively impractical."<sup>26</sup> These proposals, which were withdrawn in 1976,<sup>27</sup> resurfaced several years later.<sup>28</sup> By then, however, the list of statutory exclusions exempt from such regulations had been significantly expanded.

As befitted its title, the Tax Reform Act of 1976<sup>29</sup> was less than generous to fringe benefit recipients. Thus, Congress substantially narrowed the tax-free status of most employer-financed disability income payments,<sup>30</sup> basing eligibility to some extent on a needs test.<sup>31</sup> The only new exclusion enacted, that for employer-financed legal assistance,<sup>32</sup> even carried its own sunset provision.<sup>33</sup>

Several 1978 acts contained fringe benefits provisions. The Revenue Act of 1978, for example, excluded from gross income educational assistance program benefits.<sup>34</sup> Meals and lodging furnished an employee's spouse and dependents, a benefit whose tax status had never

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24. *Id.*

25. *Id.* at 41,119-20.

26. *Id.* at 41,120.

27. 41 Fed. Reg. 56,334 (1976).

28. Fringe Benefits Discussion Draft of Jan. 15, 1981, STAND. FED. TAX REP. (CCH) ¶ 8991 (not filed in Fed. Reg.) [hereinafter cited as 1981 Discussion Draft]. See also Discussion Draft Bill, [1979] 10 STAND. FED. TAX REP. (CCH) ¶ 6156 (proposing statutory rules).

29. Pub. L. No. 94-455, 90 Stat. 1520.

30. *Id.* § 505(a), 90 Stat. 1566 (I.R.C. § 105(d)).

31. *Id.*

32. *Id.* § 2134(a), 90 Stat. 1926 (I.R.C. § 120).

33. *Id.* 2134(e). The exclusion, granted for 1977 through 1981, was extended another three years by the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 802, Daily Tax Report, Aug. 3, 1981 (Supp.).

34. Pub. L. No. 95-600, § 164, 92 Stat. 2811 (I.R.C. § 127).

been resolved by the Internal Revenue Service,<sup>35</sup> were excluded from income by the Tax Treatment Extension Act of 1977.<sup>36</sup> That same act imposed a moratorium, extended in yet another 1978 act, preventing the issuance of fringe benefits regulations until 1980.<sup>37</sup> Finally, the Energy Tax Act of 1978 added an exclusion for group transportation provided employees between home and work.<sup>38</sup>

Each of the 1978 benefits can be defended as furthering a particular policy objective. Not only is a well-educated work force presumably more productive, but education is viewed by most people as a route to job advancement.<sup>39</sup> Tax laws have frequently been drafted to benefit families; thus, it is not surprising that Congress chose to ease the tax burden of individuals forced to live on the employer's business premises or live apart from the family-member employee.<sup>40</sup> Likewise, groups of employees traveling together in one vehicle presumably reduce traffic congestion (and the resulting accident rate), cause less highway deterioration, and use less fuel.<sup>41</sup> Nevertheless, each of these benefits would have been taxable if the 1975 Discussion Draft regulations had become final. Each involves an employer outlay which could easily involve substantial additional cost; none of them is so small that accounting for it is unreasonable or impractical; and none of them qualifies under the facts and circumstances test.<sup>42</sup>

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35. *Jacob v. United States*, 493 F.2d 1294 (3d Cir. 1974).

36. Pub. L. No. 95-615, § 205, 92 Stat. 3107 (1978) (amending I.R.C. § 119(a)).

37. *Id.* § 3, 92 Stat. 3097 (Oct. 1, 1977, through June 30, 1978); Act of Oct. 7, 1978, Pub. L. No. 95-427, § 1, 92 Stat. 997 (May 1, 1978, through December 31, 1979). A further extension was imposed by the Act of Dec. 29, 1979, Pub. L. No. 96-167, § 1, 93 Stat. 1275 (1979) (until May 31, 1981).

38. Pub. L. No. 95-618, § 242, 92 Stat. 3193 (redesignating I.R.C. § 124 as § 125 and inserting a new § 124).

39. The Senate Finance Committee was particularly concerned that the then-existing rules constituted a disincentive to upward mobility. S. REP. NO. 1263, 95th Cong., 2d Sess. 101 (1978).

40. The Tax Treatment Extension Act of 1977, of which this was but one provision, dealt in large part with employees working outside the United States.

41. The Senate Finance Committee stated its desire to encourage this energy-saving activity. S. REP. NO. 529, 95th Cong., 1st Sess. 59 (1977). At the same time, it noted that expected energy savings were negligible. *Id.* at 60.

42. Several of the examples contained in the 1975 Discussion Draft, while not exactly on point, provide useful analogies. Example (8) excluded reimbursements for

In early 1981, the Treasury Department again proposed regulations to govern items not mentioned in the Code.<sup>43</sup> This version would have taxed employees when they obtained or used any property, service or facility in connection with the performance of services; exceptions were provided only for benefits which constituted working conditions or which were excludible on grounds of administrative convenience.<sup>44</sup> While many examples in the 1975 proposals reappeared,<sup>45</sup> several 1981 items were far more onerous.<sup>46</sup> Thus, Congress' decision to extend the regulations moratorium through December 31, 1983, is hardly surprising.<sup>47</sup>

dinner and taxi fare paid to an employee who works several hours past normal quitting time because of the press of business. At the same time, Example (9) taxes chauffeur service used in transporting top executives to and from work. While Example (9) might be distinguished from the van-pooling allowed by I.R.C. § 124 because the former was limited to top executives, Example (8) would still prove troublesome as I.R.C. § 124 is not limited to overtime situations. *See also* Examples (11)-(15). In judging the exclusion for meals and lodging furnished relatives of an employee, *see* Examples (5)(c) & (6), which provide exclusions where no additional employer costs are involved for the family members.

Although an argument can be made on behalf of the educational benefits, which could enhance job performance, I.R.C. § 127 is not phrased in such narrow terms. Indeed, the only educational benefits it prevents from qualifying are those "involving sports, games, or hobbies." I.R.C. § 127(c)(1). Thus, an unlimited exclusion could easily frustrate the policy behind Treas. Reg. § 1.162-5(b). *See* Example (19), where the same argument is made with regard to employee use of the employer's day care center and the limitations of I.R.C. § 214 (which was repealed in 1976 and replaced with I.R.C. § 44A).

43. 1981 Discussion Draft, proposing Treas. Reg. §§ 1.61-17 to -20.

44. *Id.* § 1.61-17(a).

45. *E.g.*, 1981 Prop. Treas. Reg. § 1.61-18(d)(4) and 1975 Prop. Treas. Reg. § 1.61-16(f)(7) (taxi fare for safety reasons); 1981 Prop. Treas. Reg. § 1.61-18(d)(7) and 1975 Prop. Treas. Reg. § 1.61-16(f)(13) (bodyguards).

46. *Compare* 1981 Prop. Treas. Reg. § 1.61-19(b)(1) *with* 1975 Prop. Treas. Reg. § 1.61-16(f)(3) (employee discounts). *Compare* 1981 Prop. Treas. Reg. § 1.61-18(d)(9) & § 1.61-20(c)(3) *with* 1975 Prop. Treas. Reg. § 1.61-16(f)(6) (family members accompanying employee on business trips at no extra cost to employer). The 1981 proposals are reminiscent of language in S. REP. NO. 768, 93d Cong., 2d Sess. 161, 165-68 (1974), involving the examination of then President Nixon's tax returns; *cf.* INTERNAL REVENUE SERVICE, U.S. DEP'T OF THE TREASURY, PUB. NO. 463, TRAVEL, ENTERTAINMENT AND GIFT EXPENSES 4 (rev. Nov. 1980); Rev. Rul. 56-168, 1956-1 C.B. 94 (example 3).

47. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 801, Daily Tax

Congress also took the opportunity in 1981 to "grandfather in" a new exclusion<sup>48</sup> and to re-enact an expiring one.<sup>49</sup> There thus remain few fringe benefits which are not currently excluded from income by statute and, therefore, immune from the scope of any proposed regulations which may be forthcoming in 1984.<sup>50</sup>

### Effect of Exclusions

While an employee receiving compensation in kind is in no worse a position than his counterpart who receives cash and uses it to purchase the benefit,<sup>51</sup> this discussion is limited to those compensatory benefits which are excluded from the employee's income.<sup>52</sup> Such benefits allow the employee to improve his economic situation over that of the worker receiving cash and purchasing the benefit. The extent of this enrichment varies, as is shown in the following example, with the tax consequences attendant upon the purchase.

This discussion involves Employee X, whose employer will pay him a salary of \$20,000 in 1982.<sup>53</sup> The employer will also purchase Blue Cross health insurance coverage for X, pay tuition for X to attend law

Report, Aug. 3, 1981 (Supp.). Although the moratorium ended May 31, and the act was not passed by Congress until August, the Treasury Department acceded to Congressional warnings to promulgate no regulations during this period. *See* Daily Tax Report, June 17, 1981, at G-2.

48. Pub. L. No. 97-34, § 124(e). I.R.C. § 129, which this provision added, is discussed in notes 65-66 *infra*.

49. *Id.* § 802, extending the I.R.C. § 120 exclusion for group legal assistance plans through December 31, 1984.

50. *But see* S. 1479, 97th Cong., 1st Sess. (1981) (adoption subsidies). As there is a large group of tax practitioners supporting Congressional, rather than administrative, resolution of the fringe benefits problem, the 1984 rules may instead be statutory. *See, e.g.*, Discussion Draft Bill, [1979] 10 STAND. FED. TAX REP. (CCH) ¶ 6156.

51. If the benefit is taxable, he will have gross income equal to that of his counterpart receiving cash, and any deduction allowed for such purchase will reduce the amount of his income. If the benefit is excludible, he will have no increase in his taxable income whether or not he could have deducted the purchase.

52. As the discussion thus far indicates, those items are substantial in number. *See* I.R.C. § 125, which allows an employee to be taxed with reference to the benefits he chooses, rather than the benefits he could have chosen, when his employer offers a choice among benefits; *cf.* I.R.C. § 305(b)(1).

53. This example is based on the law in effect during 1982.

school part-time, and allow X's child to stay in the day care center connected to its office. Each of these benefits is worth \$600 to X, who is a widower and has no other source of income.

Because X's employer will deduct its cost for all these items,<sup>54</sup> any item excluded by X will be one on which neither party is taxed. While such omissions may result in a higher level of tax rates overall,<sup>55</sup> that issue does not concern X. He would rather know if any of the in-kind benefits are taxable and whether his tax consequences would have differed had his employer increased his salary by \$1,800 and offered no benefits.<sup>56</sup>

Only the cash salary will be included in X's 1982 income.<sup>57</sup> Thus X will have a gross income of \$20,000 if he receives the fringe benefits in kind, and \$21,800 if he instead receives their cash value. In the latter instance his tax liability will increase unless he can offset the additional \$1,800 by deductions or credits arising from his purchasing the benefits himself.

Code Section 213 provides a deduction for medical care expenses, including premiums for insurance designed to reimburse the taxpayer for costs incurred.<sup>58</sup> Because the Section 213 deduction is computed with reference to a taxpayer's income, X may be limited to a deduction of only \$150 and be left with a residual tax liability.<sup>59</sup> In fact, unless X itemizes his deductions, he will receive no relief at all.<sup>60</sup>

Regulations covering allowable trade or business expense deductions are relevant to the tuition benefit.<sup>61</sup> Because Code Section 162

54. I.R.C. § 162(a)(1).

55. See, e.g., Ott, Ott & Turner, *Burden Distribution of a Broad-Based Personal Income Tax System and Its Implications for Tax Reform Discussions*, 34 LAW & CONTEMP. PROB. 805 (1969).

56. See *Martin v. Commissioner*, 649 F.2d 1133, 1134 (5th Cir. 1981) (Goldberg, J., dissenting) for a discussion of this issue in the context of a different fringe benefit, an interest-free loan from employer to employee.

57. I.R.C. §§ 106, 127, 129.

58. *Id.* § 213(e)(1)(C).

59. Medical expenses are deductible only to the extent they exceed 3% of adjusted gross income; insurance premiums can be deducted without regard to that floor to the extent they do not exceed the lesser of \$150 or one-half of the premiums. *Id.* § 213(a).

60. *Id.* § 63(b) & (c).

61. Treas. Reg. § 1.162-5, as amended by T.D. 6918, 1967-1 C.B. 36.

allows deduction of expenses incurred in carrying on a trade or business, these regulations forbid a deduction for education expenses which would qualify the taxpayer for a new trade or business.<sup>62</sup> If X is already an attorney pursuing post-graduate studies, a deduction will be allowed; if he is seeking a J.D. degree, he could not deduct his tuition.<sup>63</sup> Moreover, because he is not self-employed, X must itemize to take any deduction otherwise allowed.<sup>64</sup>

Child care costs incurred so that a taxpayer can work are allowed as credits whether or not the taxpayer itemizes deductions, but Code Section 44A limits the credit to twenty percent of the amount paid.<sup>65</sup> Thus, while payment by X of \$600 would save him \$120 in tax, including that \$600 in his income results in a larger tax increase.<sup>66</sup>

As the above example illustrates, a taxpayer receiving benefits in kind will frequently be better off financially than a taxpayer receiving cash remuneration who purchased comparable benefits. Even in those instances where their income tax consequences are identical, the former is further benefited by the in-kind payment because it saves him the trouble of reporting an item of income and offsetting it on his tax return by the allowable deduction or credit.

### Employment Taxes

The question involved in *Rowan* was not one of gross income, but rather one of employment taxes. The particular benefit, meals and lodging for employees, had been subjected to FICA and FUTA, but not withholding taxes despite similar statutory language in the three provi-

62. *Id.* § 1.162-5(b)(3).

63. The Tax Court has denied a New York attorney a deduction for a bar review course undertaken to qualify him for practice in California. *Sharon v. Commissioner*, 66 T.C. 515 (1976), *aff'd*, 591 F.2d 1273 (9th Cir. 1978), *cert. denied*, 442 U.S. 941 (1979).

64. Compare the varying treatments of § 162 deductions granted by I.R.C. § 62(1) (self-employed individuals) and § 62(2) (employees).

65. Had X's 1982 income been substantially lower, the credit might have been as high as 30%. I.R.C. § 44A(a)(2). Because X has only one dependent, the amount against which the percentage is applied is limited to \$2,400. *Id.* § 44A(d).

66. Based upon 1982 rates for an unmarried head of household, his marginal rate would exceed 20% so long as his taxable income exceeded \$11,800. *Id.* § § 1(b)(1), 2(b).



sions.<sup>67</sup> A brief discussion of these provisions' evolution will aid in understanding the Court's opinion.

The federal government first instituted a withholding system for taxes when it established the social security system in 1935.<sup>68</sup> Because that tax was imposed at a flat rate, with no exemptions for low income taxpayers, and because a matching contribution was due from employers, this method of collection was more efficient for the government than that used for the income tax since its 1913 enactment. In fact, the relative ease of using withholding as a collection device led Congress to adopt it for the income tax in 1942 when World War II forced a "drastic increase in rates."<sup>69</sup>

As the Court noted in *Rowan*, certain exceptions to the definition of wages found in the 1942 legislation were identical to exceptions in the social security provisions.<sup>70</sup> However, the Senate Finance Committee justified these exceptions as a means of relieving farmers, housewives and certain other groups of the burden of collecting and accounting for small amounts.<sup>71</sup> This justification would be inapplicable to remuneration paid in kind by an employer who was already withholding tax on cash remuneration.<sup>72</sup>

### The *Rowan* Litigation

Although the general statutory scheme for withholding and em-

67. *Id.* §§ 3121(a) (FICA), 3306(b) (FUTA), 3401(a) (income tax withholding).

68. Social Security Act, ch. 531, tit. VIII, 49 Stat. 636 (1935).

69. H.R. REP. NO. 2333, 77th Cong., 2d Sess. 14 (1942). Congress was also interested in promoting a more uniform application of income tax law; reducing the administrative problems of collection; and reducing inflation through restricting spending. *Id.* at 14-15. See also *Hearings on Withholding Provisions Before a Subcomm. of the Senate Comm. on Finance*, 77th Cong., 2d Sess. 125-36 (1942) (statement of Milton Friedman, Division of Tax Research, Treasury Department) (confidential Comm. Print).

70. S. REP. NO. 1631, 77th Cong., 2d Sess. 166 (1942); 101 S. Ct. at 2293.

71. S. REP. NO. 1631, *supra* note 70, at 166. The government itself would be relieved of the "administrative burden and cost of collection entailed in the handling of numerous returns involving only nominal amounts." *Id.*

72. The Act clearly included non-cash compensation within its coverage. Revenue Act of 1942, ch. 619, § 172(a), 56 Stat. 884, 887; S. REP. NO. 1631, *supra* note 70, at 166.

ployment taxes still treats non-cash remuneration as wages,<sup>73</sup> Congress has specifically excluded from coverage many of the fringe benefits previously discussed.<sup>74</sup> The particular benefit provided in *Rowan* was not among these exclusions.

Rowan Companies (Rowan) operated drilling rigs, some of which were as far as sixty miles offshore. Because transporting employees between land and these rigs was more costly than feeding and housing them at the worksite,<sup>75</sup> Rowan provided meals and lodging at that site.<sup>76</sup> The company did not treat the value of these items as wages subject to withholding; nor did it consider them wages for purposes of computing FICA or FUTA tax contributions.<sup>77</sup> Acting in accord with its regulations,<sup>78</sup> the Internal Revenue Service claimed that the latter two taxes were due. Rowan paid the amount in dispute and sued for a refund. Although the government prevailed in district court as well as in the Fifth Circuit,<sup>79</sup> Rowan's position was upheld by the Supreme Court.<sup>80</sup>

The Court described in great detail the development of Code and regulations provisions defining wages.<sup>81</sup> Although the challenged regulations originated in 1940, the government's inconsistencies in interpretation negated its use of the re-enactment doctrine to refute Rowan's claim that Congress intended a uniform definition of wages for income and employment taxes.<sup>82</sup> More important, in the Court's view, was the fact that wages are defined in substantially the same terms for purposes

73. I.R.C. §§ 3121(a) (FICA), 3306(b) (FUTA), 3401(a) (income tax withholding).

74. *Id.* § 3121(a)(2), (17) & (18); § 3306(b)(2), (12) & (13); § 3401(a)(14) & (19).

75. 101 S. Ct. at 2290.

76. Only employees assigned to offshore rigs received this benefit. *Id.*

77. *Id.*

78. Treas. Reg. §§ 31.3121(a)-1(f), 31.3306(b)-1(f) (1956).

79. 624 F.2d 701 (5th Cir. 1980) (*aff'g* an unreported grant of summary judgment by the district court for the Southern District of Texas).

80. 101 S. Ct. at 2288.

81. *Id.* at 2293-97.

82. *Id.* at 2296. "The differing interpretations were not substantially contemporaneous constructions of the statutes . . . . Nor is there evidence of any particular consideration of these regulations by Congress during re-enactment." *Id.* at 2297.

of withholding and employment taxes,<sup>83</sup> particularly since the withholding statute was the last of the three enacted.<sup>84</sup> Finally, the Court was impressed with an idea expressed by it in an earlier decision,<sup>85</sup> that "wages" is a narrower concept than "income";<sup>86</sup> an item excluded from a taxpayer's income could thus not be included in his wages.<sup>87</sup>

The inconsistencies the Court noted are very real. But they become somewhat less important when it is remembered that Congress did not merely re-enact the employment and withholding tax provisions in 1954 and then stop legislating. Between 1954 and 1967, the first year litigated in *Rowan*, Congress made several changes in the statutory rules governing fringe benefits and thus had ample opportunity to express displeasure with Treasury regulations interpreting the definitions of wages.<sup>88</sup> Further, while the Court is correct in stating that the three definitions of wages are substantially the same, the coverage of these taxes has never been identical.<sup>89</sup> Indeed, in view of the different Congressional goals, differences should be expected. Employment taxes are designed to finance replacement of income during periods of unemployment, voluntary or otherwise; if an employee's fringe benefits also cease during such periods, he will need more than a mere percentage replacement of cash wages to maintain his life style.

As it clearly reduces the employer's and employee's reporting requirements (as well as their tax liabilities), the Court's determination that an item excluded from income cannot be included in wages is appealing from an administrative standpoint. Any other determination would be nonsensical for purposes of income tax withholding, since an excluded item is never taxed and the withheld amount would eventually be refunded to the taxpayer. But for purposes of the employment taxes,

83. *Id.* at 2293.

84. *Id.*

85. *Central Ill. Pub. Serv. Co. v. United States*, 435 U.S. 21 (1978).

86. *Id.* at 25. *See Rev. Proc. 80-53*, 1980-2 C.B. 848, providing for reporting items excluded from withholding as "other compensation" on the Form W-2 issued by the employer.

87. 101 S. Ct. at 2293.

88. For example, Congress enacted I.R.C. § 79 in 1964. Revenue Act of 1964, Pub. L. No. 88-272, § 204(a)(1), 78 Stat. 36.

89. *E.g.*, Students employed by their universities are not subject to FICA tax withholding, but they are subject to income tax withholding. I.R.C. § 3121(b)(10) has no counterpart in § 3401.

that rationale need not apply to compensatory items.<sup>90</sup> Not only do employment taxes have a different purpose, but on several occasions Congress itself has used language indicating that it considers the concepts of income and wages to be intersecting, rather than concentric.<sup>91</sup>

## Conclusion

*Rowan* is a troublesome case in terms of employment taxes. Both the magnitude of the particular type of fringe benefit in relation to monetary wages, and the fact that the statute did not clearly exclude these items from wages, are arguments justifying a different result.<sup>92</sup> However, *Rowan* involves one particular exclusion from employment taxes. In no way does it diminish other exclusions which have a statu-

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90. If the item is not compensatory in nature, there is no justification for the employer's deduction. I.R.C. § 162(a)(1). See H.R. REP. NO. 615, 74th Cong., 1st Sess. 32 (1935), rejected by the *Rowan* Court as ambiguous. 101 S. Ct. at 2295.

91. In the Revenue Act of 1924, ch. 234, 43 Stat. 253, Congress provided a tax credit for earned net income. In so doing, it defined earned income to include "wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered . . ." *Id.* § 209(a)(1), 43 Stat. 263. That definition was changed in 1934 to include the following language: "but does not include any amount not included in gross income . . ." Revenue Act of 1934, ch. 277, § 25(a)(5)(A), 48 Stat. 692. The Senate made specific mention of this change and included by way of example "a taxpayer whose entire earned income consists of a salary which is exempt from tax . . ." S. REP. NO. 558, 73d Cong., 2d Sess. 27 (1934).

Likewise, in 1976 Congress enacted § 120, but it did not make the conforming amendment, § 3121(a)(17), until 1978. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2134(a), 90 Stat. 1926; Act of Oct. 17, 1978, Pub. L. No. 95-472, § 3(b), 92 Stat. 1333. Moreover, I.R.C. § 3401(a) contains no comparable language.

Finally, the Senate Finance Committee Report accompanying the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, contains the following language: "Remuneration is not necessarily excluded from the definition of employment tax wages for purposes of employment taxes and income tax withholding simply because it is excludible from gross income under some other section of the Code." S. REP. NO. 1263, 95th Cong., 2d Sess. 100 (1978). While the above language does lend credence to the Court's argument that wages is defined the same way for purposes of each tax, it also shows that Congress was not troubled by the idea that income was sometimes narrower than wages.

92. Unlike the exemptions for group legal services plans and educational benefits programs, there is no statutory language excluding meals and lodging from any of the three taxes.

tory basis; those items would still have been excluded even had the government prevailed in *Rowan*.<sup>93</sup>

The impact of these exclusions reaches beyond the taxpayer's calculations for a particular year. To the extent an individual bases his life style upon items of compensation<sup>94</sup> which are not included in the tax base for social security benefits, he is likely to find his post-retirement life style inferior to that which he maintained during his working years. While individuals whose includible compensation exceeds the applicable wage base upon which FICA contributions are assessed are expected to encounter this phenomenon,<sup>95</sup> lower-paid workers may encounter a more acute problem.<sup>96</sup> Although some benefits may be continued by the former employer,<sup>97</sup> and others may be available through government transfer programs,<sup>98</sup> the retiree must self finance or forego the remainder. Before it extends tax-free status to any additional fringe benefits, Congress should consider whether subjecting such benefits to FICA tax now would result in significantly higher future benefits for individuals presently earning less than the FICA wage base. Perhaps it is time to rewrite Code Section 3121(a), not merely to reverse the result in *Rowan*, but to restore meaning to its definition of wages.<sup>99</sup>

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93. See, e.g., I.R.C. § 3121(a)(2), (17) & (18).

94. Although excluded from gross income, these items still constitute "compensation." See, e.g., *id.* § 119(b)(1); Treas. Reg. § 1.119-1(a)(1), T.D. 6220, 1957-1 C.B. 56-57.

95. Individuals whose salaries exceed \$29,700 are presumably better able to save for retirement than are individuals earning the minimum wage.

96. Particularly hard hit will be workers who are not covered by an employer-financed pension plan.

97. See, e.g., I.R.C. § 79(b)(1); Rev. Rul. 75-22, 1975-1 C.B. 49.

98. E.g., Medicare and Legal Aid.

99. The Internal Revenue Service has already issued a ruling effectuating the holding in *Rowan* but warning taxpayers that meals and lodging which do not satisfy the I.R.C. § 119 tests are subject to FICA. Rev. Rul. 81-222, 1981-39 I.R.B. 8.

Commentary

## Bringing It All Back Home: Toward a Closer Rapport Between Lawyer and Layperson

**Michael L. Richmond\***

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“Everyone strives to reach the Law,” says the man, “so how does it happen that for all these many years no one but myself has ever begged for admittance?”<sup>1</sup>

The public has never harbored any great love for the legal profession, yet it has openly avowed deep respect for and deference to the law itself.<sup>2</sup> For some reason, the public fails to translate its admiration for the law into an esteem for attorneys. Recently, manifestations of this public discomfort with the profession have exhibited themselves in mov-

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1. F. KAFKA, *Before the Law*, in THE COMPLETE STORIES 4 (Schocken Books 1971).

2. One can hardly deny the truth of this dichotomy. A simple glance through the pages of BARTLETT'S FAMILIAR QUOTATIONS (13th ed. 1955) will serve to demonstrate both the contempt felt for lawyers and the esteem for the law. See Kupferberg, *An Insulting Look at Lawyers Through the Ages*, JURIS DOCTOR, Oct./Nov. 1978, at 62 for a compendium of literary attacks on attorneys from Luke's "Woe unto ye also, ye lawyers!" to Will Rogers' "Lawyers make a living out of trying to figure out what other lawyers have written." See also Richmond, Book Review (A. HIGGINBOTHAM, IN THE MATTER OF COLOR: RACE AND THE AMERICAN LEGAL PROCESS, THE COLONIAL PERIOD), 3 NOVA L.J. 339 (1979). A remarkably thorough survey conducted in 1960 concluded that, as compared to other professions, the general reputation of lawyers (as a group in the community) was virtually at the bottom, even though as individuals attorneys were highly regarded. MISSOURI BAR PRENTICE-HALL SURVEY: A MOTIVATIONAL STUDY OF PUBLIC ATTITUDES AND LAW OFFICE MANAGEMENT 41 (1963) [hereinafter cited as MISSOURI BAR SURVEY].

ies, television shows, and highly popular literature. This attitude toward lawyers, rather than improving over the years, remains just as poor today as ever.

One recent film, *And Justice for All*, perhaps exemplifies the problem as well as any. As the film opens, the attorney-hero finds himself imprisoned for contempt of court. Since he came to this unfortunate state of affairs by insulting a judge during an overzealous representation of his client, the film from its very outset requests the viewer to accept that the only "good" attorney has no respect for the system itself. Assuming we can fairly judge from this showing, the public still conceives of lawyers as negative figures, put on earth to hinder rather than effectuate the course of justice.

Nor should we lightly dismiss the impact of nonscholarly works, since a great demand exists for popular works about the law. *And Justice for All* was a highly popular production, as were *The Paper Chase* and its film version.<sup>3</sup> However, these films do not portray the lawyer as those in the profession would wish. Attorneys appear as petty, bickering individuals with narrow minds and low morals. The attorney-hero must fight the other members of the profession, or at least demonstrate disgust and dismay at their antics. The entertainment industry, at least, views attorneys as fit objects for criticism and ridicule, but for little else.<sup>4</sup>

While fiction about lawyers fares well at the bookseller's, nonfiction also receives considerable public attention. Despite fairly widespread criticism in legal literature, *The Brethren* made a good deal of

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3. J. OSBORNE, *THE PAPER CHASE* (1971). The television version did not fare as well. However, despite its relatively weak showing (it was aired in direct time conflict with two highly popular comedies), it still had an average viewing audience of 8.5 million households every week and was warmly received by television critics. Houseman, *Kingsfield's Folly: The Death of The Paper Chase*, *STUDENT LAW.*, Jan. 1980, at 36. Even with *The Paper Chase*, which presented a sympathetic view of one law student's efforts to gain a legal education, the public received a negative view of attorneys. The blocking characters placed in the path of the student — his professors, his fellow classmates — continued to demonstrate all of the negative stereotypes which have plagued the profession in popular depictions. Osborne's 1977 work, *The Associates*, also sold well as a novel but met a sadder fate as a television comedy series.

4. See Cohen, *Has the Media Ruined the Image of Lawyers?*, *NOVA PERSPECTIVE*, Fall 1980, at 9. But see *MISSOURI BAR SURVEY*, *supra* note 2, at 191.

money for its authors and publisher.<sup>5</sup> Virtually every major figure involved in the Watergate affair has published a book, some analyzing the situation from a close legal perspective.<sup>6</sup>

Quite simply, the public wants to learn more about the legal profession — the way attorneys conduct themselves, the way the law is fashioned, the way justice proceeds. Unfortunately, what they learn has not come in packaging designed to display the profession at its best. In 1977, only 27% of those surveyed in the Gallup poll rated the honesty and ethical standards of attorneys as being high or very high. In contrast, 62% of those surveyed gave such a rating to the clergy and 52% to physicians.<sup>7</sup> In terms of public confidence in the profession, a Harris poll taken the same year showed only 16% of those surveyed had a great deal of confidence in law firms — a drop from 24% in 1973.<sup>8</sup>

These public opinions are danger signals. Lawyers need to exert more leadership in community affairs, and lawyers who are involved in community affairs should be identified as lawyers. Finally, the organized Bar must assume an active role in making more clear to the public the nature and necessity of a lawyer's services, and the manner in which he charges for his services.<sup>9</sup>

If the profession does not heed this advice, we will continue to see even the best intentioned plans of the bar received by the public in an unsavory and negative manner.<sup>10</sup>

In Kafka's parable, which provided the introductory quotation, a

5. B. WOODWARD & S. ARMSTRONG, *THE BRETHERN: INSIDE THE SUPREME COURT* (1979). Cf. *Sharp Blows at the High Bench*, TIME, Mar. 10, 1980, at 48: "Tell-it-all books on the Supreme Court may yet become a new publishing genre."

6. E.g., L. JAWORSKI, *THE RIGHT AND THE POWER: THE PROSECUTION OF WATERGATE* (1976); J. SIRICA, *TO SET THE RECORD STRAIGHT* (1979).

7. *View from the Other Side of the Bar: the Public Looks at Lawyers*, PUB. OPINION, July/Aug. 1978, at 37-38. A 1981 Gallup poll shows the rating for attorneys has slipped to 25% of those surveyed. Miami Herald, Sept. 20, 1981, § A, at 20, col. 2.

8. *View from the Other Side of the Bar*, supra note 7, at 36-37.

9. Thomason, *What the Public Thinks of Lawyers*, 46 N.Y.S. B.J. 151, 157 (1974).

10. Consider the headline of an article in a national newsmagazine, discussing the plans of the profession to improve itself through continued education: "Message for Bungling Lawyers — 'Shape Up!'" U.S. NEWS & WORLD REPORT, Aug. 27, 1979, at 57.



man from the country seeks admission to the law. The doorkeeper confronting him makes him comfortable and takes his bribes, but nonetheless refuses him admission. At the moment the man dies, the doorkeeper tells him that the door was fashioned for him and him alone, and will now be shut.<sup>11</sup>

This parable best summarizes the perceived relationship between lawyer and layperson. The layperson believes he or she has the absolute right to understand the law. Barring the way stands the lawyer who, despite all pleading, deliberately obscures all knowledge of the law. Instead of appearing as a facilitator, the lawyer seems to be a blocking figure. In such a relationship, the layperson cannot help but resent the attorney. We thus differ from physicians, who have superior knowledge in a field about which the layperson has no reason to know. Lawyers have superior knowledge in a field which so pervades daily life that the layperson feels the need to intimately understand it.

We serve ourselves poorly when we contribute, actively or passively, to perpetuate the layperson's relative ignorance of the law. Instead, we should assist the nonlawyer to comprehend the problems which the attorney encounters on a daily basis. Only in this manner can we achieve the proper balance between the professional and the layperson — a relation in which the client comprehends the basic ground rules and looks to the lawyer as a professional who, rather than interpreting the rules, performs the highly skilled duties required by a complex legal system.

The very language a lawyer uses contributes to this client dissatisfaction.

Another thing wrong with many of us lawyers is that we conduct our professional affairs in an impenetrable idiom, akin to the physician with his cryptic diagnoses and his inscrutable prescriptions, written in chicken-tracks. The truth is that the doctor's cryptography is a lesson in lucidity when compared with the lawyer's written and oral hieroglyphics.<sup>12</sup>

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11. F. KAFKA, *supra* note 1. Kafka's distressing vision of the citizen, placed innocently and unknowingly before an inscrutable legal mechanism, finds its fullest development in *THE TRIAL* (1937), published in German as *DER PROZESS* (1925).

12. Waltz, *The Unpopularity of Lawyers in America*, 25 CLEV. ST. L. REV. 143, 147 (1976). See generally Richmond, *supra* note 2.

Beyond any question, the public feels even more alienated from the law when it cannot understand the very language in which we attempt to communicate its concepts.

The public may be said to view law as a system of rules by which society governs itself — a sort of complex conglomeration of regulations permitting one to live as a social animal. Accordingly, the average citizen must of necessity reach the ultimate depths of frustration when the rules themselves are incomprehensible. When attorneys, by their language, reinforce the public image that the law is indeed an impenetrable fortress whose entrance is barred by reams of obfuscating verbiage, that frustration leads the public to lash back at those who created the blockage.

Again, virtually everything attorneys do, particularly on a subconscious level, seems calculated to alienate the public from the law. This problem permeates the entire system. "Trial judges . . . retreat to the sanctity of their chambers where they can perform without embarrassment, off the record. Those paneled walls provide a shelter for the timid, the artless, the indecisive, who routinely take even the simplest matters under advisement, rather than risk a clumsy ruling."<sup>13</sup> This ivory tower portrayal is compounded by the Chief Justice of the United States who routinely shuns television reporters, to the point of refusing to appear at a conference should cameras dare to be present. Yet in direct contrast to this "high citadel" image,<sup>14</sup> "[m]ore than ever before, the layman feels the influence of the law on his life."<sup>15</sup> We must work to improve our image with the public by improving the public's access to the law itself. Attorneys must improve their communicative skills.<sup>16</sup>

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13. Stafford, *Our Tottering Legal System*, 43 TEX. B.J. 207, 212 (1980).

14. Consider the recent argument for change in the hoariest bastion of legal education, Harvard Law School. J. SELIGMAN, *THE HIGH CITADEL: THE INFLUENCE OF HARVARD LAW SCHOOL* (1978).

15. Mersky, Berring & Richmond, *Acquisition & Selection of Primary & Secondary Legal Material for Social Science Collections*, 1 BEHAVIORAL & SOC. SCI. LIBRARIAN 127, 127 (1979).

16. "We lawyers cannot write plain English. We use eight words to say what could be said in two. We use old, arcane phrases to express commonplace ideas. Seeking to be precise, we become redundant. Seeking to be cautious, we become verbose." Wydick, *Plain Language for Lawyers*, 66 CALIF. L. REV. 727 (1978). Professor Wydick's article and later book provide the attorney with a superb guide for improving English prose. If members of the profession would simply use the aids available to

Judges must be more open in their dealings with the public.<sup>17</sup> We must publicly acknowledge our shortcomings, and actively work to correct them.<sup>18</sup> At the same time, we must affirmatively bend our efforts to improving our image overall.

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them, the general level of writing among lawyers would rise dramatically.

17. Stafford, *supra* note 13, at 212.

18. The area of legal malpractice deserves far greater treatment than is possible within the confines of this commentary. It deserves mention because there can be no greater way of breaching public faith with a profession than to have the profession include among its members those who can practice in an unethical or shoddy manner with little or no fear of censure by their peers. In this area in particular, however, great strides have been made in the last decade.

After initial prodding by Ralph Nader in the early 1970's, the legal profession began to examine its role in society and its own ethical superstructure. See Nader, *The Role of the Lawyer Today*, MICH. ST. B.J., Nov. 1970, at 17. Continuing beyond Nader's preliminary considerations, Monroe Freedman raised the profession's awareness of the serious problems with its ethical standards in his highly controversial *LAWYERS' ETHICS IN AN ADVERSARY SYSTEM* (1975). Whatever view an attorney took of Freedman's depiction of an attorney, as one who acts ethically only when actively defending the rights of a client against all comers, that attorney was certain to be discussing the matter — perhaps for the first time in his or her entire career. Today, formulations and reformulations of codes of ethics abound.

More to our purpose is the current dialogue on improving the quality of the profession while at the same time policing malfasants. Most comforting is that the dialogue takes place not only in the journals of law schools (see, e.g., Wolkin, *On Improving the Quality of Lawyering*, 50 ST. JOHN'S L. REV. 523 (1976)), but in the journals of state bar associations as well. E.g., England, *In Defense of Regulation by the Supreme Court*, 54 FLA. B.J. 254 (1980); Gaines, *Legal Malpractice*, 40 ALA. LAW. 477 (1979); Gordon, *Incompetent Lawyers? A Trial Judge's Perspective*, KY. BENCH & B., Jan. 1979, at 8. Axiomatically, we must first clean our house before we can expect to open it to company. This should not come with the negative feeling of airing dirty linen; rather, our housecleaning chores will demonstrate to the public that we no longer wish to hide with traditional aloofness — that we now conduct ourselves in an open and active association with our clients.

Similarly heartening is the concept of peer review which has recently gained in popularity, seen not in a punitive light but rather as a necessary support to strengthening the skills of practitioners. "It is aimed at helping lawyers improve the quality of their performance and services. It is punitive only in cases of extreme incompetence that cannot or will not be corrected." Smith, *Peer Review: Its Time Has Come*, 66 A.B.A.J. 451, 454 (1980).

But we must still keep in mind that the discussion constitutes only a matrix within which action must occur. As yet, the system has not yet developed to the point where results will be apparent. The profession must yet demonstrate its willingness and ability

The entire legal community is subjected to censure because, by and large, only its most reprehensible members are continuously visible to the general public. . . . The public rarely sees the legal profession's most competent and more scrupulously ethical practitioners. They are too busy doing what they ought to be doing, and doing it very well, to receive much media exposure.<sup>19</sup>

This should not require a major public relations campaign, with all the hoopla and flag waving attendant upon a Madison Avenue production. While individual bar associations already maintain public relations offices,<sup>20</sup> what must happen should come from the efforts of virtually every individual connected with the legal profession. Complacency should not guide us; rather, we must affirmatively take steps to correct a seriously negative image in the minds of the public.<sup>21</sup>

One place we might start house-cleaning is in the area of unauthorized practice of law. One recent article<sup>22</sup> presents a hypothetical discussion among a lawyer, a legislator, and a layperson. The dialogue demonstrates lucidly how our present efforts to keep even the simplest chores hidden behind the mask of professionalism tend to alienate and confuse the public. More than this, by retaining even the most elementary tasks within the exclusive domain of the professional, we diminish

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to seize upon these fine beginnings and put into practice a truly effective system for improving the skills of its members.

19. Waltz, *supra* note 12, at 145.

20. Cf. M. BLOOM, *THE TROUBLE WITH LAWYERS* 329 (1968).

21. It has been suggested that attorneys do quite well at blowing their own horns. "A peculiar and quite noticeable feature . . . is the profession's propensity for self-praise. . . . Contemporary public opinion about the legal profession is such that such image-building does not seem necessary. In public opinion polls covering several scores of occupations, lawyers appear consistently close to the top . . ." O. MARU, *RESEARCH ON THE LEGAL PROFESSION: A REVIEW OF WORK DONE* 45 n.114 (1972). Unfortunately, Mr. Maru's conclusion rests on an invalid premise: public confidence in the attorney today is approaching the bottom of the scale. Cf. authorities cited at note 2 *supra*; Thomforde, *Public Opinion of the Legal Profession: A Necessary Response by the Bar and the Law School*, 41 *TENN. L. REV.* 503 (1974). Even at the time Mr. Maru put his pen to ink, lawyers were viewed as considerably less than saintly. M. BLOOM, *supra* note 20, is replete with examples which belie Maru's conclusion. Thus, the need for an affirmative response by the organized bar clearly exists.

22. Hunter & Klonoff, *A Dialogue on the Unauthorized Practice of Law*, 25 *VILL. L. REV.* 6 (1979).

the public's perceived need for a professional to handle all legal affairs. In other words, we deprofessionalize our image when we maintain that only professionals can handle rudimentary matters. Thus, it is not at all strange that Mr. Layman, in the above-noted discussion concludes: "In light of the discussion we've just had, I'm even more convinced than before that the lay adjuster and my son should be allowed to handle my legal problems. . . . I just can't see why nonlawyers should be barred from law practice . . . ." <sup>23</sup>

More significant, perhaps, than the theoretical musings of a law review article, is the experience of the Arizona Bar in attempting to foreclose realtors from drafting simple preliminary documents. In *State Bar of Arizona v. Arizona Land Title & Trust Co.*,<sup>24</sup> the unauthorized practice committee of the Arizona Bar Association sought a declaratory judgment to prevent a prevalent practice among the realtors of the state. Realtors drafted various legal documents relating to the sale of real property in which they neither held nor proposed to acquire an interest, and charged for the service. The Supreme Court of Arizona held that this constituted the unauthorized practice of law and, on rehearing, made it pointedly clear that this also applied to the drafting of a preliminary purchase agreement.<sup>25</sup>

Rather than accept this decision, the realtors took their case to the public. In a move destined to produce a bitterly contested campaign, they attempted to amend the Arizona Constitution to permit realtors to prepare all instruments incident to a sale in which they represented one of the parties. Beyond doubt, the public knew well the issues represented by the amendment.

Every traditional campaign technique was employed on both sides: The Bar rallying under the call of red, white and blue placards, warning "Save the Constitution", and the realtors united under the banner "Protect Your Pocketbook". Methods employed by both sides included public relations firms, bumper stickers, telephone calls, pamphlets, [etc.]. Leading newspapers took editorial stands

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23. *Id.* at 21-22.

24. 90 Ariz. 76, 366 P.2d 1 (1961).

25. *State Bar of Ariz. v. Arizona Land Title & Trust Co.*, 91 Ariz. 293, 371 P.2d 1020 (1962).

(frequently against the Bar).<sup>26</sup>

The public passed the amendment by a margin of almost four to one.<sup>27</sup>

The public had its say, and quite forcefully too. As commentators later noted,<sup>28</sup> the entire issue put a new perspective on the public's feelings toward the legal profession. The public's image of the attorney remained seriously deficient; but more importantly, traditional methods used by the profession to achieve interaction with the public had failed.<sup>29</sup> Undoubtedly, the citizens of Arizona felt that a profession had no right to stamp the imprimatur of "professional" on matters which called simply for filling out some uncomplicated forms.

Has the profession taken the hint? Decidedly not. Several years after the State Bar of Arizona decisions, the professional literature still bemoaned the state of affairs.

Encroachments coupled with the great number of prospective lawyers now in training create a situation in which it might not be economically feasible to practice law. It is respectfully submitted that in order to survive economically, many law trained personnel will either have to work for the government or for large corporations. As a result the general public and the profession of law will suffer.<sup>30</sup>

Six years later, those predictions of economic disaster have failed to come true.

What we must do is relax our definition of the practice of law. Simple matters, particularly those which nonprofessionals well versed in the subject matter can easily handle, should indeed be ceded to those nonlawyers. It seems absurd to have an attorney of thirty years' experience handle a simple real estate closing, when a novice realtor acting in

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26. Marks, *The Lawyers & the Realtors: Arizona's Experience*, 49 A.B.A.J. 139, 141 (1963).

27. *Id.* at 141 n.11.

28. *Id.* See also M. BLOOM, *supra* note 20, at 110 *et seq.*

29. *Id.*

30. Miller, *What Others Think: Where Has the Practice of Law Gone?*, 48 FLA. B.J. 445 (1974), reprinted in 39 UNAUTHORIZED PRAC. NEWS 40, 41 (1974). See also Resh, *Unfounded Attacks on Unauthorized Practice*, 40 UNAUTHORIZED PRAC. NEWS 272 (1977).

accord with general instructions from house counsel could handle it quite competently. In permitting — in welcoming — this result, the profession can forcefully demonstrate to the public that it no longer wants the role of pickpocket. The public will instead see a profession which charges professional fees for professional work.

More and more, the public seeks alternatives to legal representation in matters which might traditionally call for an attorney. In Minnesota, complaints against the press are taken before the Minnesota News Council, where a panel composed equally of press and public hands down advisory opinions published across the state.<sup>31</sup> There exist “do-it-yourself kits” for divorce, probate, incorporating businesses, and numerous other matters. Small claims courts and direct personal representation before consumer-oriented state agencies have rapidly gained in popularity.<sup>32</sup> Even the profession itself tacitly concedes that many matters can readily be handled by a nonlawyer with the proper training.

The use of legal assistants has proved beneficial to the attorney and the client, in terms of economic advantages and the ability to provide more and varied legal services to a greater number of clients. The question for most firms is no longer whether or not to hire paralegals, but rather how can the firm best use them.<sup>33</sup>

There even exists a law school (albeit unaccredited), *sans* dean, *sans* faculty, run entirely by one administrator and a group of highly motivated students destined for careers in public interest law.<sup>34</sup> The profession, rather than ignoring or deprecating these efforts, should take an active role in assuring they function smoothly and properly. This would guarantee the public adequate protection of its rights while requiring

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31. Peterson, *Minnesota News Council: Solving Disputes Without Courts*, 66 A.B.A.J. 970 (1980).

32. *The Logical Extension of the Do-It-Yourself Syndrome or “Qui Facit Per Alium Facit Per Se”*, 37 UNAUTHORIZED PRAC. NEWS 111 (1973). See also Nader, *The Legal Profession: A Time for Self-Analysis*, 13 AKRON L. REV. 1 (1979).

33. Guman & Ferguson, *The Changing Role of Paralegals*, 40 UNAUTHORIZED PRAC. NEWS 280, 289 (1977).

34. Manna, *The Other Half Goes to Law School*, STUDENT LAW., Apr. 1980, at 18. See also Heflen, *Preserving Professional Values in the Legal Services Marketplace of the Eighties*, 41 ALA. LAW. 157 (1980).

that the attorney exercise only indirect supervision. The lawyer seeking to improve the public's attitude toward the profession should instruct nonprofessionals desiring to do this basic work or should verify the accuracy of simple forms, thus ensuring the public receives competent service at a reasonable price.

Just as attorneys should not prevent laypersons from performing simple functions in a legal setting, they should actively assist the public in obtaining counsel when truly needed. "A main present challenge to the bar is to make absolutely sure that, out of the present partnership between private and public support, there emerges a system under which no poor person shall want for counsel."<sup>35</sup> Undeniably, the profession has long espoused this goal, and the American Bar Association has certainly taken an active role in championing its realization. In 1977, its Special Committee on Public Interest Practice put forth a forceful report designed to stimulate discussion on the matter.<sup>36</sup> Using as its touchstone the Code of Professional Responsibility,<sup>37</sup> the Special Committee proceeded on the basic assumption that "the professional responsibility to contribute public interest legal service is inherently an obligation to contribute one's time — one's abilities."<sup>38</sup> Now the emphasis has shifted again. Regrettably, the most recent proposed revision of the ABA Model Code of Professional Responsibility no longer demands the donation of "unpaid public interest legal service" by each member of the profession.<sup>39</sup> Nevertheless the concern demonstrated by

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35. W. N. SEYMOUR, *THE OBLIGATIONS OF THE LAWYER TO HIS PROFESSION* 26 (1968) (25th Annual Benjamin Cardozo Lecture before the Association of the Bar of the City of New York, March 19, 1980).

36. ABA SPECIAL COMMITTEE ON PUBLIC INTEREST PRACTICE, *IMPLEMENTING THE LAWYER'S PUBLIC INTEREST PRACTICE OBLIGATION* (1977).

37. ABA CODE OF PROFESSIONAL RESPONSIBILITY, Canon 2 and EC 2-25 (1978).

38. ABA SPECIAL COMMITTEE ON PUBLIC INTEREST PRACTICE, *supra* note 36, at 6.

39. Compare ABA PROPOSED MODEL CODE OF PROFESSIONAL RESPONSIBILITY, Rule 8.1 (1980) with ABA PROPOSED FINAL DRAFT MODEL RULES OF PROFESSIONAL CONDUCT, Rule 6.1 (1981). See generally Gilbert, *The Bar's Position on Proposed Model Rules*, 54 FLA. B.J. 752 (1980). The profession should also attempt to improve the level of its services in general, and the methodology by which the services get to the public. See Christensen, *Toward Improved Legal Service Delivery: A Look at Four Mechanisms*, 1979 AM. B. FOUND. RES. J. 277 (1979).



the profession<sup>40</sup> must be given life; each attorney should actively donate much needed services to those financially unable to obtain them. Further, we should take steps to make certain the public knows of our efforts in this regard.

The effort, however, should not rest merely with the practicing bar. All branches of the profession must join in educating the public about the business of the lawyer, in the law itself, and in the complex mechanics of the process as a whole. The judiciary must also take a hand in the active supervision of the profession. One commentator suggests that courts, acting perfectly within their rights to pass on the competence of attorneys who practice before them, must exercise what he believes is "a duty to the public to deny unqualified applicants admission [to their bars]."<sup>41</sup> The judges, he feels, have shirked this duty.

Beyond this, we must also acknowledge that the judiciary itself has been the target of deserved criticism. "Judges, their black robes once symbolic coats of armor shielding them from the barbs of public criticism, are drawing increasing fire both for their decisions and for the way in which they conduct their business."<sup>42</sup> Due perhaps to the physical isolation in which the judiciary functions and the poor relations between bench and press, the public views judges with the same jaundiced eye with which it regards attorneys.<sup>43</sup> "It is being said that judges, too bound by the strictures that go with the job to respond in kind to criticism, need mechanisms that would enable others to take up arms in their behalf."<sup>44</sup> In short, the judiciary must take pains to make itself more available to the public — to improve its relations with the press, to participate in and promote public discussions of the job of the judiciary, and to educate the public in the role the bench and bar play in society as a whole.

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40. See, e.g., Palmer & Aaronson, *Placing Pro Bono Publico in the National Legal Services Strategy*, 66 A.B.A.J. 851 (1980).

41. Toll, *A Modest Suggestion for Chief Justice Burger*, 66 A.B.A.J. 816 (1980).

42. Winter, *Black Robes No Longer Shield Judges from Public Criticism*, 66 A.B.A.J. 433 (1980).

43. *Id.* The profession itself has also placed the judiciary under fire of late. See, e.g., Carrington, *Ceremony & Realism: Demise of Appellate Procedure*, 66 A.B.A.J. 860 (1980).

44. *Id.*

Education of the public should go far beyond simple speeches, newspaper columns, and occasional television and radio information shows. Fortunately the bar is willing to participate in wider areas. For example, the American Bar Association strongly favors an effort to bring legal education into primary and secondary schools.<sup>45</sup> This program should receive great local support. “[E]lementary and secondary students must be provided with an operative understanding of how our system of law and legal institutions function.”<sup>46</sup> This would seem the ideal opportunity for legal educators to aid in the process. Rather than relying on the time and skills of practitioners (who would, perhaps, be better used representing indigents), professional educators and law students should shoulder the burden of developing and implementing an effective program in the schools. Thus, still another branch of the profession can make a positive contribution to the overall effort.<sup>47</sup>

One commentator suggests that the duty of the law schools goes far deeper than this. “[L]egal education generally fails to consider the combined and often uncoordinated efforts of the several components of the legal process to resolve particular social problems.”<sup>48</sup> Thus, law schools should accept the duty of teaching students the law, not as abstract theory, but rather as a unified method of resolving disputes in society. The law should appear as a tool of social utility rather than a means to personal gratification. Lawyers trained to accept this view will go into practice with an outlook more conducive to better relations with the public. “Generation after generation of students graduate from law school without having been required to evaluate critically the moral factors in decision-making. Even worse, they often graduate believing erroneously that morality has no place in the workings of the

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45. ABA SPECIAL COMMITTEE ON YOUTH EDUCATION FOR CITIZENSHIP, HELP! WHAT TO DO, WHERE TO GO (1973), cited in Roche, *The Three R's are Not Enough: The Need for Law-Related Education in South Dakota*, 22 S.D.L. REV. 41, 51 n.39 (1977).

46. Roche, *supra* note 45, at 43.

47. Some schools have made significant contributions in this area. The student-run program at North Carolina Central University School of Law can serve as an excellent model for schools wishing to become involved in heightening the respect for and awareness of the legal profession among high school students.

48. Thomforde, *supra* note 21, at 525.

legal process.”<sup>49</sup> In the main, legal education must accept its responsibility for the lack of public confidence in the profession. It, too, must take an active role in solving the problem.

Individual law professors can assist by bolstering a sadly deficient body of literature which discusses the law at a level which a layperson can readily understand. Academic and public libraries increasingly find demand for legal material, yet must face the dilemma of too little accurate material which their patrons can use without professional guidance. A recent article,<sup>50</sup> written for librarians seeking to acquire material for social science collections, could cite only two dictionaries<sup>51</sup> and one series of monographs<sup>52</sup> written by lawyers yet designed specifically for the lay audience. In contrast, a superb contribution designed for the nonlawyer has recently appeared, which attempts

to make available as concisely as possible information about some of the principal legal institutions, courts, judges and jurists, systems of law, branches of law, legal ideas and concepts, important doctrines and principles of law, and other legal matters which not only a reader of legal literature but readers in other disciplines and indeed any person whose work or reading in any way touches on legal matters may come across.<sup>53</sup>

Unfortunately, as *The Oxford Companion to Law* was designed specifically to cover British law, it contains relatively few references to the law of the United States.<sup>54</sup> The American public deserves a work such

49. *Id.* at 530. *But see* Taylor, *Juris Pastor: A Return to the Counselor-at-Law*, 31 MERCER L. REV. 545 (1980).

50. Mersky, Berring & Richmond, *supra* note 15.

51. S. GIFIS, *LAW DICTIONARY* (1975); D. ORAN, *LAW DICTIONARY FOR NON-LAWYERS* (1975).

52. *THE LEGAL ALMANAC SERIES*, published by Oceana Press, Dobbs Ferry, N.Y.

53. D. WALKER, *Preface to THE OXFORD COMPANION TO LAW* at v (1980).

54. Those which appear, however, are brief and accurate, frequently revealing a fascinating glimpse of the British view of our practice. Cardozo, for example, is described as “one of the very greatest American judges, probably second only to Holmes in making the judicial process creative yet evolutionary.” *Id.* at 186. The coverage of the United States, however, is spotty. While Cardozo and other Justices of the United States Supreme Court appear, such leading state jurists as Roger Traynor and legal scholars as William Prosser do not. While there is a discussion of *Brown v. Board of*

as this, which attempts to describe in one or two paragraphs the essence of legal concepts with which they might wish to become familiar. Rather than writing exclusively for academic and bar publications, law professors should contribute their writing skills to works designed for the public at large. Law schools can assist this effort with grants and permission for such works to qualify their authors for tenure and promotion.

For some time, law librarians have wrestled with the problem of supplying adequate reference services to their patrons. As indicated earlier, these problems have begun to appear in non-law libraries as well.<sup>55</sup> Succinctly stated, problems arise when the librarian with legal training attempts to assist the patron who, although not an attorney, seeks to use legal materials. The first dilemma confronting the reference librarian, and the one with the widest ramifications, is the danger of giving too much advice, thus running afoul of restrictions against the unauthorized practice of law.<sup>56</sup> Here, law librarians must tread the straight and narrow, keeping within the confines of a narrow precept: "[I]f no conclusion as to legal validity is made or no legal opinion is offered, but only a statement as to the findings on a particular matter by a nonlawyer, there is no unauthorized practice involved."<sup>57</sup> In practice, this can create not only problems with the organized bar, but a breach of the code of ethics of law librarians as well.<sup>58</sup>

The librarian has "the responsibility to make the resources and services of the library known to its potential users; he must 'seek above all else to be an effective instrument for the dissemination of legal information.'"<sup>59</sup> Thus, more than perhaps any other branch of the profession, the law librarian tries to familiarize the public (at least on an

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*Education*, a similar treatment of *Miranda v. Arizona* is lacking. In assessing the value of such a work, the American practitioner can readily see how much it reveals about the practice of law in England.

55. See text accompanying note 51 *supra*.

56. Although no cases have been decided directly relating to law librarians, the fear still exists. Schanck, *Unauthorized Practice of Law and the Legal Reference Librarian*, 72 L. LIB. J. 47, 57 (1979).

57. *Id.* at 58. See also Mills, *Reference Service vs. Legal Advice: Is It Possible to Draw the Line?*, 72 L. LIB. J. 179, 186 (1979).

58. Schanck, *supra* note 56, at 58. See also Begg, *The Reference Librarian & the Pro Se Patron*, 69 L. LIB. J. 26, 31 (1976).

59. Begg, *supra* note 58, at 30 (citations omitted).

individual basis) with the law. Yet the librarian has been hampered. First, the ethical and legal problems caused by the risk of unauthorized practice restrain the librarian. Second, the time and resources needed to adequately inform the patron with no legal knowledge prove so great that they may severely cripple a facility intended to support a profession, thus jeopardizing the primary mission of the law library.<sup>60</sup> Third, when the librarian has expended all of this time and effort, the increased knowledge extends to only one person.

Without intending to minimize the very real problems the law librarian faces in this regard, this branch of the profession can still do much more to improve the public's opinion. Most significantly, law librarians must not view the dissemination of information about the law as providing legal services to the public. Rather, they should acknowledge that assisting the general public is indeed their role.<sup>61</sup> However, this assistance should not come on an individual basis. Law libraries can sponsor seminars, if not for the general public then for those librarians who serve the general public, discussing the general rudiments of legal research.<sup>62</sup> They can maintain community bulletin boards, sponsor public awareness programs, lectures and film societies, and generally assist by offering their facilities for community-related activities. Finally, in conjunction with local bar associations, law libraries can serve as clearinghouses for those seeking to retain attorneys or for those indigents in need of legal assistance.

### Conclusion

This commentary proceeds on the basic assumption that lawyers share a general concern for the welfare of their clients and for the public as a whole. It also accepts that lawyers as a whole follow basic ethi-

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60. *Id.*

61. The issue of the law library and the practice of law ultimately raises the question of what the role of the law library should be in the provision of legal services. . . . Law librarians who wish to do more to assist in providing legal services to the public can effectively do so by working indirectly, lecturing and teaching at graduate library schools when asked and assisting public libraries by providing instruction in legal bibliography and the selection of legal materials.

*Id.*

62. See Mills, *supra* note 57, at 193.

cal precepts, and make every effort to deal fairly and honestly with those people with whom they deal. Nonetheless, we must realize that the legal profession, never the public's darling, has fallen into even greater disfavor since Watergate.<sup>63</sup> The problem now threatens to expand beyond bounds with which we can deal. To solve it, the profession must immediately embark upon a major effort to improve the attitude of the public toward the bar by instructing the public in the basics of our legal system, in the need for skilled professionals to handle the complexities of their legal problems, and in the qualifications and ethics which are required of an attorney.

This conclusion is by no means novel. Some twenty years ago, the Missouri Bar, in conjunction with Prentice-Hall, ran a thorough survey which concluded that the bar must turn its attention toward improving public relations through education.<sup>64</sup> The intervening years have seen few serious attempts at meeting these objectives. Today, particularly in the lingering light of Watergate, we find the crisis of public disfavor at a peak. We must turn public opinion around. Otherwise, when a new

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63. The severity of the problem has provoked comment in leading British law journals as well. *See, e.g., Ayer, Do Lawyers Do More Harm than Good?*, 129 *NEW L.J.* 1040 (1979); Cohen, *Unpopularity and Criticism of Lawyers*, 123 *SOLICITORS' J.* 499 (1979); *The Legal Profession and the Public*, 6 *ANGLO-AM. L. REV.* 1 (1977).

64. While the education of the public through the client-attorney relationship is deemed to be of number one importance, it is nevertheless necessary that many other means of public education be employed. (1) Development and distribution of pamphlets. (2) The development and promotion of well organized Speakers Bureaus by local bar associations in every part of the state. (3) The development and promotion of Public Forums on legal subjects to be conducted by local bar associations. (4) Continuing efforts to educate the public through use of informational media such as radio, television and newspapers. (5) Closer cooperation with educational institutions so that the citizens of tomorrow will be correctly informed concerning the role of the legal profession and its importance to our American System of Government. (6) Continuing efforts through every means, including those listed above, to develop in the public a greater appreciation for the rights and freedoms guaranteed by the Constitution and protected by our courts.

MISSOURI BAR SURVEY, *supra* note 2, at 51. However, it should be noted that the survey continued to stress that "A deluge of publicity . . . will be worthless so long as the lawyer himself, in his contact with the client, fails to lay the groundwork for a better public image of the profession." *Id.* at 52.

John Cade arises, the public may indeed heed the advice of his rebellious followers: "The first thing we do, let's kill all the lawyers."<sup>65</sup>

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65. W. SHAKESPEARE, HENRY VI, PART II, Act IV, Scene II, Line 83 (1600).

## The District Courts of Appeal—After The 1980 Jurisdictional Amendment: A New Obligation Toward Decisional Harmony

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The purpose of this note is to explore the effect that a per curiam affirmance by a Florida District Court of Appeal might have on decisional harmony in the State of Florida. This examination focuses on concerns raised by the new constitutional jurisdiction<sup>1</sup> of the Supreme Court of Florida. While each of the sections of the amendment presents special problems, specific emphasis will be placed on that portion of Article V, section 3(b)(3) of the Florida Constitution which allows discretionary review of district court decisions which are in conflict.<sup>2</sup>

Effective April 11, 1980, the Florida Supreme Court's jurisdiction was restructured to drastically reduce the volume of cases requiring its review.<sup>3</sup> Now, the decisions of the various district courts of appeal are final in all but a few well delineated situations. However, in at least one specific area, the district courts have discretionary authority to determine whether their decisions will be truly final by precluding further appellate review in Florida, or are capable of being heard in the Florida Supreme Court. This specific area is commonly known as "conflict certiorari"<sup>4</sup> and the discretion involved is whether to write an opinion.

If a litigant finds an adverse decision at the district court "expressly and directly conflicts with a decision of another district court of appeal, or of the supreme court on the same question of law,"<sup>5</sup> further

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1. FLA. CONST. art. V, sec. (3)(b).

2. Art. V, sec. 3(b)(3) reads in part: "(3) May review any decision of a district court of appeal that . . . expressly and directly conflicts with a decision of another district court of appeal or of the supreme court on the same question of law."

3. "The impetus for these modifications was a burgeoning caseload and the attendant need to make more efficient use of limited resources." FLA. R. APP. P. 9.030, Committee Notes.

4. FLA. CONST. art. V, sec. 3(b)(3). While the amendment specifically deletes the words "by certiorari," conflict certiorari merely refers to the Florida Supreme Court's discretionary jurisdiction to review conflicts of decision. *Id.*

5. FLA. CONST. art. V. sec. 3(b)(3).



appellate review is available through the discretionary certiorari power of the supreme court. However, when the district court of appeal decision is merely a per curiam affirmance without written opinion, the appellate process is halted.<sup>6</sup> This occurs even if the reasoning behind that particular decision would otherwise be in direct conflict with another district court of appeal. Under the old jurisdictional standards, the case must merely be "in direct conflict"<sup>7</sup> with another case regardless of whether the decision was rendered with a full written opinion. In at least one instance,<sup>8</sup> conflict was founded in a dissenting opinion to a per curiam decision. However, since the new standard has been imposed requiring an "express" conflict, review by the Florida Supreme Court requires a written opinion.<sup>9</sup>

Granting certiorari in cases where particular points of law have been decided differently in the various districts allows the Supreme Court of Florida to prevent inconsistency in the lower courts.<sup>10</sup> Thus, "conflict certiorari" serves as an important tool in establishing uniform justice. However, a decision without opinion hampers this ability to provide a uniform application of the laws of Florida. The architect of the new amendment, Justice Arthur England,<sup>11</sup> has recognized the significance per curiam affirmances have under the new rules of discretionary conflict jurisdiction:

A decision not to write an opinion in any particular case may be dispositive of the litigation. Therefore, district court judges will play a significant role in the state's justice system by the exercise of their judgment in this regard. No one questions the desirability of some dispositions without opinion at the district court level, for example, in cases which involve a straightforward application of ex-

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6. See *Jenkins v. State*, 385 So. 2d 1356 (Fla. 1980).

7. FLA. CONST. art. V. sec. 3(b)(3).

8. *Commerce Nat'l Bank in Lake Worth v. Safeco Ins. Co. of America*, 284 So. 2d 205 (Fla. 1973); See also *Huguley v. Hall*, 157 So. 2d 417 (Fla. 1963) (using case citations accompanying the "affirmed" decision along with an exhaustive dissenting opinion).

9. See 385 So. 2d 1356 (Fla. 1980).

10. *Id.*

11. For a complete discussion of the features of the amendment see England, Hunter & Williams, *Constitutional Jurisdiction of the Supreme Court of Florida: 1980 Reform*, 32 U. FLA. L. REV. 147 (1980).

isting law to individual and non-unique fact situations. On the other hand, the responsibility for articulating decisions on questions of law which might have statewide importance, or which might be in conflict with other appellate decisions, now rests more heavily on the district courts' judges. Perhaps greater precision will also be required of counsel to isolate, identify, and discuss the issues of law which they present to the district courts.<sup>12</sup>

Thus, the obligation toward the appellate decision-making process is two-fold: the responsibility of district court judges to issue opinions where conflict would otherwise exist, and the responsibility of counsel to assist in delineating these conflicts.

### Discussion

The basis for invoking conflict certiorari jurisdiction arises when there is a "real and embarrassing" conflict between the decisions of the appellate courts.<sup>13</sup> However, the question has always been, to what extent can the Florida Supreme Court search for such a conflict? Soon after the creation of the district courts, the court recognized that

[t]here may be exceptions to the rule that this court will not go behind a judgment per curiam, consisting only of the word 'affirmed'. . . . Conceivably it could appear from the restricted examination required in proceedings in certiorari that a conflict had arisen with resulting injustice to the immediate litigant.<sup>14</sup>

The general rule referred to was overruled in effect by the decision in *Foley v. Weaver Drugs*,<sup>15</sup> which allowed the Court to examine the "record proper" to ascertain if a conflict had arisen. Although the "record proper" analysis was never defined,<sup>16</sup> *Foley* described it as "scrutiny on

12. *Id.* at 198.

13. *See* *Ansin v. Thurston*, 101 So. 2d 808, 811 (Fla. 1958).

14. *Lake v. Lake*, 103 So. 2d 639, 643 (Fla. 1958).

15. 177 So. 2d 221 (Fla. 1965).

16. *See* *Gibson v. Maloney*, 231 So. 2d 823, 832 (Fla. 1970) (Thornal, J., dissenting):

The majority is out-Foleying *Foley*. . . . Just once, it would be helpful if my colleagues who follow the *Foley* majority would actually define what is meant by "record proper" and "transcript of testimony." There is no clear

. . . the written record of the proceedings in the court under review except the report of the testimony. . . .<sup>17</sup> This type of analysis merely allowed the Florida Supreme Court to inquire whether its own decisions, or decisions of the various districts, would have decided the case differently.<sup>18</sup>

The new jurisdictional amendment "abolishes the *Foley* doctrine by requiring an 'express' as well as a 'direct' conflict of district court decisions as a prerequisite to supreme court review."<sup>19</sup> Consequently, the Florida Supreme Court will no longer look behind decisions without written opinions.

The majority opinion of *Jenkins v. State*,<sup>20</sup> the major case after the new amendment, squarely disposes of this issue:

Accordingly, we hold that from and after April 1, 1980, the Supreme Court of Florida lacks jurisdiction to review per curiam decisions of the several district courts of appeal of this state rendered without opinion, regardless of whether they are accompanied by a dissenting or concurring opinion, when the basis for such review is an alleged conflict of that decision with a decision of another district court of appeal or of the Supreme Court of Florida.<sup>21</sup>

It leaves no doubt as to the posture of the Supreme Court in this issue. Justice England's concurring opinion wholly supports and extends this result, while providing a historical overview of the jurisdictional amendment.<sup>22</sup>

The dissenting opinion,<sup>23</sup> however, forewarns of the problems with such a position:

We are embarking on a course which limits our jurisdiction to matters concerning deep questions of law, while the great bulk of liti-

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cut definition in the books and I think our cases on the subject are extremely confusing.

17. 177 So. 2d at 223.

18. *Id.*

19. FLA. R. APP. P. 9.030, Committee Notes.

20. 385 So. 2d 1356 (Fla. 1980).

21. *Id.* at 1359.

22. *Id.* at 1360-63.

23. *Id.* at 1363-66 (Adkins, J., dissenting).

gants are allowed to founder on rocks of uncertainty and trial judges steer their course over a chaotic reef as they attempt to apply 'Per Curiam affirmed' decisions.<sup>24</sup>

Noting the potential chaos in a system in which the Florida Supreme Court is precluded from harmonizing the district court decisions, Justice Adkins wrote that "[u]nder the construction proposed by the majority we will have well-written *opinions*, but the *decisions* of the five district courts of appeal will be in hopeless conflict."<sup>25</sup> In the interest of reducing a "burgeoning caseload,"<sup>26</sup> the amendment denies the supreme court any chance of reconciling this conflict. This was precisely the thrust of the arguments against the amendment before its passage into law.<sup>27</sup> The burden of providing this opportunity for uniformity now rests with the district courts. Writing opinions in marginally conflicting cases gives the Florida Supreme Court the *choice* of invoking their harmonizing power.<sup>28</sup>

Obviously there is a place for decisions without opinion. However, this method should be exercised only in circumstances when the case below requires the "application of well settled rules of law,"<sup>29</sup> and the use of a written opinion would not add anything to the general body of law in the particular area at issue. Cases which would otherwise conflict but for the per curiam affirmance, do not fall into this category. A decision that might conflict with another appellate court would surely add something to the law, albeit if only to allow the Florida Supreme Court to harmonize the decisions. The large number of cases in which certiorari was granted both pre and post *Foley*, illustrates this proposition.<sup>30</sup>

Moreover, in at least twenty cases, the Florida Supreme Court re-

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24. *Id.* at 1363.

25. *Id.* at 1364.

26. FLA. R. APP. P. 9.030, Committee Notes.

27. *See* England, Hunter & Williams, *supra* note 11, at 159.

28. Conflict jurisdiction lies within the discretionary portion of the supreme court's jurisdiction. FLA. CONST. art. V. sec. 3(b)(3)-(9).

29. *Newmons v. Lake Worth Drainage Dist.*, 87 So. 2d 49 (Fla. 1956).

30. The Committee Notes to Fla. R. App. P. 9.030 characterized conflict petitions as comprising "the overwhelming bulk of the Court's caseload and gave rise to an intricate body of case law interpreting the requirements for discretionary conflict review." *Id.* at 311. *See* *Grant v. State*, 390 So. 2d 341 (Fla. 1980).

viewed the “record proper” after a per curiam decision and quashed or reversed the decision of the district.<sup>31</sup> *Carmen Bank of Miami Beach v. R.G. Wolff & Co.*<sup>32</sup> is an extreme example where after a per curiam affirmance by the Third District, the court reviewed the “record proper” and reversed per curiam.<sup>33</sup> It is ironic that a case that once would have been summarily reversed, would now be allowed to stand without review. Recently, the Fifth Circuit Court of Appeal affirmed a United States District Court grant of federal habeas corpus to a petitioner whose conviction had been per curiam affirmed by the Second District of Florida.<sup>34</sup> These problems of silent questionable decisions can be avoided by the district courts choosing to write opinions, however terse, in even marginally conflicting cases. This approach does not conflict with the supreme court’s goal of reducing its caseload; petitions of review from these cases would, nonetheless, remain within the court’s discretionary jurisdiction<sup>35</sup> and could be rejected unless clear conflict is shown. Little district court labor would be expended outlining the reasons for the decision in a short paragraph accompanying the affirmance.

The underlying rationale in denying review to affirmances without opinion is that the decision merely affects the individual litigants, having little, if any, effect on the overall jurisprudence in the state, regard-

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31. See *City of Pompano Beach v. Big Daddy’s, Inc.*, 375 So. 2d 281 (Fla. 1979); *Wills v. Sears, Roebuck & Co.*, 351 So. 2d 29 (Fla. 1977); *Carmen Bank of Miami Beach v. R.G. Wolff & Co.*, 329 So. 2d 298 (Fla. 1976); *AB CTC v. Morejon*, 324 So. 2d 625 (Fla. 1976); *Baycol, Inc. v. Downtown Dev. Auth.*, 315 So. 2d 451 (Fla. 1975); *D’Agostino v. State*, 310 So. 2d 12 (Fla. 1975); *De La Portilla v. De La Portilla*, 304 So. 2d 116 (Fla. 1974); *In re Estate of McCartney*, 299 So. 2d 5 (Fla. 1974); *Manufacturers Life Ins. Co. v. Cave*, 295 So. 2d 103 (Fla. 1974); *Adams v. Whitfield*, 290 So. 2d 49 (Fla. 1974); *Lake Killarney Apts., Inc. v. Estate of Thomson*, 283 So. 2d 102 (Fla. 1973); *Dyer v. Nationwide Mut. Fire Co.*, 276 So. 2d 6 (Fla. 1973); *Fountainbleau Hotel Corp. v. Walters*, 246 So. 2d 563 (Fla. 1971); *Walden v. Borden Co.*, 235 So. 2d 300 (Fla. 1970); *Gibson v. Maloney*, 231 So. 2d 823 (Fla. 1970); *Balbontin v. Pirias*, 215 So. 2d 732 (Fla. 1968); *SAF-T-CLEAN, Inc. v. Martin-Marietta Corp.*, 197 So. 2d 8 (Fla. 1967); *Coleman v. Coleman*, 190 So. 2d 332 (Fla. 1966); *Kennedy v. Vandine*, 185 So. 2d 693 (Fla. 1966); *Young Spring & Wire Corp. v. Smith*, 176 So. 2d 903 (Fla. 1965).

32. 329 So. 2d 298 (Fla. 1976).

33. Roberts, Acting C.J., Adkins, Boyd, England and Sundberg concurred.

34. *Hicks v. Wainwright*, 633 F.2d 1146 (5th Cir. 1981).

35. FLA. CONST. art. V, sec. 3(b)(3)-(9).

less of the *ratio decidendi*. Unquestionably, this theory fails in two respects. First, the affirmance settles the particular point of law for both the district court and the trial courts below. Second, it was precisely this perceived injustice to the individual litigant which paved the way to the *Foley*<sup>36</sup> era of “record proper” analysis.<sup>37</sup>

As to the first point, while an affirmance without opinion has no precedential value in the sense that it will not be cited or used by future courts, it does reflect the attitudes of the appellate court on those specific points of law. Whether they are precedent, these decisions will be the model for future appellate decisions. Concerning the trial courts, a summary affirmance merely encourages a trial judge to believe his or her application of the law was proper. *Foley* recognized this theme: “Nor can we escape that in common parlance, an affirmance without opinion of a trial court by a district is generally deemed to be an approval of the judgment of the trial court, and becomes a precedent, certainly in the trial court rendering the judgment.”<sup>38</sup> The law thus settled becomes subject to straight-forward application resulting in further per curiam affirmances. A particular type of case could become subject to peculiar treatment in one district, while the other districts or the Supreme Court of Florida could decide the same type of case in a different fashion. Notwithstanding the *Hoffman v. Jones*<sup>39</sup> prohibition against the districts rendering decisions which conflict with the settled law of the Supreme Court of Florida, many cases have been granted certiorari for just such a conflict.<sup>40</sup> It is poor policy for the supreme court to be precluded from protecting its own decisions.

Secondly, even though a per curiam affirmance only directly af-

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36. 177 So. 2d at 223.

37. See *Lake v. Lake*, 103 So. 2d 639, 641 (Fla. 1958).

38. 177 So. 2d at 225-26.

39. 280 So. 2d 431 (Fla. 1973).

40. See *Wills v. Sears, Roebuck & Co.*, 351 So. 2d 29 (Fla. 1977); *Courtelis v. Lewis*, 348 So. 2d 1147 (Fla. 1977); *Williams v. State*, 340 So. 2d 113 (Fla. 1976); *De La Portilla v. De La Portilla*, 304 So. 2d 113 (Fla. 1974); *In re Estate of McCartney*, 299 So. 2d 5 (Fla. 1974); *Manufacturers Life Ins. Co. v. Cave*, 295 So. 2d 103 (Fla. 1974); *Adams v. Whitfield*, 290 So. 2d 49 (Fla. 1974); *Lake Killaney Apts., Inc. v. Estate*, 283 So. 2d 102 (Fla. 1973); *Escobar v. Bill Currie Ford, Inc.*, 247 So. 2d 311 (Fla. 1971); *Walden v. Borden*, 235 So. 2d 300 (Fla. 1970); *SAF-T-CLEAN, Inc. v. Martin-Marietta Corp.*, 197 So. 2d 8 (Fla. 1967); *Coleman v. Coleman*, 190 So. 2d 332 (Fla. 1966).

fects the individual litigant, it was this type of “resulting injustice to the immediate litigant” that prompted the supreme court to begin “record proper” analysis. Originally it took nine years after the advent of the district courts for the *Foley* type of exception to arise. A system such as the present one may pave the way to its own exception to the strict rule of no review without a written opinion.

In order to protect against loose use of per curiam decisionmaking, briefing and argument by counsel at the district court level should not only address the merits of their case, but also the possible conflicts that may arise from a decision on these merits.<sup>41</sup> This would help to promote “reckonability of result”<sup>42</sup> by alerting appellate judges to the possible conflicts which may arise, and ease the burden of fruitless appeals from the trial courts. Moreover, it is generally recognized that petitions for rehearing or clarification should now be more freely granted in the district courts, thus providing another avenue for full written review.<sup>43</sup> For example, if a case originally disposed of by per curiam affirmance is granted either rehearing en banc<sup>44</sup> or given clarification,<sup>45</sup> the written opinion, if any, flowing from such a procedure might support conflict jurisdiction. This, of course, would require the written opinion to be “express” in its reasoning.<sup>46</sup> It may also be argued that as an alternative to conflict certiorari jurisdiction, a litigant might seek to invoke the extraordinary writ jurisdiction of the Florida Supreme Court.<sup>47</sup>

### Conclusion

As a matter of policy, the courts of Florida should strive to obtain decisional harmony at the district court level. Although the new jurisdictional amendment was a hard fought battle, access to the Florida

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41. *Lake v. Lake*, 103 So. 2d 639, 643 (Fla. 1958).

42. See LLEWELLYN, *THE COMMON LAW TRADITION—DECIDING APPEALS* 26 (1960).

43. See England, Hunter & Williams, *supra* note 11, at 198.

44. FLA. R. APP. P. 9.330.

45. *Id.*

46. FLA. CONST. art. V, sec. 3(b)(3).

47. FLA. CONST. art. V, sec. 3(b)(7)-(9). *But see* *St. Paul Title Ins. Corp. v. Davis*, 392 So. 2d 1304 (Fla. 1980) (holding that petitioner seeking review of per curiam affirmance with our opinion, cannot invoke “all writs” provision of art. V, sec. 3(b)(7)).

Supreme Court should still be available in all deserving cases. Justice England rightly describes this aspect of the process as an obligation:

Section 3(b)(3) now places an increased obligation on district court judges who again have some ability to control a party's right to supreme court review. Now, as was originally intended, these judges must keep a wary eye on the broad import of their decisions before issuing an affirmance without opinion. It goes without saying that the press and the public will keep a wary eye on them.<sup>48</sup>

Karl Llewellyn in *The Common Law Tradition*<sup>49</sup> saw "recognition of doubt"<sup>50</sup> as an important aspect of an appellate judge's responsibility in formulating opinions. Under the new Florida constitutional scheme, district court judges should consider "recognition of doubt" in determining whether to use per curiam affirmances. If there is any doubt regarding the potential for conflict, the courts should discard the option of a per curiam decision without opinion, and write an opinion, no matter how brief, which permits Florida Supreme Court resolution of honestly arguable conflicts.<sup>51</sup>

*Victor Lance*

48. England, Hunter & Williams, *supra* note 11, at 181.

49. See LLEWELLYN, *supra* note 42.

50. *Id.* at 12.

51. In a recent article, Justice England reviews the percentages of per curiam affirmances without opinion following the adoption of the jurisdictional amendment. Finding them substantially unchanged with respect to statistics of earlier years, he makes this observation: "The district courts apparently did not seize upon the amendment to expand the percentage of their dispositions without opinions during calendar 1980." England, A. & Williams, R., *Florida Appellate Reform One Year Later*, 9 FLA. ST. U. L. REV. 223, 256 (1981). This seems to be an attempt at providing ad hoc evidentiary support to an observation made in *Florida Greyhound Owners & Breeders Ass'n Inc. v. West Fowler Assoc.*, 347 So. 2d 408 (Fla. 1977): "The foul assumption which underlies any review is that the district court perpetrated an injustice which it could not explain away in an opinion. I refuse to indulge that assumption." *Id.* at 411 (concurring opinion). However, both observations miss the mark. It would be ludicrous to assert that district court judges would ever attempt to "hide their mistakes". Yet, because of the complexity of the issues in various cases, conflicts arise all too often. This is aptly demonstrated by the unintentionally created conflicts reviewed during the *Foley* era. See notes 31 & 40 *supra*.

Nonetheless, the thrust of this article is merely to point out the need for careful



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consideration by the district courts of possible unstated conflicts. Inasmuch as Justice England finds that the rate of per curiam affirmances has remained virtually unchanged, it may be argued that the district courts have not recognized their "obligation" in this respect. It can be asserted that the percentage of per curiam affirmances should *decrease* in proportion to the rate that review was formerly granted by the Supreme Court for review of per curiam affirmances during the *Foley* era.

## *M'Naghten*: Right or Wrong for Florida in the 1980s? It Flunks the Test

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The members of the jury listened solemnly as the judge instructed them on the law.<sup>1</sup> The defendant was charged with murder in the first degree. There was ample evidence indicating that the defendant had, indeed, committed the crime. In fact, he did not deny doing it. The defense relied exclusively upon insanity to support the pleading of not guilty. "Due to his mental condition," the defense attorney argued, "he did not have the ability to form an *intent*." Psychiatrists testifying for the defense stated that, due to his mental impairment, the defendant could not control his actions. The prosecution, through its medical experts, countered that the defendant *knew* his actions were wrong.

With this testimony in mind, the jury would wrestle with the ultimate decision of the sanity of the accused. In deciding the extent of the defendant's criminal responsibility, the jury would apply the law as instructed by the judge.

The judge continued his charge:

A person is sane and responsible for his crime if he has a sufficient mental capacity when the crime is committed to understand what he is doing and to understand that his act is wrong. If at the time of the alleged crime a defendant was by reason of mental infirmity, disease or defect, unable to understand the nature and quality of his act or its consequences, or, if he did understand it, was incapable of distinguishing that which is right from wrong, he was legally insane and should be found not guilty by reason of insanity.<sup>2</sup>

Thus, the jury faced the dilemma of deciding whether the defendant was mentally infirm to a degree which rendered him unable to recognize the wrongfulness of his act. If the jury should find that the accused was infirm, but still knew the difference between right and

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1. This is merely hypothetical and is not intended to represent any actual case.

2. *Florida Standard Jury Instructions in Criminal Cases*, approved in *In re Standard Jury Instructions in Criminal Cases*, 327 So. 2d 6 (Fla. 1976).

wrong, they would have no choice but to convict.

This colloquy is intended to illustrate the diverse and difficult choice thrust upon the unwary juror deciding the insanity question in *M'Naghten*<sup>3</sup> jurisdictions. The difficulty results from the rigidity of the *M'Naghten* test, which confines juror alternatives. It permits a finding of insanity *only* if the accused did not know (or understand) that his act was wrong. The test is directed toward the accused's ability to form the required mental intent (*mens rea*). Mental intent must be demonstrated if the accused is to be held responsible for his act. This test effectively cloaks the fact finder with judicial "blindness": it precludes jurors from considering any evidence showing the defendant labored under a mental disease or defect which, while not rendering him incapable of distinguishing right from wrong, affected his ability to rationally control his behavior. This all-or-nothing approach, sometimes referred to as the "*mad or bad*" doctrine,<sup>4</sup> ignores the existence of the grey area between sanity and insanity. According to the *M'Naghten* criteria, mentally ill persons failing to meet the rigid standards of the "right-wrong" test would be determined criminally responsible despite their infirmities.<sup>5</sup>

Florida still clings to the *M'Naghten* test<sup>6</sup> in deciding on the sanity of its criminals. The rationale for continued adherence to a test deemed unacceptable<sup>7</sup> by so many medical and legal scholars, is that the court is not convinced the rule is not the best available for measuring an accused's mental condition.<sup>8</sup> Thus, despite its intrinsic infirmities and

3. 10 Clark & Fin. 200, 210, 8 Eng. Rep. 718, 722 (1843) wherein the court stated:

[T]o establish a defense on the ground of insanity, it must be clearly proved that at the time of the commission of the act, the party accused was labouring under such a defect of reason, from disease of the mind as to not know the nature and quality of the act he was doing; or, if he did know it, that he did not know what he was doing was wrong.

4. Note, *Insanity-Guilty But Mentally Ill-Diminished Capacity: An Aggregate Approach to Madness*, 12 J. MAR. J. OF PRAC. AND PROC. 351 (1979).

5. Arnella, *The Diminished Capacity and Diminished Responsibility Defenses: Two Children of a Doomed Marriage*, 77 COLUM. L. REV. 827 (1977).

6. See, e.g., *Wheeler v. State*, 344 So. 2d 244 (Fla. 1977), cert. denied, 440 U.S. 924 (1979).

7. See notes 58-68 *infra*.

8. *Piccotte v. State*, 116 So. 2d 626 (Fla. 1959), appeal dismissed 364 U.S. 293

backhanded support, the *M'Naghten* test still reigns supreme in the State of Florida.

This note advocates the abrogation of this rule, which, in the opinion of this writer, has failed to weather the passage of time, and which was based on faulty premises, outmoded even at the time of the rule's inception. This note will review the history of the *M'Naghten* rule and its application in Florida. Additionally it will consider the reasoning which necessitates abrogation. Of course, one cannot merely advocate abrogation of one doctrine without supporting implementation of a successor. Therefore, an examination of the potential alternatives which have supplemented or replaced *M'Naghten* in other jurisdictions will follow this analysis.

## I. *M'Naghten*-The Best Test Available or History's Mistake?

### *Pre-M'Naghten Tests*

The *M'Naghten* test has origins dating back to the Eirenarch era of 1582 wherein William Lombard of Lincoln's Inn declared that "[i]f a mad man or a natural fool, or a lunatic in the time of his lunacy, or a child who apparently has no knowledge of good nor evil do kill a man, this is no felonious act . . . for they cannot be said to have any understanding will."<sup>9</sup> Even in this period, the law recognized that one could not be culpable if he could not, due to mental infirmities, form the intent to commit the crime. This attempt at civility evolved into the "wild beast" test, which provided for exculpation if the defendant "be wholly deprived of his understanding and memory," to such an extent that he "doth not know what he is doing no more than . . . a wild beast."<sup>10</sup> A later rule developed, formulated by the humane Sir Matthew Hale, which based criminal responsibility on whether the accused at least had the understanding of a normal child of fourteen.<sup>11</sup>

Prior to *M'Naghten*, no clear formulation had emerged as a uniformly accepted test of criminal responsibility. Prior cases had been decided according to the "right-wrong" dichotomy, a school of thought

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(1960); *Van Eaton v. State*, 205 So. 2d 298 (Fla. 1967).

9. Moore, Jr., *M'Naghten is Dead - Or Is It?* 3 HOUS. L. REV. 58, 62 (1965).

10. *Rex v. Arnold*, 16 How. St. Tr. 685, 764 (1724).

11. 1 Hale P.C. as cited in Annot., 44 A.L.R. 584 (1926).

strongly influenced by beliefs in witchcraft, phrenology, and monomania.<sup>12</sup> Monomania, which was predicated upon the assumption that one idea could dominate the other cognitive aspects of the mind, was a basic precept upon which the “right-wrong” test was premised. Thus, it was reasoned, if a person had an insane delusion, it would totally control that person.

At that point in time, however, the accuracy of these concepts was already being questioned. Many of the legal and medical scholars recognized the intrinsic shortcomings created by such a simplistic test. *M’Naghten’s* case offered those scholars the opportunity to reject the “right-wrong” test and adopt a more modern approach.

Yet in perhaps the cruelest irony in the history of the common law, the *M’Naghten* court was forced to adopt these ideas (which it recognized as being outdated) due to intense political pressure applied by the Queen. Because no clear test had previously been promulgated, the court’s reluctant endorsement of the “right-wrong” test crystallized the fallacious concepts into the virtual vacuum of legal precedent.<sup>13</sup> Thus the test was outdated as it was being adopted.

### *M’Naghten’s Case*<sup>14</sup>

Daniel M’Naghten has become infamous as one of history’s most unproficient lunatics. A victim to some degree of mental impairment, he suffered from delusions of persecution.<sup>15</sup> He thought he was being pursued, unjustly accused of crime, and in danger of being murdered.<sup>16</sup>

12. *United States v. Freeman*, 357 F.2d 606, 616 (2d Cir. 1966), particularly nn. 23 & 24. *See also* BIGGS, *THE GUILTY MIND* 61 (1955).

13. *Id.*

14. 8 Eng. Rep. 718. The name “M’Naghten” is sometimes incorrectly spelled as “M’Naughton”. When this error was committed by *The London Times*, Justice Frankfurter wrote to the editors correcting them. The *Times* replied that its spelling was based on the spelling “signed by the man himself” in signing a letter. The Justice replied, in typical Frankfurtian humor, “To what extent is a lunatic’s spelling of his own name to be deemed an authority?” *OF LAW AND LIFE AND OTHER THINGS THAT MATTER: PAPERS AND ADDRESSES OF FELIX FRANKFURTER, 1956-1963* 1-4 (Kurland ed. 1964). *See also* 357 F.2d at 608.

15. *See* Ellison & Haas, *A Recent Judicial Interpretation of the M’Naghten Rule*, 4 *BRIT. JOUR. OF DELINQUENCY* 129 (1953).

16. This diagnosis was reached by GUTTMACHER & WEIHOFEN, *PSYCHIATRY*

As a result of these delusions, in which Robert Peel, the English Prime Minister was the chief culprit, M'Naghten was driven to murder. To carry out his plan, M'Naghten stalked the Prime Minister and waited for him outside his carriage. However, in his effort to kill the Prime Minister, M'Naghten instead shot and killed Peel's secretary, Drummond, who happened to be riding in the carriage of the Prime Minister that day.

The obvious defense was insanity. Unbeknownst to those involved, the methods used and result reached by the *M'Naghten* court would influence similar defendants for over a hundred years. This trial became the setting for an attempt to utilize new psychological studies which, it was felt, would aid in creating a realistic formula for determining criminal responsibility. M'Naghten's defense counsel relied heavily on a recent psychological work which contained new approaches to the subject of criminal responsibility in general, and in particular, criticized the "right-wrong" test.<sup>17</sup> This work impressed Lord Chief Justice Tindal with its logical insight into the workings of the human mind, as well as its theories on behavior. This convinced him of M'Naghten's incompetency to such an extent that he practically directed a verdict for the accused.<sup>18</sup>

As a consequence of the finding of "not guilty by reason of insanity," the Queen, who was quite angry with the verdict, summoned the court before the House of Lords to clarify the law in such cases. Her motivation stemmed from a rash of assassination attempts on the Royal Family, including three aimed at the Queen herself. Faced with an atmosphere of intense pressure,<sup>19</sup> Lord Chief Justice Tindal spoke for the court. In responding to queries submitted by the House of Lords, Tindal reaffirmed the "right-wrong" test<sup>20</sup> *despite* the fact that

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AND THE LAW 403 (1952).

17. The famous work relied upon was I. RAY, *MEDICAL JURISPRUDENCE OF INSANITY* (1838).

18. 357 F.2d at 617. *See* BIGGS, *supra* note 12, at 102.

19. *Id.* citing to S. GLUECK, *MENTAL DISORDER AND THE CRIMINAL LAW* 162-63 (1925).

20. The Lord Chief Justice stated:

We have to submit our opinion to be that the jury ought to be told in all cases that every man is to be presumed to be sane, and to possess a sufficient degree of reason to be responsible for his crimes, until the contrary

he felt it outmoded. In so doing, he turned his back on the work of Dr. Ray<sup>21</sup> which had impressed him so greatly at the trial. As a result, the strides science had made in attempting to more adequately understand the mind were virtually nullified, and the legal test for insanity in criminal cases continued to focus on the accused's knowledge of right from wrong. Thus, this brave attempt to forge a more significant and accurate legal test was frustrated. In time, this test was adopted in every state<sup>22</sup> except New Hampshire,<sup>23</sup> whose supreme court was also impressed with the work of Dr. Ray.

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be proven to their satisfaction; and that to establish a defense on the ground of insanity it must be clearly proved that, at the time of the committing of the act, the party accused was laboring under such a defect of reason from disease of the mind as not to know the nature and quality of the act he was doing, or, if he did know it, that he did not know he was doing what was wrong. The mode of putting the latter part of the question to the jury on these occasions has generally been, whether the accused at the time of doing the act knew the difference between right and wrong, which mode, though rarely, if ever, leading to any mistake with the jury, is not, as we conceive, so accurate, when put generally and in the abstract, as when put with reference to the party's knowledge of right and wrong in respect to the very act with which he is charged. If the question were to be put as to the knowledge of the accused solely and exclusively with reference to the law of the land, it might tend to confound the jury by inducing them to believe that an actual knowledge of the law of the land was essential in order to lead to a conviction; whereas the law is administered upon the principle that everyone must be taken conclusively to know it, without proof that he does know it. If the accused was conscious that the act was one which he ought not to do, and if that act was at the same time contrary to the law of the land, he is punishable; and the usual course, therefore, has been to leave the question to the jury whether the party accused had a sufficient degree of reason to know that he was doing an act that was wrong; and this course, we think, is correct, accompanied with such observations and explanations as the circumstances of each particular case may require.

8 Eng. Rep. at 722. See Annot., 44 A.L.R. 584-85 (1926) for a general discussion.

21. See note 17 *supra*.

22. The United States Supreme Court recognized the test in *Davis v. United States*, 165 U.S. 373 (1897).

23. *State v. Pike*, 6 A.R. 533, 49 N.H. 399 (1870). See also *State v. Jones*, 50 N.H. 369 (1871), wherein the court stated that the defendant was not guilty by reason of insanity if his crime "was the offspring of product of mental disease . . ." *Id.* at 398.

But the die had been cast. Despite its receding acceptability in the scientific community, the "right-wrong" test, now synonymous with *M'Naghten*, was chisled into the stone of the common law. Thus sanity was, and is, being decided according to psychological understanding *circa* 16th century!

### *M'Naghten - Florida's Test*

The *M'Naghten* test was expressly adopted in Florida in 1902.<sup>24</sup> Despite periodic attacks<sup>25</sup> the courts have continued to lend vitality to the doctrine as "the best available rule for determining the question of the legal accountability of the accused for his criminal act . . ."<sup>26</sup>

This adherence has not been evidenced by a wholehearted commitment, however. For example, in 1973, when the court was again asked to review *M'Naghten's* viability, the test received a backhanded affirmation because of a "lack of a better alternative."<sup>27</sup>

While virtually unchanged since its inception, the *M'Naghten* test was altered by the inclusion of the terms "disease or defect"<sup>28</sup> in defining the types of infirmities which would, if affecting the person's ability to differentiate right from wrong, deny criminal responsibility. In light of the current criticisms of the test's rationality, this judicial attempt to resuscitate the doctrine seems belated and misses the mark. Despite several strong challenges, the test remains intact.<sup>29</sup> The first of these occurred in *Reid v. Florida Real Estate Commission*.<sup>30</sup> The Second

24. *Davis v. State*, 44 Fla. 32, 32 So. 822 (Fla. 1902).

25. See notes 58-68 *infra*.

26. *Campbell v. State*, 227 So. 2d 873, 877 (Fla. 1969), *cert. dismissed*, 400 U.S. 801 (1970). *But see* *Anderson v. State*, 276 So. 2d 17 (Fla. 1973) (Ervin, J., dissenting). Justice Ervin, who had previously concurred in *Campbell*, proposed abandoning *M'Naghten* in favor of the MODEL PENAL CODE test.

27. 276 So. 2d at 18.

28. See *Wheeler v. State*, 344 So. 2d 244, 246 (Fla. 1977) *cert. denied*, 440 U.S. 924 (1979). The terms "disease or defect" were part of the MODEL PENAL CODE § 4.01(1) (Final Draft 1966).

29. See *Van Eaton v. State*, 205 So. 2d 298 (Fla. 1967); *Wheeler v. State*, 344 So. 2d 244 (Fla. 1977); *Campbell v. State*, 227 So. 2d 873 (Fla. 1977); *Anderson v. State*, 276 So. 2d 17 (Fla. 1973).

30. 188 So. 2d 846 (Fla. 2d Dist. Ct. App. 1966). This opinion was later expressly disapproved of. 205 So. 2d 298 (1967).



District Court of Appeal stated:

A person otherwise sane and competent may nevertheless be under a lawful mental disability so as to be incapable of formulating a rational intent to do *a particular act at a particular time*. Thus legal 'insanity' which incapacitates from civil responsibility and exonerates from crime is a mental deficiency with reference to the *particular act* in question, although it may not be a *general* incapacity.

[A] person is entitled to acquittal on the ground of mental incapacity if at the time of the commission of the act he either did not know the difference between right and wrong or *he was unable to refrain from doing wrong* . . . . Thus if it is established from the evidence that as the result of some mental defect or disease a person was unable to refrain from doing wrong . . . he could not be held criminally responsible notwithstanding he did not deny . . . that he knew the difference between right and wrong.<sup>31</sup>

This was a radical stand in view of the historical rigidity with which the state supreme court had clung to *M'Naghten*. The court not only utilized the irresistible impulse rationale,<sup>32</sup> but also allowed that the incapacity need only be partial. This nonconformance may be partially explained by the sympathy evoking fact situation. Kathleen Reid, a 49 year old real estate broker, was arrested and convicted of shoplifting after lifting a three dollar steak from a supermarket. Apparently, the woman was suffering from mental infirmities created by the onset of menopause. As a result of her conviction, the Florida Real Estate Commission had revoked her broker's license. The appellate court reversed the conviction concluding that she lacked the capacity to form the requisite legal intent and her license should not, therefore, be suspended.

Although this decision contained elements which modified the *M'Naghten* test in a positive manner, and could have opened the door for a more modern approach to the conundrum, the Florida Supreme Court nevertheless disapproved unanimously.<sup>33</sup>

Most of the United States Circuit Courts of Appeal have dis-

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31. *Id.* at 854 (emphasis supplied)(footnotes omitted).

32. See notes 69-72 *infra*.

33. 205 So. 2d 298.

carded *M'Naghten*<sup>34</sup> with the Fifth Circuit joining the fold in *Blake v. United States* decided in 1969.<sup>35</sup> In *Blake*, the court attempted to find a definition of insanity "more nearly attuned to present day concepts of psychiatry."<sup>36</sup> There the defendant had been charged with bank robbery<sup>37</sup> and relied on the defense of insanity. The lower court had charged the jury according to the standard definition of insanity.<sup>38</sup> However, the appellate court felt the *M'Naghten* test was outmoded and sought to replace it with the "substantial capacity" language of the American Law Institute's Model Penal Code (M.P.C.) Test.<sup>39</sup>

After carefully considering the alternatives, the court adopted the M.P.C. test because, "[m]odifying the lack of mental capacity by the adjective 'substantial', still leaves the matter for the jury under the evidence, lay and expert, to determine mental defect *vel non* and its relationship to the conduct in question. A substantial lack of capacity is a more nearly adequate standard."<sup>40</sup>

As a result of this decision, a defendant who commits a federal offense will be judged according to the more liberal insanity test. The divergent results thus created exemplify the ludicrous inconsistency precipitated by utilizing such different tests.<sup>41</sup>

34. Those circuits which have replaced *M'Naghten* with a modified or complete version of § 4.01 of the MODEL PENAL CODE are: *United States v. Brawner*, 471 F.2d 969, 979 (D.C. Cir. 1972); *United States v. Freeman*, 357 F.2d 606, 624 (2d Cir. 1966); *United States v. Currens*, 290 F.2d 751, 774 (3d Cir. 1961); *United States v. Chandler*, 393 F.2d 920, 926 (4th Cir. 1968); *Blake v. United States*, 407 F.2d 908, 915 (5th Cir. 1969); *United States v. Smith*, 404 F.2d 720, 727 (6th Cir. 1969); *United States v. Shapiro*, 383 F.2d 680, 685-88 (7th Cir. 1967); *United States v. Frazier*, 458 F.2d 911, 917 (8th Cir. 1972); *Wade v. United States*, 426 F.2d 64, 65 (9th Cir. 1970); *Wion v. United States*, 325 F.2d 420, 430 (10th Cir. 1963).

35. 407 F.2d 908.

36. *Id.* at 909.

37. This was a violation of 18 U.S.C. § 2113 (1964).

38. This standard definition was based upon dictum in *Davis v. United States*, 165 U.S. 373 (1897), and was adopted by the Fifth Circuit in *Howard v. United States*, 232 F.2d 274, 275 (5th Cir. 1956)(en banc).

39. See notes 79-84 *infra*.

40. 407 F.2d at 915. Also, the court adopted the alternative term "wrongfulness" to be used instead of "criminality."

41. Section 4.01 of the MODEL PENAL CODE could be adopted by either the courts or by the legislature. See, e.g., ILL. ANN. STAT. ch. 38, § 6-2 (Smith-Hurd 1962).

The next frontal attack on *M'Naghten* occurred in 1973 as a closely divided Florida Supreme Court again affirmed the doctrine. The case of *Anderson v. State*,<sup>42</sup> was not factually unlike any other challenge which had arisen in the past. In this instance, however, three members of the seven member panel dissented, finding the current test outmoded as applied.<sup>43</sup> Relying heavily on the logic asserted in *United States v. Freeman*,<sup>44</sup> the dissenters attempted to vitiate the test and proposed the adoption of the M.P.C. test.<sup>45</sup> The opinions of Justices Ervin and Boyd indicated strong discomfort with *M'Naghten*. Justice Ervin felt that:

In this age of increasing psychiatric sophistication, it is naive to believe a determination as to a person's sanity can be made solely on the basis of his ability to distinguish right from wrong. A jury should be given a defendant's entire mental record if he raises the issue of his sanity . . . . In addition, the jury should be charged in a manner which would allow it to find a defendant not guilty by reason of insanity not only when he does not know what he is doing is wrong but also when he cannot control his actions because of a mental disease. I believe the time has come to discard *M'Naghten* . . . .<sup>46</sup>

Similarly, Justice Boyd concluded: “[s]urely with all the modern advances in court procedures and the abandonment of antiquated approaches to justice the time has come to adopt a better standard than the *M'Naghten* rule . . . .”<sup>47</sup> Interestingly enough, despite Justice Boyd's strong dissent, when the question was again raised in *Wheeler v. State*,<sup>48</sup> he concurred with the majority leaving Justices Adkins and England (two additions since the *Anderson* decision) as the only dissenters. In *Wheeler* the court retained *M'Naghten* but supplemented it with the “disease or defect” language from the M.P.C.<sup>49</sup>

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42. 276 So. 2d 17.

43. *Id.* at 19 (Ervin, J. dissenting).

44. 357 F.2d 606.

45. See MODEL PENAL CODE § 4.01 (final draft 1966) at note 80 *infra*.

46. 276 So. 2d at 23.

47. *Id.* at 24.

48. 344 So. 2d 244.

49. See note 28 *supra*.

In 1973, *M'Naghten* was challenged on constitutional grounds. The appellant in *Walker v. State*<sup>50</sup> urged that the *M'Naghten* test was arbitrary, unreasonable and denied an accused his substantive due process rights. The court dismissed this argument in cursory fashion. Thus another attempt at abrogating the test had fallen short of the mark.

In 1977 the Florida legislature attempted to make the insanity issue clearer for the jury by creating the bifurcated trial system.<sup>51</sup> The bifurcated trial system had been tried in several states<sup>52</sup> in an effort to provide greater safeguards for the defendant. The system provided that the issue of guilt-innocence be tried prior to the issue of insanity, in a completely separate hearing, thereby avoiding the potential prejudice

50. 284 So. 2d 448 (Fla. 3d Dist. Ct. App. 1973).

51. FLA. STAT. § § 921.131 [918.017] (1977). Section one of this statute reads: Separate proceedings on issue of insanity.

(1) When in a criminal case it shall be the intention of the defendant to plead not guilty and to rely on the defense of insanity, no evidence of insanity shall be admitted until it is determined through trial or by plea whether the defendant is guilty or innocent of committing or attempting to commit the alleged criminal act. Advance notice of intention to rely upon the defense of insanity shall be given by the defendant as provided by rule. Upon a finding that the defendant is guilty of the commission or attempted commission of the criminal act, a trial shall be promptly held, either by the same trial jury, if applicable, or by a new jury, in the discretion of the court, solely on the question of whether the defendant was sane at the time the criminal act was committed or attempted. The defendant shall have the option, with approval of the court, of waiving the jury trial on the issue of insanity and allowing the determination of sanity to be made by the judge. Evidence may be presented as to any matter that the court deems relevant to the issue of sanity regardless of its admissibility under the exclusionary rules of evidence, except as prohibited by the Constitutions of the United States or State of Florida; provided, however, that the defendant is given the opportunity to rebut any such evidence. If the jury or the judge shall determine that the defendant was guilty of committing or attempting to commit the criminal act and was sane at the time, then the court shall proceed as provided by law. If it is determined that the defendant was guilty of committing or attempting to commit the criminal act but was insane at the time, the court shall adjudicate the defendant not guilty by reason of insanity.

52. At one time, Arizona, California, Colorado, Louisiana, Texas, Wisconsin and Wyoming all used the bifurcated trial system. *See, e.g.*, COLO. REV. STAT. § 16-8-104 (1973).

which could result from the introduction of the wide range of evidence relevant to an insanity defense.<sup>53</sup>

Despite its noble intent, the Florida Supreme Court struck down the statute concluding that it violated a defendant's due process rights.<sup>54</sup> The court pointed out that under the statute

[s]anity is, in effect presumed, giving rise to an irrebuttable presumption of the existence of the requisite intent. Thus, the state is relieved of its burden of proving each element beyond a reasonable doubt because the defendant is precluded from offering evidence to negate the presumption of intent . . . . [Prohibiting] the introduction of any or all evidence bearing on proof of insanity at the trial of guilt or innocence . . . deprive[s] a defendant of the opportunity of rebutting intent, premeditation, and malice, because an insane person could have none.<sup>55</sup>

Thus another attempt at altering the insanity defense had failed.

Those relying on the defense of insanity did receive token judicial relief in *State v. Roberts*,<sup>56</sup> where the *Lyles* rule<sup>57</sup> was adopted. The rule states that when an accused relies on the insanity defense, the jury must be told of the consequences following a finding of "not guilty by reason of insanity"; i.e. confinement and supervision in a mental hospital. Thus the court helped inform jurors, previously unaware, of the consequences attaching to their verdict.

Although this additional step does make the *M'Naghten* test somewhat more palatable, it nonetheless fails to mollify the test's harsh results. In the final analysis, Florida retains a test to determine an accused's ability to form a cognitive *mens rea* - a determination which is not medically, scientifically or legally proficient in the current era of modern psychiatry.

53. See Comment, *Due Process and Bifurcated Trials: A Double-Edged Sword*, 66 NW. U.L. REV. 327 (1971).

54. *Boyd v. Green*, 355 So. 2d 789 (Fla. 1978). See *State v. Shaw*, 106 Ariz. 103, 471 P.2d 715 (1970), and *Sanchez v. State*, 567 P.2d 270 (Wyo. 1977), wherein both courts invalidated the bifurcated trial system on similar grounds.

55. 355 So. 2d at 793-94 (citations omitted).

56. 335 So. 2d 285.

57. *Lyles v. United States*, 254 F.2d 725 (D.C. Cir. 1957).

## The Critics Attack

The most fundamental criticism of the *M'Naghten* test is the narrow scope of behavior it addresses: the cognitive, rather than volitional, aspects of an accused's personality are the sole factors considered in determining sanity.<sup>58</sup> Thus, sanity is gauged according to whether the accused knows the difference between right and wrong while the degree of his awareness and the ability to control his behavior are rendered immaterial. "This is an anathema to modern psychiatry."<sup>59</sup> It creates a situation in which the jury may acquit, and thereby hospitalize, only those who are unable to distinguish between right and wrong. Those who suffer from mental infirmities and are unable to *control* their behavior must be found guilty.

The net result is a disservice to society. Mentally deficient people, not insane according to *M'Naghten*, are incarcerated rather than treated in hospitals and return to the mainstream of society untreated. In recognizing this principle, it was stated that:

Because *M'Naghten* unrealistically considered mentally ill only those who are unable to distinguish right from wrong, many defendants with severe mental defects receive guilty rather than not guilty by reason of insanity verdicts. This does nothing to accomplish the two goals of criminal punishment, the maximum rehabilitation of criminals, and the protection of society, against crime . . . . [Thus mentally] ill defendants are found guilty . . . and placed in prisons without psychiatric facilities; mental rehabilitation is impossible. When they have finished serving their sentences, they are released to society uncured and ready to unwittingly commit another crime.<sup>60</sup>

This potential for recidivism is a problem inherent in the treatment afforded those failing the test, and can only be corrected by a more

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58. See, e.g., Note, *Criminal Law The A.L.I. Model Penal Code Insanity Test* 44 TUL. L. REV. 192 (1969), Note, *The Legal Standard for Determining Criminal Insanity: A Need for Reform*, 20 DRAKE L. REV. 353 (1971), Platt, *Choosing a Test for Criminal Insanity*, 5 WILLAMETTE L.J. 553 (1969); 276 So. 2d at 22.

59. 276 So. 2d at 22.

60. *Id.* at 22-23, citing Diamond, *Criminal Responsibility of the Mentally Ill*, 14 STANFORD L. REV. 59 (1961). See, e.g., BIGGS, *supra* note 14, at 24.

liberal application of standards in determining criminal responsibility.

A secondary defect which further debilitates the effectiveness of *M'Naghten* results from the unnecessarily great demarcation of expert psychiatric testimony.<sup>61</sup> As a result,

[w]hen the law limits a testifying psychiatrist to stating his opinion whether the accused is capable of knowing right from wrong, the expert is thereby compelled to test guilt or innocence by a concept which bears little relationship to reality. He is required, thus to consider one aspect of the mind as a 'logic tight compartment in which the delusion holds sway leaving the balance of the mind intact . . . .'<sup>62</sup>

Psychiatrists who must couch their responses in the "right-wrong" context when testifying, find themselves in a frustrating, if not professionally onerous situation. The test is too confining for a science as infinite as psychiatry. This sentiment was illustrated by Dr. Lawrence Kolb who stated that "answers supplied by a psychiatrist in regard to questions of rightness or wrongness of an act or 'knowing' its nature constitute a professional perjury."<sup>63</sup> The "right-wrong" dichotomy does not adequately lend itself to the complicated diagnosis which the craft demands.

This leads to another deleterious effect *M'Naghten* has on the efficiency of psychiatric testimony, that being inhibition in communicating knowledge concerning the accused's disease or defect. Too often this results in the psychiatrist talking about mental illness and the attorney talking in terms of "right and wrong."<sup>64</sup> This can only serve to further confuse the jury, making its task of ultimately deciding on the defendant's sanity that much tougher.

The unpopularity of the test became evident when a group of psychiatrists was polled.<sup>65</sup> Seventy-nine percent believed the *M'Naghten*

61. United States v. Freeman, 357 F.2d 606 (2d Cir. 1966).

62. *Id.* at 619 citing GLUECK, *supra* note 19, at 169-70.

63. Remarks, Annual Judicial Conference, *Insanity as a Defense*, 37 F.R.D. 365, 387 (2d Cir. 1964).

64. United States v. Currens, 290 F.2d 751, 766 (3d Cir. 1961). See Guttmacher, *The Psychiatrist as an Expert Witness*, 22 U. CHI. L. REV. 325 (1955).

65. The poll was conducted through a questionnaire on medical problems sent to members of the American Psychiatric Association. In view of the unscientific nature of

test to be unsatisfactory.<sup>66</sup> In a similar questionnaire, eighty-seven per cent felt the test did not present a realistic and adequate statement of the medical facts.<sup>67</sup> Dissatisfaction of that magnitude clearly indicates that many in the field of psychiatry would concur in the test's abrogation and would not find such a movement vituperative.

Perhaps the most pernicious result of limiting expert testimony to the confines of the rigid "right-wrong" formula is not that "psychiatrists will feel constricted in artificially structuring their testimony but rather that the ultimate deciders — the judge or the jury — will be deprived of information vital to their final judgment."<sup>68</sup> It can only result in a disservice for all concerned if jurors continue to render verdicts based on inadequate expert testimony. In this respect, an uneducated jury surely is an ignorant jury. In view of the state of the science, inadequate education of the jury is both unfortunate and unnecessary.

Whether Florida will recognize these criticisms and relinquish adherence to *M'Naghten* remains to be seen. In light of the strong attacks of test opponents, the question will no doubt be raised again. As alternatives to *M'Naghten* withstand the test of time, or if some new test evolves which evokes support, proponents will urge its adoption here. The crux of this dilemma centers not on whether *M'Naghten* should be replaced, but on what should take its place.

### The Alternatives

One alternative, penned by the respected Chief Justice of the Massachusetts Supreme Court, gained judicial impetus soon after *M'Naghten* was decided. In what came to be known as the irresistible impulse doctrine, an entirely new element, intended as a supplement to the *M'Naghten* instruction, was added to the test. Chief Justice Shaw stated:

If then it is proven to the satisfaction of the jury, that the mind of

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the survey, the author recognizes the inherent inadequacies of the poll. It is cited, however, not to stress any exact formulation of opinion, but to show the basic contempt with which many psychiatrists view the *M'Naghten* test.

66. Appendix B to § 4.01 of the MODEL PENAL CODE (final draft 1966).

67. 276 So. 2d at 22.

68. 357 F.2d at 620.



the accused was in a diseased and unsound state, the question will be, whether the disease existed to so high a degree that for the time being it overwhelmed the reason, conscience and judgment, and whether the prisoner, in committing the homicide, acted from an irresistible and uncontrollable impulse; if so, then the act was not the act of a voluntary agent, *but the involuntary act of the body*, without the concurrence of a mind directing it.<sup>69</sup>

The “irresistible impulse” focus shifts away from a pure “right-wrong” dichotomy, exculpating the defendant who acted from an internal impulse resulting from an actual existing disease of the mind, which he could neither resist nor control. It was not intended to encompass irresistible impulse produced *entirely* by emotion, although the two were often mistakenly intermingled. If it could be shown (despite an accused’s knowledge that his act was wrong) he was acting on an internal impulse caused by a diseased mind, and that he was unable to control this impulse, grounds for acquittal were established. Despite its acceptance in many states as a supplement to *M’Naghten*, this test also received criticism as some courts questioned the viability of the doctrine.<sup>70</sup>

Many courts view the test, which attempted to ameliorate the harmful results of *M’Naghten*, as inherently inadequate. An additional criticism of “irresistible impulse” enunciated a doubt that the concepts upon which the test were based even existed.<sup>71</sup> The term implies that a crime impulsively committed was necessarily the result of an uncontrollable urge. Thus, “the ‘irresistible impulse’ test is unduly restrictive because it excludes the numerous instances of crimes committed after excessive brooding and melancholy by one who is unable to resist psychic compulsion or to make any real attempt to control his conduct.”<sup>72</sup> This leads to inconsistent verdicts where the manner in which the crime was perpetrated becomes more important than the accused’s state of mind.

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69. *Commonwealth v. Rogers*, 7 Metc. 500, 502 (1844), as cited in WEINREB, *CRIMINAL LAW: CASES, COMMENTS, QUESTIONS* 393 (2d ed. 1975) (emphasis added).

70. *State v. Maish*, 29 Wash. 2d 52, 185 P.2d 486 (1947); *State v. Witt*, 342 So. 2d 497 (Fla. 1977); 357 F.2d 606. See also Hall, *Psychiatry and Criminal Responsibility*, 65 YALE L.J. 761 (1956).

71. 357 F.2d 606.

72. *Id.* at 620-21. See also Wechsler, *The Criteria of Criminal Responsibility*, 22 U. CHI. L. REV. 367 (1955).

Shrewd defense counsel were able to confuse juries and thus vitiate any improvement this test had over *M'Naghten*.

In finding "irresistible impulse" unsatisfactory, one court concluded that the test was "little more than a gloss on *M'Naghten*, rather than a fundamentally new approach to the problem of criminal responsibility."<sup>73</sup> This view forced some courts finding *M'Naghten* too rigid, to look elsewhere.

In 1954, Judge Bazelon opined in *Durham v. United States*<sup>74</sup> that a defendant was not criminally responsible "if his unlawful act was the product of mental disease or defect." This concept not only removed the limitations which had previously burdened expert testimony, but encouraged the psychiatrist to fully report all relevant information concerning the accused's sanity.

The *Durham* test completely replaced *M'Naghten* in those jurisdictions which adopted it. Because it deemphasized the cognitive element, looking instead to the accused's volitional makeup on a subjective basis, its advantages over *M'Naghten* were clearly apparent. However, despite its great improvement over the *M'Naghten* test, *Durham* too had deficiencies rendering it unacceptable. There was recognition of an intrinsic nexus problem, which required proving that the offense committed was a product of mental disease or defect. Moreover, the lack of tangible guidelines to aid the fact-finder was an even greater fundamental flaw. This resulted in the battle of the psychiatrists which had the effect of "usurp[ing] the jury's function."<sup>75</sup> Thus, the *Durham* test fell into disfavor, being rejected by all but two states.<sup>76</sup> Even Bazelon's court eventually rejected the concept.<sup>77</sup>

During the year preceding the pronouncement in *Durham*,<sup>78</sup> a group of medical and legal scholars began to meet in an attempt to create a more accurate and workable definition of criminal responsibil-

73. 357 F.2d at 621.

74. 214 F.2d 862, 874 (D.C. Cir. 1954).

75. 357 F.2d at 621. *But see* Blocker v. United States, 288 F.2d 853 (D.C. Cir. 1961)(Burger, J., concurring).

76. *See* ME. REV. STAT. ANN. tit. 15, § 102 (1980); State v. Pike, 6 A.R. 533, 49 N.H. 399 (1870).

77. United States v. Brawner, 471 F.2d 969 (D.C. Cir. 1972).

78. 214 F.2d 862 (D.C. Cir. 1954).

ity.<sup>79</sup> After nine years of research, drafting and revising, the American Law Institute adopted Section 4.01 of the Model Penal Code in 1962.

This new test held an accused not responsible for criminal conduct which, due to a mental disease or defect renders him *substantially* incapable of appreciating the criminality of his conduct or conforming with the requirements of the law.<sup>80</sup> The improvement over *M'Naghten* appears obvious. By using the word "substantial" the test recognizes the difficulty implicit in demanding incapacity be *total* in order to find the accused criminally responsible.

The choice of the word "appreciate" rather than "know" was critical in that "mere intellectual awareness that conduct is wrongful, when divorced from appreciation or understanding of the moral or legal import of behavior, can have little significance."<sup>81</sup> By modifying "criminality" in this manner, ALI authors recognized the grey area dividing the two terms with respect to the human mind.

Another area of improvement over its predecessors was the lesser degree of importance the ALI standard placed on expert testimony. Although psychiatric testimony is admissible whenever relevant, it does not pretend to encroach upon the purview of the jury. Thus the pratfall of *Durham* was avoided by ALI's careful elimination of rigid classifications.

The ALI formulation "accounts for a defendant's entire mental condition, including both cognitive and volitional capacities, and

79. This group was headed by Professors Herbert Weshcler of Columbia University who served as the chief reporter, and Louis B. Schwartz of the University of Pennsylvania.

80. MODEL PENAL CODE § 4.01 (final draft 1966):

(1) A person is not responsible for criminal conduct if at the time of such conduct as a result of mental disease or defect he lacks substantial capacity either to appreciate the criminality of his conduct or to conform his conduct to the requirements of law.

(2) The terms 'mental disease or defect' do not include an abnormality manifested by repeated criminal or otherwise antisocial conduct.

The drafters created a possible alternative by allowing the adopting jurisdictions to replace the word "criminality" with "wrongfulness". *See, e.g.*, 357 F.2d 606, 622 n.52, wherein the court stated that "[w]e have adopted the word 'wrongfulness' . . . because we wish to include the case where the perpetrator appreciates that his conduct is criminal, but because of a delusion, believes it to be morally justified." *Id.*

81. 357 F.2d at 623.

properly recognizes that partial impairment may preclude criminal responsibility."<sup>82</sup> The recognition that a partial impairment could affect an accused's volitional capacities was a vast improvement over *M'Naghten's* total incapacity edict.

Additionally, the test is couched in simple language enabling medical experts to more clearly communicate their clinical observations to the jury.<sup>83</sup> Because of this, the jury is able to reach its own conclusion as to the accused's criminal responsibility, rather than accept the expert's opinion as determinative.<sup>84</sup> Thus an additional weakness of *Durham* is avoided.

The Model Penal Code test is not, however, without critics. One objection is that its "substantial impairment" requirement is vague and therefore "susceptible to purely personal interpretation by jurors."<sup>85</sup> Judge Bazelon claims that the use of the word "result" would lead to conclusory expert opinions in the same manner which resulted from the product language of the *Durham* test.<sup>86</sup>

Despite these criticisms, the test continues to flourish. Accepted in the vast majority of the federal jurisdictions,<sup>87</sup> it is increasingly being used to replace *M'Naghten* in those jurisdictions which had maintained the older test.

### Conclusion

There is little doubt that the *M'Naghten* test fails to adequately consider all of those elements comprising the decision making process. Focusing entirely on cognition, while ignoring volitional aspects of behavior, seems primitive in light of the current state of psychiatric science. Because of the test's rigid limitations, defendants who are not adjudicated insane are confined in penal institutions rather than hospi-

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82. Comment, *M'Naghten Rule Abandoned in Favor of "Justly Responsible" Test for Criminal Responsibility*, 14 SUFFOLK L. REV. 617, 624 (1980) (footnotes omitted).

83. *Id.* at 625.

84. *Id.*

85. *Id.* at 625. See *Wade v. United States*, 426 F.2d 64, 77-78 (9th Cir. 1970) (Trask, J., dissenting).

86. *United States v. Brawner*, 471 F.2d 969, 1027 (D.C. Cir. 1972) (Bazelon, C.J., concurring and dissenting).

87. See note 34 *supra*.

tals. This results in untreated mentally ill people returning to society, providing no inhibition of recidivism.

Although the Model Penal Code test is not without drawbacks, it appears to have a more solid foundation in current medical diagnostic ability than any other test currently used. To say that it more nearly reflects the state of modern psychiatry than *M'Naghten* is an understatement.

Because the Model Penal Code test promotes a more liberal approach in the determination of insanity, it assures that mentally infirm defendants will receive necessary medical treatment, and juries will be able to make more accurate and educated decisions. This serves the needs of society to a far greater extent than does maintenance of the current test in Florida, which, despite minor alterations, is still a woefully inadequate index of criminal responsibility.

*Joseph R. Dawson*

## Landlord Liability to Tenants for Crimes of a Third Party: The Status in Florida

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### Introduction

In recent decisions,<sup>1</sup> Florida courts have allowed tenants to recover damages from landlords resulting from criminal acts of third parties which occurred on the landlord's premises. These decisions raise questions regarding the basis of the landlord's duty to provide security, the foreseeability of the crime, and the standard of care to which the landlord will be held.

The decisions of Florida District Courts of Appeal which have addressed the issue share common denominators which will serve to narrow the focus of this note. Each of the three cases dealt with a landlord-tenant relationship in a residential setting where the tenant was the victim of a violent crime.<sup>2</sup> The criminal's access to the premises was accomplished in each instance by entry through a common area. The landlord in all three situations had no prior connection with the criminal; but each landlord had some form of notice of previous crimes on the premises or in the surrounding area.

There is a dearth of Florida cases<sup>3</sup> on the issue of a landlord's liability to his tenant for the violent crimes of a third party. The three district courts which have addressed the issue proposed criteria, albeit hazy, for the finding of duty and foreseeability. Equally vague are the courts' guidelines establishing the standard of care to which the land-

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1. *Ten Assocs. v. McCutchen*, 398 So. 2d 860 (Fla. 3d Dist. Ct. App. 1981); *Whelan v. Dacoma Enterprises, Inc.*, 394 So. 2d 506 (Fla. 5th Dist. Ct. App. 1981); *Holley v. Mt. Zion Terrace Apts., Inc.*, 382 So. 2d 98 (Fla. 3d Dist. Ct. App. 1980).

2. The court in *Holley* describes these reported crimes as "class one" presumably indicating those crimes which are typified by personal injury to the victim. 382 So. 2d at 99.

3. Judge Letts' majority opinion expressly notes the scarcity of Florida case law on the question of a landlord's liability to his tenants for the violent crimes of a third party. 394 So. 2d at 507

lord is to be held.<sup>4</sup> In the following discussion an attempt will be made to predict the possible responses of Florida courts to the questions of: a) whether a landlord has a duty to provide the tenant with security in the leased premises; b) whether the foreseeability of criminal activity on the leased premises can be imputed to the landlord; and c) to what standard of care is the landlord to be held.

Traditionally the landlord has been insulated from liability to his tenant. Consideration will be given to changes in the legal relationship between the landlord and tenant which have caused a diminution in the traditional insulation. In addition, leading cases from other jurisdictions which have addressed the issue of landlord liability will be examined along with the reaction of Florida courts to these decisions.

### Background

The court's reluctance to impose liability on landlords for the criminal acts of third parties has its discernable roots in the agrarian based landlord-tenant relationship.<sup>5</sup> The nature of this relationship at early common law centered upon the conveyance of land for a term of years, or an estate at will<sup>6</sup> which gave the tenant a property interest in the land.<sup>7</sup> Once this interest vested, the tenant acquired exclusive possession of, and control over, the land.<sup>8</sup> With power and control came the tenant's unfettered ability to provide self-protection.<sup>9</sup> Hence, it was unreasonable to impose upon the landlord liability for injuries occurring on property over which he had no control or present possessory interest.<sup>10</sup>

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4. 398 So. 2d 860; 382 So. 2d at 100-01.

5. *Kline v. 1500 Massachusetts Ave. Apt. Corp.*, 439 F.2d 477, 481 (D.C. Cir. 1970).

6. 2 *W. Blackstone, Commentaries\** 140-42.

7. 2 R. POWELL, *THE LAW OF REAL PROPERTY* ¶ 221 [1] (P.J. Roahn rev. 1977); 1 CASNER, *AMERICAN LAW OF PROPERTY* § 1.11 (1952).

8. *RESTATEMENT (SECOND) OF THE LAW OF PROPERTY*, Historical Perspective (1977); see generally R. BOYER, *SURVEY OF THE LAW OF PROPERTY* (3d ed. 1981) for a discussion of the nature of the leasehold as a mutant of personal and real property interests.

9. R. SCHOSHINSKI, *AMERICAN LAW OF LANDLORD TENANT* § 1.3 (1980).

10. W. PROSSER, *THE HANDBOOK OF THE LAW OF TORTS* § 63 (4th ed. 1971); see generally *AMERICAN LAW OF LANDLORD TENANT*, note 9 *supra* for a thorough

Traditional theories of tort liability for acts of a third party were equally narrow.<sup>11</sup> The general rule, that no duty is placed on an individual to control the behavior of a third party which results in physical harm to another is reflected in the *Restatement (Second) of Torts*.<sup>12</sup> But, as set forth in the *Restatement (Second) of Torts*, the general rule has two exceptions: when "(a) a special relation exists between the actor and the third party which imposes a duty upon the actor to control the third person's conduct; or (b) a special relation exists between the actor and the other which gives to the other a right to protection."<sup>13</sup> Employing these exceptions Florida courts have limited finding the existence of a special relationship to innkeeper-guest, common carrier-passenger, and business-invitee relationships.<sup>14</sup> The landlord-tenant relationship has not yet been recognized as sufficiently special for the purpose of imposing liability on the landlord.<sup>15</sup>

### Evolution of the Traditional Theories in *Kline v. 1500 Massachusetts Avenue, Inc.*

The United States Court of Appeals for the District of Columbia Circuit considered the traditional landlord-tenant relationship in *Kline v. 1500 Massachusetts Avenue Apartments, Inc.*<sup>16</sup> The plaintiff in *Kline* was a female tenant residing in the defendant's high rise apart-

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treatment of the agrarian tenurial relationship and its gradual progression into the contemporary landlord-tenant setting.

11. SCHOSHINSKI, *supra* note 9, § 4.1.

12. RESTATEMENT (SECOND) OF TORTS § 315 (1965).

13. *Id.*

14. Orlando Executive Park, Inc. v. P.D.R., 402 So. 2d 442 (Fla. 5th Dist. Ct. App. 1981); Reichenback v. Days Inn of America, Inc., 1981 Fla. Law Weekly 1673 (Fla. 5th Dist. Ct. App. July 15, 1981); Werndli v. Greyhound Corp., 365 So. 2d 177 (Fla. 2d Dist. Ct. App. 1978); Robart v. Jordan Marsh Co., 305 So. 2d 255 (Fla. 3d Dist. Ct. App. 1974).

15. See note 42 and accompanying text *infra*. Although Florida district courts have imposed a landlord's duty to take reasonable security measures in the face of foreseeable criminal acts of a third party, the duty stems from either contract obligation, the foreseeability of the criminal acts, or a combination of both. 382 So. 2d 98; 398 So. 2d 860; 394 So. 2d 506. None of the Florida district court decisions imposing the duty do so on the basis of a special relationship between the landlord and tenant. *Id.*

16. 439 F.2d 477 (D.C. Cir. 1970).



ments.<sup>17</sup> She was robbed and assaulted in the hallway of her apartment building and she sought compensation for the injuries she had received.

When the plaintiff initially moved into the building the defendant provided its tenants with some security measures. There were attendants by the front door and in the lobby of the building on a round-the-clock schedule. In addition, garage attendants locked street entrances when they went off duty in the evening. These measures deteriorated to such a degree that, at the time plaintiff was assaulted, the building was unattended and frequently left unlocked. As a result, criminal activity, of which the landlord had notice, occurred on the premises.<sup>18</sup>

Analyzing the traditional theories governing landlord liability,<sup>19</sup> the court discussed the landlord's early common law insulation from liability to tenants and its evolution into the present day landlord's duty to use reasonable care in maintenance of common areas.<sup>20</sup> The court noted that this duty was based on the landlord's exclusive control over undemised areas. Furthermore, the court recognized that the landlord would be liable for tenant injuries caused by his failure to use reasonable care in the maintenance and repair of common areas.<sup>21</sup>

After discussing the general rule that individuals are under no duty to protect others from the crimes of third parties, the *Kline* court

17. The *Kline* court notes that portions of defendant's building housed office space. *Id.* at 487 n.24. This fact is not determinative to the *Kline* court in light of the fact that the assault on plaintiff took place well past normal business hours.

To this we add our own comment that it is unlikely . . . that a patron of one of the businesses, even if disposed to criminal conduct, would have waited for five hours after the usual closing time to perpetrate his crime - especially one of a violent nature. Further, although it is not essential to our decision in this case, we point out that it is not at all clear that a landlord who permits a portion of his premises to be used for business purposes and the remainder for apartments would be free from liability to a tenant injured by the criminal act of a lingering patron of one of the businesses. If the risk of such injury is foreseeable, then the landlord may be liable for failing to take reasonable measures to protect his tenant from it.

*Id.*

18. *Id.* at 479.

19. See notes 9-14 and accompanying text *supra*.

20. 439 F.2d at 480-81.

21. *Id.* at 481; see also *Marlo Invs., Inc. v. Verne*, 227 So. 2d 58 (Fla. 4th Dist. Ct. App. 1969).

listed the traditional reasons for its application to the landlord-tenant relationship:

judicial reluctance to tamper with the traditional concept of the landlord-tenant relationship; the notion that the act of a third person in committing an intentional tort or crime is a superseding cause of the harm to another resulting therefrom; the oftentimes difficult problem of determining foreseeability of criminal acts; the vagueness of the standard which the landlord must meet; the economic consequences of the imposition of the duty; and conflict with public policy of allocating the duty of protecting citizens from criminal acts to the government rather than the private sector.<sup>22</sup>

Implicit in this catalogue of reasons is the court's hesitancy to establish a duty for which a basis and standard of care are difficult to ascertain. On the other hand the *Kline* court stated that "the rationale falters when it is applied to the conditions of modern day apartment living . . . . The rationale of the general rule exonerating a third party from criminal attack has no applicability to the landlord-tenant relationship."<sup>23</sup> Thus, the establishment of the landlord's duty to use reasonable care to protect a tenant from the foreseeable crimes of a third party<sup>24</sup> ultimately rests on the anachronistic character of the general rule and the foundation laid by the duty to use ordinary, reasonable, prudent care in the maintenance of common areas.

In establishing the landlord's duty, the *Kline* court emphasized the landlord's control over the common areas and his power to regulate security.<sup>25</sup> This power and control over the common areas has shifted from the tenant, where it rested in the agrarian relationship, to the landlord in the contemporary setting. In the court's opinion the tenant

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22. 439 F.2d at 481.

23. *Id.*

24. The court in *Kline* declines credit for creating this exception to the general rule choosing rather to view the decision as an amplification of the holding in *Kendall v. Gore Properties, Inc.*, 236 F.2d 673 (D.C. Cir. 1956). *Id.* at 485 n.19. The court in *Kendall* was faced with an issue which can be distinguished from *Kline* in that plaintiff's decedent in *Kendall* was strangled by an employee of the landlord. The gravamen of plaintiff's complaint was not the landlord's failure to provide adequate security but rather the negligent hiring and supervision of the employee.

25. 439 F.2d at 481.

no longer has the control and the power necessary to adequately protect himself against the violent crimes of third parties. This shift of power, coupled with the landlord's notice of criminal activity on the premises led the court to conclude that "it d[id] not seem unfair to place upon the landlord a duty to take those steps which are within his power [and] to minimize the predictable risk to his tenant."<sup>26</sup> This analysis provided the reasoning underlying imposition of tort based liability on the landlord. It stopped short, however, of declaring the landlord-tenant relationship as 'special' for the purpose of establishing a *prima facie* duty such as found in the innkeeper-guest relationship.

The court broadly defined foreseeability in terms of the probability and the predictability of the criminal acts of third parties.<sup>27</sup> Other than the broad range of conceivable situations suggested by these terms, the *Kline* decision offered no guidelines as to fact patterns which might be predictable or establish foreseeability. The court recognized that the finding of a duty without guidelines would result in uncertain and inconsistent application of the duty,<sup>28</sup> but the standards it set forth, i.e., predictability and probability, do little to alleviate these pitfalls.<sup>29</sup>

After examining the traditional property interpretation of the leasehold interest, which it found to be anachronistic,<sup>30</sup> the court suggested an alternative basis of recovery founded on contract theory. The basis for this alternative recovery is found in the holding of *Javins v. First National Realty Corp.*<sup>31</sup> *Javins* advocated departure from the feudal based interpretation of the landlord-tenant relationship in favor

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26. *Id.*

27. *Id.* at 483. The court takes issue with the looser definition set forth by the New Jersey Supreme Court in *Goldberg v. Housing Auth. of Newark*, 38 N.J. 578, 186 A.2d 291 (1962) which defined foreseeability with a view towards possibilities as opposed to probabilities. The *Kline* court presumably is not engaging in a semantic discussion, but rather underscoring the thought that its decision is not a radical departure from prior case law. *See* note 24 *supra*.

28. 439 F.2d at 481.

29. *See generally* Selvin, *Landlord Tort Liability for Criminal Attacks on Tenants: Developments Since Kline*, 9 REAL EST. L.J., 311 (1981); Comment, *The Landlord's Duty in New York to Protect His Tenant Against Criminal Intrusions*, 45 ALB. L. REV. 988 (1981); Note, *Security: A New Standard For Habitability*, 42 U. PITT. L. REV. 415 (1981).

30. 439 F.2d at 481. *See* note 25 and accompanying text *supra*.

31. 428 F.2d 1071 (D.C. Cir. 1970).

of one based on contract theory, recognizing “the modern trend toward treating leases as contracts [as] wise and well considered.”<sup>32</sup> In *Kline*, this interpretation was the groundwork for implying that the landlord assumed a contractual obligation to provide security.<sup>33</sup> The landlord’s power and control over common areas again were found at the heart of his obligation.<sup>34</sup> *Kline* suggests that the landlord’s contractual obligations to repair the common areas may be more far-reaching than those imposed by tort theories.<sup>35</sup> By using contract theory the court placed “the duty of taking protective measures guarding the *entire premises* and the areas peculiarly under the landlord’s control against the perpetration of criminal acts upon the landlord, the party to the lease contract who has the effective capacity to perform these necessary acts.”<sup>36</sup>

Finally, the *Kline* court suggested a landlord’s duty to provide security might be found by analogy to recognized special relationships.<sup>37</sup> The court suggested an analogy to the innkeeper-guest relationship<sup>38</sup> because of its contractual nature and the court’s perception of the landlord-tenant relationship as one of its modern equivalents.<sup>39</sup> The analogy is predicated on the identical factors used in establishing foreseeability in tort and contract based duties: power and control. The court reasoned that where “the ability of one of the parties to provide for his own protection has been limited in some way by his submission to the control of the other, . . . [the] duty should be imposed upon the one possessing control . . . .”<sup>40</sup> However, courts of other jurisdictions have overwhelmingly found the landlord-tenant relationship to be outside the confines of recognized special relationships.<sup>41</sup> Therefore, the analogy based duty found in *Kline* has had, at best, a tepid reception.<sup>42</sup>

32. *Id.* at 1076.

33. 439 F.2d at 481.

34. *Id.* at 482.

35. See note 21 and accompanying text *supra*.

36. 439 F.2d at 482 (emphasis supplied).

37. *Id.* at 485.

38. *Id.* See also note 14 *supra*.

39. *Id.*

40. *Id.* at 483.

41. SCHOSHINSKI, *supra* note 9, § 1.3.

42. *Gulf Reston Inc. v. Rogers*, 215 Va. 155, 207 S.E.2d 841 (1974); *Ten Assocs. v. McCutchen*, 398 So. 2d 860; *Whelan v. Dacoma Enterprises, Inc.*, 394 So. 2d 506; *Scott v. Watson*, 278 Md. 160, 359 A.2d 548 (Ct. App. 1976); *Hall v. Frakoni*, 68

Tort and contract theories as applied in *Kline* present litigants with a practicable means of establishing a landlord's duty although the innkeeper-guest analogy has met with little success. The remainder of this note will examine Florida's reaction to tort and contract theories, as well as the treatment they have received in other jurisdictions.

### Florida's Reaction to *Kline* and its Progeny

The *Kline* court used the modern contractual construction of the leasehold, as suggested in *Javins*,<sup>43</sup> to find landlord duty, and Florida generally has accepted the same interpretation of the leasehold interest.<sup>44</sup> This approach removes the obstacles associated with traditional property-oriented methods of lease interpretation. *Holley v. Mt. Zion Terrace Apartments, Inc.* and *Ten Associates v. McCutchen*<sup>45</sup> acknowledged the existence of a contractual duty to provide security. In neither case did the landlord overtly assume to protect the tenant from crimes of third parties.<sup>46</sup>

Florida's Third District Court of Appeal, in *Holley*<sup>47</sup> approved and followed the *Kline* inroads to landlord liability when it set aside a summary judgment in favor of the landlord.<sup>48</sup> In *Holley* the defendant leased an apartment located in a high crime area to the plaintiff's decedent.<sup>49</sup> The defendant instituted and charged fees over and above the

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Misc. 2d 470, 330 N.Y.S.2d 637 (Civ. Ct. 1972); *but see* *Trentacost v. Brussel*, 82 N.J. 214, \_\_\_, 412 A.2d 436, 441 (1980) where the court in dictum indicates that reconsideration of the feasibility of a special duty based on the landlord-tenant relationship might be in order.

43. See note 31 and accompanying text *supra*.

44. The case generally credited as Florida's acceptance of a contractual interpretation of the leasehold interest is *Butler v. Maney*, 146 Fla. 41, 200 S. 226 (1941).

45. 382 So. 2d 98; 398 So. 2d 860.

46. Presumably since *Holley* and *McCutchen* have legitimized recovery based on implied contractual obligations the landlord's duty would be crystalline in a factual setting with an express assumption of the landlord's obligation to provide security. Research has not divulged a landlord who was willing to expressly assume this obligation. *Id.* See note 15 and accompanying text *supra*.

47. 382 So. 2d 98.

48. *Id.* at 99-100. In order for the *Holley* court to find the existence of a genuine issue of fact regarding the defendant's conduct which might give rise to liability, the court first had to recognize that the landlord had a duty to provide security.

49. 382 So. 2d at 99.

agreed rent for security measures it subsequently abandoned.<sup>50</sup> The court greatly emphasized that although the defendant continued to derive income from these fees,<sup>51</sup> none of this money was spent on security the year plaintiff's decedent was raped and murdered.<sup>52</sup> In finding that a contractual duty to provide security existed, the court focused on the defendant's continued acceptance of these additional monies. It found that receipt of the fees raised a genuine issue as to whether the landlord had implicitly assumed to provide protective measures for the tenants. The existence of this factual question required reversal of the summary judgment; thus the cause was remanded for further determination.<sup>53</sup>

The *Holley* decision also established a duty on the landlord based on the foreseeability of criminal acts as set forth in *Kline*.<sup>54</sup> The court found foreseeability via its reference to the frequency of reported violent crimes on the landlord's premises.<sup>55</sup> The foundation for finding foreseeability in *Holley* stemmed from defendant's notice of crime in the area.<sup>56</sup> Not only were crimes frequently reported, but the defendant himself refused to accept cash for business transactions on the premises.<sup>57</sup>

It is apparent that an individual landlord's notice<sup>58</sup> of repeated criminal incidents on, or near, his premises is determinative in finding sufficient foreseeability to impose liability.<sup>59</sup> A broad range of circum-

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.* at 100.

54. *Id.* at 99.

55. *Id.*

56. *Id.* at 100.

57. *Id.* at 99.

58. An issue which conceivably would have a great impact on Florida's non-resident landlords deals with basing the duty to protect against foreseeable criminal acts on constructive notice. The court in *Kline* refers to numerous police reports of crimes on the landlord's premises and states that the "reports in themselves constitute constructive notice to the landlords." 439 F.2d at 479 n.2.

59. *But see* *Trentacost v. Brussel*, 82 N.J. at \_\_\_, 412 A.2d at 443, where, in dictum, the New Jersey Supreme Court indicates that a landlord's duty to protect tenants from foreseeable criminal acts of third persons might be founded on a breach of an implied warranty of habitability which the court reasoned "exists independently of . . . [the landlord's] knowledge of any risks, [hence] there is no need to prove notice of

stances have provided a landlord with the necessary notice for the imposition of a duty based on foreseeability. Florida decisions indicate that the location of the landlord's premises in a high crime area may be sufficient to impose this duty.<sup>60</sup> Other jurisdictions have suggested that any of the following factual settings warrant imposition of a foreseeability based duty: a) previous crimes specifically on the landlord's property;<sup>61</sup> b) possession of "composite drawings of the suspect and a general description of his *modus operandi*" coupled with the knowledge that prior crimes meeting this description had occurred on, or near, the landlord's premises;<sup>62</sup> c) the posting of a notice by the landlord informing the tenants of the commission of crimes on the premises.<sup>63</sup>

The question of whether the criminal attack must occur in an area under the landlord's exclusive control apparently presents little controversy. The murder in *Holley* did not occur in the common area, under the landlord's exclusive control; rather, the act occurred in the decedent's apartment which was entered through a window adjoining the building's common walkway.<sup>64</sup> However, this fact did not preclude recovery where "the basis of the plaintiff's case [was] the almost undisputed fact that the intruder could have entered the apartment only through the common walkway . . . ."<sup>65</sup>

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such a defective and unsafe condition to establish the landlord's duty." It could be argued that faced with the proper situation New Jersey courts would dispense with the notice requirement found in the vast majority of other jurisdictions. For a sampling of these holdings, see cases cited in notes 59-61 *infra*.

60. 398 So. 2d 860; 394 So. 2d 506.

61. *Scott v. Watson*, 278 Md. at \_\_\_, 359 A.2d at 554. The court in *Scott* "think[s] this duty arises primarily from criminal activities existing on the landlord's premises, and not from knowledge of general criminal activities in the neighborhood." *Id.*

62. *O'Hara v. Western Seven Trees Corp.*, 75 Cal. App. 3d 802, 142 Cal. Rptr. 487 (Ct. App. 1977). In addition, there apparently had been previous rapes in the same building that the plaintiff inhabited. *Id.*

63. *Sherman v. Concourse Realty Corp.*, 47 A.D.2d 134, 365 N.Y.S.2d 239 (App. Div. 1975); but see *Dick v. Great South Bay Co.*, 106 Misc. 2d 686, 435 N.Y.S.2d 240 (Civ. Ct. 1981) wherein the court held that plaintiff's failure to prove prior criminal activity did not negate her cause of action. Plaintiff sought recovery from her landlord for injuries she suffered in a robbery in the hallway of her apartment building. *Id.*

64. 382 So. 2d at 99.

65. *Id.* at 101. See also 75 Cal. App. 3d at \_\_\_, 142 Cal. Rptr. at 490, wherein

In Florida, the related question of whether a previous crime must be of the same specific kind as the one complained of remains unanswered in the context of the landlord-tenant relationship.<sup>66</sup> The Court of Appeals of the District of Columbia responded to the question in *Spar v. Oboya*,<sup>67</sup> where the tenant was shot as he was walking through an unsecured door into the foyer of his apartment building. The landlord argued that a record of prior robberies was inadequate to establish that he could have foreseen a shooting.<sup>68</sup> The court found no merit in this argument in light of “evidence of (a) individual apartment units of the building being burglarized . . . , and (b) the presence of unauthorized persons in the building.”<sup>69</sup> The court in *Spar* considered these factors collectively and concluded the prior incidents were sufficient “to have put . . . [the landlords] on notice of the likelihood of unauthorized entry into the building by persons with criminal intent.”<sup>70</sup> It is possible that a stricter standard than that used in *Spar* will be required by Florida courts. The application of a stricter standard was suggested by the Fourth District Court of Appeal in *Relyea v. State*.<sup>71</sup> The plaintiff alleged that the assault and murder of students at a state university was the result of inadequate security.<sup>72</sup> However, plaintiff was unable to prove the incidence of prior assaults on campus, the “similar criminal acts committed” requirement necessary for a successful recovery.<sup>73</sup>

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the landlords “contend[ed] that the fact the assault took place inside [the tenant’s] apartment should absolve them, since she, not they had control over the common area. This fact is not determinative. Failure to take reasonable precautions to safeguard the common areas under . . . [the landlord’s] control could have contributed substantially, as alleged, to [the tenant’s] injuries.” *Id.*

66. See dissenting opinion by Judge MacKinnon in *Kline*. He takes issue with a finding of notice on the landlord’s part arguing that evidence of “one solitary instance of an assault and robbery is an insufficient base to support a finding that assaults and robberies are a predictable risk from which the landlord would have every reason to expect like crimes to happen again.” 439 F.2d at 489.

67. 369 A.2d 173 (D.C. Cir. 1977).

68. *Id.* at 177.

69. *Id.*

70. *Id.*

71. 385 So. 2d 1378 (Fla. 4th Dist. Ct. App. 1980).

72. *Id.* at 1383.

73. *Id.* The *Relyea* court upheld a judgment for the defendant insurance company based on the absence of prior crimes and consequently the unforeseeability of the incident complained of. *Id.* The State of Florida and its agents operating the university



The sufficiency of foreseeability alone as a basis for imposition of a duty in Florida is unclear. *Holley* recognized duties based on both foreseeability and contract theories, but the court never declared them to be interdependent or independent. The Fifth District Court of Appeal in *Whelan v. Dacoma Enterprises, Inc.*<sup>74</sup> found a duty existed on the part of the landlord to protect his tenant from the foreseeable criminal acts of a third party despite the absence of any allegation of a contractual obligation. Certainly this holding suggests that the court is amenable to imposition of a duty based on foreseeability alone.<sup>75</sup> It could be argued that this hypothesis is supported, implicitly, in Judge Beranek's dissenting opinion in *Whelan*.<sup>76</sup> He would require either the landlord's express or implied contractual obligation to provide security prior to

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in question were exempted from liability based on theories of sovereign immunity. *Id.* at 1381.

74. 394 So. 2d 506. Although *Whelan* emanates from Florida's Fifth District, the panel is comprised of Judges Letts, Downey and Beranek all of whom are Fourth District judges. It could be argued that presented with a similar case the Fourth District would impose liability similar to that found in *Whelan*.

75. The court in *Whelan* notes the absence of any allegation of statutory violations on the landlord's part. FLA. STAT. § 83.51 (2)(a) (1973)(emphasis supplied) provides:

Unless otherwise agreed in writing, in addition to the requirements of subsection (1) which deals with health code violations and structural requirements, the landlord of dwelling units other than a single-family home or a duplex shall, at all times during the tenancy, make *reasonable* provisions for:

1. . . .
2. Locks & keys
3. The clean and safe condition of common areas . . . .

This portion of the Landlord Tenant Act apparently has never been presented as a basis for recovery for injuries resulting from a criminal attack. The likelihood of success on such a basis is limited in light of the holding in *deJesus v. Seaboard Coast Line R. Co.*, 281 So. 2d 198, 200 (Fla. 1973), and *Beaches Hosp. v. Lee*, 384 So. 2d 234, 237 (Fla. 1st Dist. Ct. App. 1980). Both the Florida Supreme Court and the First District Court of Appeal concluded that violation of a statute which does not impose strict liability is not negligence per se, but rather evidence of negligence. It is interesting to note that FLA. STAT. § 83.51(2)(a) requires a landlord to employ *reasonable* measures. This standard presents the same difficulties as tort and contract recoveries in failing to establish parameters of conduct for the landlord. See note 89 and accompanying text *infra*.

76. 394 So. 2d at 508-09.

the imposition of duty.<sup>77</sup> The dissent's addition of a prerequisite contractual duty suggests that Judge Beranek also viewed the majority's decision as approval for landlord duty based on foreseeability alone.

Whether Florida will impose a duty based solely on foreseeability is clouded by the Third District Court of Appeal in the *McCutchen* opinion.<sup>78</sup> The court in *McCutchen* imposed a duty on a landlord to use reasonable care in providing his tenants with protection against criminal acts of third parties without stating whether this duty arose from a tortious or contractual basis. The facts in *McCutchen* showed the defendant's apartment complex was located in a high crime area where there had been "substantial criminal activity within the year prior to the attack on McCutchen . . . ."<sup>79</sup> Furthermore, defendant's advertisements specifically referred to the provision of twenty-four hour security services.<sup>80</sup> Based on these facts the court concluded that the landlord "clearly recognized and assumed the duty to protect his tenants from foreseeable criminal conduct."<sup>81</sup> Noting the presence of both foreseeability and express or implied contractual duties the court specifically declined to decide "whether in Florida foreseeability alone is a sufficient basis for finding the duty, or whether, in addition, a landlord must expressly or impliedly assume such a duty."<sup>82</sup>

The stage is set for potential conflict between at least two of Florida's five judicial districts. There is a suggestion that the *Whelan* court is amenable to the imposition of a landlord's duty based on foreseeability alone.<sup>83</sup> The *McCutchen* court expressly declined to decide whether either tort or contract theories would serve independently as a basis for finding a duty to provide security.<sup>84</sup> Obviously, without a duty to provide security a landlord cannot be held liable for injuries resulting from inadequate security. As such, the basis for the landlord's duty is a critical element of an action seeking recovery for injuries resulting from inadequate security measures and clarity of the requisite basis of the

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77. *Id.* at 508.

78. 398 So. 2d 860.

79. *Id.* at 1023.

80. *Id.*

81. *Id.*

82. *Id.* at 1024 n.2.

83. See note 74 and accompanying text *supra*.

84. See note 81 and accompanying text *supra*.

duty undoubtedly would be helpful to litigants, their counsel and the courts.

The decisions of *Holley*, *McCutchen* and *Whelan*<sup>85</sup> embrace the landlord's duties under contract and tort theories to provide a tenant with protection from the foreseeable crimes of a third party. The recognition of the threshold requirement of duty, however, does not establish a landlord's liability nor does it guarantee a tenant's recovery for injuries suffered.<sup>86</sup> The next question becomes: what measures must a landlord take in order to discharge this duty? Certainly the answer to this question is of paramount concern to the landlord, in his attempt to avoid incurring liability,<sup>87</sup> and to the tenant, in his attempt to prove an actionable breach of duty.<sup>88</sup>

As in most situations where the issue hinges upon an individual's use of ordinary, reasonable, prudent care, Florida courts have placed the responsibility of determining the issue on the jury.<sup>89</sup> In attempting to offer a prediction of the jury's determination of the standard of care,

85. See note 1 *supra*.

86. *Navajo Circle, Inc. v. Developments Concepts Corp.*, 373 So. 2d 689, 691 (Fla. 2d Dist. Ct. App. 1979).

87. "One who has performed his full duty with respect to the exercise of care is not liable for an injury to the person of another . . ." *Robb v. Pike*, 119 Fla. 833, —, 161 So. 732, 734 (1935).

88. In addition to proving duty and subsequent breach the tenant should be aware of possible defenses to actions sounding either in contract or in tort. A thorough analysis of the possible defenses is beyond the scope of this note, however, see *John's Pass Seafood Co. v. Weber*, 369 So. 2d 616 (Fla. 2d Dist. Ct. App. 1979); *Smith v. General Apt. Co.*, 133 Ga. 927, 213 S.E.2d 74 (Ct. App. 1975); FLA. STAT. § 83.47 for an indication of the effect of exculpatory clauses on a landlord's liability to a residential tenant. See 382 So. 2d at 101; *Scott v. Watson*, 278 Md. 160, 359 A.2d 548 (Ct. App. 1976); *Gibson v. Avis Rent-a-Car Sys., Inc.*, 368 So. 2d 520 (Fla. 1980), for rejections of arguments seeking to dispel liability based on proximate cause where the foreseeability of intervention and the resultant avoidable harm is the negligent conduct in itself. See *Hoffman v. Jones*, 280 So. 2d 431 (Fla. 1973); *Blackburn v. Dorta*, 348 So. 2d 287 (Fla. 1977); *Kuhn v. Harless*, 390 So. 2d 721 (Fla. 4th Dist. Ct. App. 1980); 394 So. 2d at 508 for language to the effect that, in Florida, a plaintiff's comparative negligence would not preclude recovery.

89. "Under our system, it is peculiarly a jury function to determine what precautions are reasonably required in the exercise of a particular duty of due care." 382 So. 2d at 100-01. See also *Bennett v. Mattison*, 382 So. 2d 873, 875 (Fla. 1st Dist. Ct. App. 1980).

consideration of the findings of other courts offer little elucidation. Other courts have suggested provisions ranging from a lock "capable of adequately performing the function to which it was put"<sup>90</sup> to avoidance of conditions which are "conducive to criminal assaults."<sup>91</sup> The spectrum of reasonable care seems to range from preventive measures<sup>92</sup> to steps which avoid fostering the criminal's purposes.<sup>93</sup> In essence the range consists of the subtle distinction between keeping an incident from happening and not promoting its occurrence.

In light of the prominent role a jury plays in finding what is currently demanded of an ordinary, reasonable, prudent landlord, it is virtually impossible to accurately predict what measures will satisfy a landlord's duty in any but the most extreme cases. The Court of Appeals of the District of Columbia Circuit in *Ramsey v. Morrisette* addressed the question of standard of care as follows: "We by no means suggest that there is a general legal duty on the landlord to provide full time resident managers or to install locks on the front door of an apartment house. The test is what is reasonable in all the circumstances."<sup>94</sup> Ultimately, as suggested by *Ramsey*, and alluded to by the Florida courts, the fact finder will have to make a determination of reasonable care considering the facts and circumstances of each individual case.

### Conclusion

Under traditional property interpretations of the leasehold interest, and tort concepts basing liability on the existence of a special relationship, a landlord was exempted from liability to a tenant for the crimi-

90. *Warner v. Arnold*, 133 Ga. App. 174, —, 210 S.E.2d 350, 353 (1974). It is interesting to note that the *Warner* court defines adequate security measures in terms of adequacy. The definition of a word which employs the word sought to be defined has never proven effective and serves to emphasize the elusive nature of the standard of care.

91. *Johnston v. Harris*, 387 Mich. 569, 198 N.W.2d 409 (1972). This case deals with the inadequacy of locks and illumination. Apparently the testimony of a public lighting expert who drew corollaries between the inadequacy of the lighting and the high incidence of crime carried some weight in the court's decision.

92. *E.g.*, the installation of locks. 133 Ga. App. 174, 210 S.E.2d 350.

93. *E.g.*, increasing the intensity of lighting to provide an atmosphere which discourages criminal activity. 387 Mich. 569, 198 N.W.2d 409.

94. 252 A.2d 509, 512 (D.C. Cir. 1969).

nal acts of a third party. Two of Florida's district courts have limited a landlord's exemptions and imposed upon him a duty to provide adequate security measures in instances where a landlord has contractually assumed that obligation or when criminal acts of third parties are foreseeable.<sup>95</sup> The question of whether Florida will impose a duty to provide security based on the tort concept of foreseeability alone remains unanswered.

Even when the duty has been established, circumstances constituting foreseeability appear unsettled. Notice of prior criminal activity, hence foreseeability, is elementary to the imposition of a duty. Whether to constitute notice these prior activities must have occurred on the landlord's premises and whether the incidents must be of the same kind as the acts complained of remains unclear in the context of the landlord-tenant relationship.<sup>96</sup> Furthermore, Florida decisions do not indicate whether the landlord must have actual notice of the incidents of crimes on, or near, his premises.<sup>97</sup>

The determination of fulfillment of the standard of care continues to be a factual question for the jury to decide. Cases from other jurisdictions indicate that these decisions will be made on a case by case basis. Florida courts have not expressly adopted the case by case approach in the context of a landlord's use of reasonable care to protect his tenants from the criminal acts of third parties. However, application of a case by case approach in the landlord-tenant context is probable in light of its use in other tort actions dependent on a standard of reasonable care.

The threshold question of whether a landlord has a duty to protect his tenants from the foreseeable criminal acts of third parties has been answered affirmatively by two District Courts of Appeal in Florida.<sup>98</sup> Now that a landlord is under an obligation to exercise reasonable care in his provision of security against foreseeable criminal acts, the area of liability resulting from a breach of this duty may be litigated more often. With new cases will come clearer pronouncements by Florida courts on the questions of the basis for the duty, the criteria for finding

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95. Florida's Third District Court of Appeal in *McCutchen* and *Holley*, and Florida's Fifth District Court of Appeal in *Whelan*.

96. See note 72 and accompanying text *supra*.

97. See note 57 and accompanying text *supra*.

98. See note 94 *supra*.

foreseeability, and the standards of care to be employed when addressing the landlord's liability to his tenants for the crimes of a third party made possible by inadequate security.

*Theresa M. B. Van Vliet*

# The Impact of FIRPTA and ERTA on Florida Real Estate Investment by a Netherlands Antilles Corporation

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## Introduction

The tax advantages once granted a foreigner using a foreign corporation to invest in United States real estate have disappeared. This paper will comment on the provisions of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA)<sup>1</sup> and the Economic Recovery Tax Act of 1981 (ERTA).<sup>2</sup>

Many foreign investors will be affected by the new laws. Recently, a study was conducted by the Secretary of the Treasury identifying foreign investment in United States real property. Although the information was taken from press clippings and the actual amount invested is probably much greater, the Office of Foreign Investment found that foreigners had invested \$1,101,000,000 in United States real property in 1978.<sup>3</sup> Of this dollar volume, an estimated 25% was invested in Florida realty alone. As was reported in a recent edition of *Florida Trend* magazine,<sup>4</sup> \$241,000,000 was invested in Miami in 1979, including an "alarming number [of investments] traced to . . . narcotics [money], tax evasion and currency smuggling." In view of this phenomenon, Congress promulgated FIRPTA and ERTA in an effort to curb the use of illicit funds in purchase of United States realty. Moreover, the legislation was passed to stem the growing tide of foreign investment with its perceived attendant influence on the American public.

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1. Pub. L. No. 96-499, § 1121, 94 Stat. 2682.

2. Pub. L. No. 97-34, § 831, 95 Stat. 352.

3. DEPARTMENT OF THE TREASURY, TAXATION OF FOREIGN INVESTMENT IN U.S. REAL ESTATE (May 1979).

4. Calonius, *Offshore Money Floods Miami*, FLORIDA TREND, at 38.

## Taxation of the United States Citizen and the United States Corporation by the United States

Unlike citizens of other countries, United States citizens, residents and corporations are taxed on their worldwide income. Deductions are allowed for most of the ordinary and necessary expenses involved in the earning of income.<sup>5</sup> Usually, gains from one activity may be offset against the losses of another.<sup>6</sup> The allowance of deductions and the ability to offset gains against losses are most important to the real estate investor. Income from real estate investments can be reduced by the amounts paid for operating the property,<sup>7</sup> mortgage interest,<sup>8</sup> insurance,<sup>9</sup> taxes<sup>10</sup> and depreciation.<sup>11</sup>

Real estate in Florida, appreciating rapidly over the last ten years, lures investors with the promise of large capital gain. Income earned from operating the property has not been the primary motivation for investment in Florida real estate, since it pales in comparison to the profits made through property resale.

When real estate which is held for more than one year is sold, the United States taxpayer must treat the gain, up to the amount of excess depreciation, as ordinary income and the remainder may be treated as capital gain.<sup>12</sup> Additionally, an individual is able to deduct sixty percent of the capital gain on the sale of the property and is only required to pay tax on the remaining forty percent.<sup>13</sup> Thus, with a maximum tax rate of fifty percent on ordinary income in 1982, the maximum effective rate of tax on an individual's capital gain will be twenty percent (forty percent of fifty percent).

An individual with substantial long term capital gain may be affected by the alternative minimum tax.<sup>14</sup> This tax, imposed on the sum of taxable income plus the long term capital gains deduction plus cer-

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5. I.R.C. § 162.

6. *Id.* § 1231.

7. *Id.* § 162.

8. *Id.* § 163.

9. *Id.* § 162.

10. *Id.* § 164.

11. *Id.* § 167.

12. *Id.* § 1238.

13. *Id.* § 1202(a).

14. In determining the taxpayer's total tax liability, the alternative minimum tax



tain adjusted itemized deductions, is assessed at progressive rates up to twenty percent. The individual's tax liability is the higher of the tax computed by the ordinary rules, or the tax computed under the alternative minimum tax rules. In contrast, the long term capital gains of a United States corporation are taxed, without any special deduction, as ordinary income or at twenty-eight percent, whichever is lower.<sup>15</sup>

### Taxation of Non-Resident Aliens and Foreign Corporations by the United States

The United States taxes a non-resident alien<sup>16</sup> or a foreign corporation<sup>17</sup> on three types of income. These include: income effectively connected with a United States trade or business as opposed to investment income;<sup>18</sup> certain other income including interest, dividends, rents and other gain from a United States source not effectively connected with a United States trade or business;<sup>19</sup> and income derived from real property located in the United States, if an election is made to treat that income as connected with a United States trade or business.<sup>20</sup>

### Tax Treaties

Tax treaties avoid double taxation on the income of persons, residents or corporations organized in one country, deriving income in another.<sup>21</sup> These treaties regulate contracting states rights to tax par-

is to be paid only to the extent that the tax exceeds the taxpayer's regular tax liability. *Id.* § 55.

15. *Id.* § 1201.

16. A non-resident alien is "an individual whose residence is not within the United States, and who is not a citizen of the United States." Treas. Reg. § 1.871-2(a), T.D. 6258, 1957-2 C.B. 368.

17. A foreign corporation is a corporation, association, joint-stock company or insurance company which is not created or organized under the laws of the United States or any state. I.R.C. §§ 7701(a)(3), (4) & (5).

18. This income can be offset by the usual allowable deductions and is generally taxed in the same manner as the income of a United States citizen or corporation.

19. No deductions are allowed to offset this type of income, and it is taxed at thirty percent (or less if a tax treaty applies).

20. I.R.C. § 871 (d); Treas. Reg. § 1.871-10, T.D. 7332, 1975-1 C.B. 204.

21. Tax treaties between the United States and foreign countries greatly change the results that would otherwise obtain under domestic tax law. *See generally* M.

ticular types of income through reciprocal concessions. Generally, United States treaties require the United States to recognize and allow a credit for taxes paid to the treaty partner and the United States agrees to reduce or eliminate its tax on United States source income of persons or corporations organized in the treaty partner's country.<sup>22</sup> Although recent treaties limit the aforementioned benefits, some of the older conventions do not, and they may still be used by third country residents for tax avoidance.<sup>23</sup>

In 1948, the United States signed an income tax treaty with the Netherlands,<sup>24</sup> the provisions of which were extended by protocol to the Netherlands Antilles in 1955.<sup>25</sup> A Naamloze Vennootschap (N.V.), a limited liability company similar to the familiar United States corporation, can deduct operating expenses, property taxes, mortgage interest and depreciation in calculating its corporate income tax.<sup>26</sup> Additionally, the Netherlands Antilles permits its corporations to issue bearer shares, which allows for anonymity.<sup>27</sup> Insofar as the United States assesses tax against the N.V., the United States-Netherlands Antilles treaty modifies the treaty partner's law in three ways which are of prime importance to the real estate investor.

Article V of the treaty states:

"Income of whatever nature derived from real property and interest from mortgages secured by real property shall be taxable only in the Contracting State in which real property is situated."<sup>28</sup>

This provision obviates the possibility of taxation by both treaty partners. Thus, foreign investors using an N.V. to hold title to United States real estate are assured that they will not be taxed in the Netherlands Antilles. The reservation clause of Article V permits the United States (i.e., the country in which the property is located) to tax the

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LANGER, PRACTICAL INTERNATIONAL TAX PLANNING (2d ed. 1979).

22. *Id.*

23. *Id.*

24. M. LANGER, THE NETHERLANDS ANTILLES-UNITED STATES OF AMERICA INCOME TAX TREATY (1973).

25. *Id.*

26. See generally PRICE WATERHOUSE, DOING BUSINESS IN THE NETHERLANDS ANTILLES (1979).

27. *Id.*

28. See note 24 *supra*.

gains derived from the disposition of real property situated in the United States. However, in many instances, United States income producing property does not generate United States taxable income.<sup>29</sup> By taking all the allowable deductions, a real estate investor may be able to reduce his United States tax liability to a minimum. Thus, the typical N.V. investing in United States real estate pays little or no United States income tax, not because of the treaty, but because of normal United States tax rules which encourage investment in real estate by anyone as a tax sheltering device.

Article XII of the treaty states:

“Dividends and interest paid by a Netherlands Antilles corporation shall be exempt from United States tax except where the recipient is a citizen, resident or corporation of the United States.”<sup>30</sup>

The treaty article takes priority over conflicting Internal Revenue Code provisions.<sup>31</sup> Consequently, this treaty provision allows interest to be paid tax free to the foreign shareholder of an N.V., effectively avoiding United States tax since I.R.C. Sections 1442 and 861 could subject that foreign shareholder to United States withholding tax in certain circumstances.<sup>32</sup>

Article X as amended by Article II of the 1963 Protocol states: “A resident or corporation of one of the Contracting States deriving from sources within the other Contracting State royalties in respect of the operation of mines, quarries, or natural resources, or rentals from real property, may elect for any taxable year to be subject to the tax of such other Contracting State on such income on a net income basis.”<sup>33</sup>

This provision of the treaty allows the N.V. to elect to be taxed, on a net income basis, for all income derived from the rental of United States real estate and mineral royalties. The election allows the N.V. to

29. J. BISCHER, *INCOME TAX TREATIES* 405 (1978).

30. *See* note 24 *supra*.

31. I.R.C. § 7852(d). *See also* text accompanying notes 59 and 60 *infra*.

32. A shareholder of a foreign corporation will be subject to United States withholding tax on dividends received if fifty percent or more of the gross income of the foreign corporation was effectively connected with the conduct of a trade or business within the United States over a certain period of time. A similar withholding tax is applied to interest received by a shareholder of a foreign corporation. I.R.C. §§ 861(a)(2)(B), (a)(1)(C) & (D).

33. *See* note 24 *supra*.

take advantage of any deductions generated by the real property and subjects it to a progressive income tax on its net income rather than the flat thirty percent tax of Section 1442.

Obviously, Article X is important only when the N.V. is not actually engaged in a trade or business within the United States,<sup>34</sup> although the election subjects it to taxation as though it was. The guidelines are unclear as to when a foreign corporation is engaged in a United States trade or business as distinct from investment. It would seem that agricultural land held for investment, and net leased to a farmer, would not be considered connected with a United States trade or business. Similarly, improved property, leased to a single tenant under a net lease, should produce the same result.<sup>35</sup>

### FIRPTA's New Rules

Extensive publicity about the large degree of foreign investment in United States real estate, including Florida farmland and income producing property,<sup>36</sup> resulted in Section 553 of the Revenue Act of 1978.<sup>37</sup> This provision directed the treasury department to conduct a study of the tax treatment of gain derived from the sale of United States real property owned by non-resident aliens and foreign corporations.<sup>38</sup>

From the recommendations of this study came Public Law No. 96-499, entitled the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) which added Section 897 to the Internal Revenue Code of 1954. Prior to the enactment of FIRPTA, a foreign investor could avoid United States income taxation on gain realized from the sale or exchange of United States real property<sup>39</sup> so long as the gain was "not effectively connected with the conduct of a trade or business within the

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34. Garelik, *What Constitutes Doing Business Within the United States by a Non-resident Alien Individual or a Foreign Corporation*, 18 TAX L. REV. 423 (1963).

35. A net lease contains a provision which requires the lessee to pay taxes, insurance and maintenance in addition to rent.

36. *E.g.*, Calonius, *Offshore Money Floods Miami*, FLORIDA TREND, Apr. 1980.

37. Pub. L. No. 95-600, § 553, 92 Stat. 2891.

38. *See* note 3 *supra*.

39. I.R.C. § 862(a)(5).

United States."<sup>40</sup> These avoidance devices included an installment sale,<sup>41</sup> a tax free exchange for foreign real property<sup>42</sup> and the sale of corporate stock to a corporate purchaser who would transfer the cost of the stock to the general assets of that corporation upon its liquidation.<sup>43</sup> The Act radically changed the way in which foreign investors are taxed on disposition of their real property investments and contains new filing and disclosure rules.

The new rule of Section 897 is: gain or loss from the disposition of a United States real property interest by a non-resident alien or foreign corporation must be reported under Section 871(B)(1) or 882(a)(1), "as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business."<sup>44</sup> This provision effectively eliminates the disparity in the tax treatment of foreign and domestic investors upon the disposition of United States real property.

Section 897 broadly defines a United States real property interest to include any interest in real property, including an interest in a mine, well or other natural deposit located in the United States.<sup>45</sup> The definition includes fee ownership, leaseholds, and options to acquire real property, as well as personalty associated with the real estate.<sup>46</sup> Additionally, it includes any interest in a domestic corporation holding real property.<sup>47</sup> Though an equity interest in a foreign corporation is not a United States real property interest,<sup>48</sup> the Act specifically requires the recognition of gain by a foreign corporation on a distribution to its shareholders of a United States real property interest including a distribution in liquidation or redemption.<sup>49</sup>

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40. *Id.* §§ 872(a) & 882(b).

41. *Id.* § 453.

42. *Id.* § 1031.

43. *Id.* §§ 331, 334(b)(2), & 336.

44. *Id.* § 897(a)(1).

45. *Id.* § 897(c)(1)(i).

46. *Id.* § 897(c)(6).

47. *Id.* § 897(c)(1)(ii).

48. *Id.* §§ 897(c)(1)(i) & (ii) by negative implication.

49. The gain recognized is an amount equal to the excess of the fair market value of the United States real property interest over its adjusted basis. *Id.* § 897(d)(1).

### *Nonrecognition Provisions*

Nonrecognition of gain or loss provisions are applicable to Section 897 only when there is an exchange of a United States real property interest for an interest which would itself be taxable when sold.<sup>50</sup> The secretary of the treasury, charged with the task of prescribing regulations necessary to prevent federal income tax avoidance, will determine the extent to which other nonrecognition provisions will apply.<sup>51</sup> Until regulations are issued, it would be imprudent to rely on any nonrecognition provisions other than Section 1031, involving like-kind exchanges of property.<sup>52</sup> However, a Section 1031 exchange of a United States real property interest for a foreign property interest will be subject to United States taxation under Section 897 because the property received would not be subject to future United States taxation.<sup>53</sup>

FIRPTA provides that gain will not be recognized "if the basis of the distributed property in the hands of the distributee is the same as the adjusted basis of such property before the distribution increased by the amount of any gain recognized by the distributing corporation."<sup>54</sup> However, the Economic Recovery Tax Act of 1981<sup>55</sup> amends this subsection to override the nonrecognition provision if the purchaser would not be subject to taxation on a later sale or exchange of the property. The new rule of Section 897(d)(1)(B) provides that in addition to the carryover basis requirement, the distributee must be subject to taxation on a subsequent disposition of the distributed property at the time the distributee received the property. The amendment makes it clear that a foreign corporation cannot avoid paying tax on gain from the disposition of a United States real property interest where a carryover basis transaction is entered for the purpose of avoiding taxation.

The following example illustrates the new provisions. Sociedad Anonima N.V., a Netherlands Antilles corporation, owns an apartment

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50. *Id.* § 897(e)(1).

51. *Id.* § 897(e)(2).

52. This section provides nonrecognition treatment for the exchange of property held for productive use in a trade or business, or for investment, solely for like-kind property.

53. I.R.C. § 897(e)(1).

54. *Id.* § 897(d)(1)(B).

55. Pub. L. No. 97-34, § 831, 95 Stat. 352.

building in Miami. The corporation exchanges this United States real property for an apartment building in Rio de Janeiro in a Section 1031 like-kind exchange. The foreign property held by the N.V. after the like-kind exchange would never have been subject to United States taxation, as ultimately its disposition would not be that of a United States real property interest. Nonetheless, this transaction will now be subject to immediate United States taxation under Section 897. The result would be different if the N.V. exchanged the apartment building in Miami for one in Vail, Colorado. This exchange would not be subject to immediate United States taxation, since any gain realized on the later disposition of this property is subject to United States taxation.

Although permitted in the past, the Act specifically precludes a foreign corporation's utilization of Section 337 liquidation provisions in the disposition of a United States real property interest.<sup>56</sup>

As a result of these changes, the foreign investor is left with three unpleasant choices. The foreign corporation can sell the property and be taxed accordingly. Alternatively, the investor can sell the stock at a discount reflecting the tax liability the corporation would incur when it distributes the property. Finally, the foreign corporation can be liquidated and pay the tax imposed upon the liquidation.<sup>57</sup>

### *Effective Date*

Section 894(a) provides that income of any kind will be exempt from taxation to the extent required by any treaty obligation of the United States, and Section 7852(d) precludes the application of any Internal Revenue Code provision which would be contrary to any treaty obligation of the United States. As previously noted, the United States entered into a bilateral treaty with the Netherlands Antilles in 1955.<sup>58</sup> Where no treaty exists, Section 897 is applicable to dispositions of United States real property interests after June 18, 1980. Where treaty obligations do exist, Section 897 will not apply until January 1, 1985. If, before January 1, 1985, an existing treaty is renegotiated, to resolve conflicts between the old treaty and Section 897 provisions, the new

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56. I.R.C. § 897(d)(2).

57. Feder, *Planning Under the Foreign Investment in Real Property Tax Act of 1980*, 59 TAXES 81 (1981).

58. See text accompanying notes 21-35 *supra*.

treaty may delay the application of Section 897 for a period not to exceed two years after the signing of the new treaty.<sup>59</sup>

### *Disclosure Requirement*

In 1980, Congress added Section 6039C and amended Section 6652<sup>60</sup> to provide new filing and disclosure requirements for foreign corporations having a substantial investor in a United States real property interest at any time during the calendar year.<sup>61</sup> A substantial investor is defined as any person whose holdings in a foreign corporation's United States real property interest exceed \$50,000.<sup>62</sup>

The following information must be reported to the Internal Revenue Service:<sup>63</sup>

- 1) The name and address of each substantial investor.
- 2) Information regarding the entity's assets.
- 3) Any other information that the regulations might require.

A foreign corporation which is required to file must also provide the substantial investor with a statement containing the following:<sup>64</sup>

- 1) The name and address of the foreign corporation.
- 2) The substantial investor's pro-rata share of the United States real property interest held by it.
- 3) Any other information that the regulations may require.

Section 6039(b)(2) waives the filing requirement if the foreign corporation furnishes the "necessary security" to ensure payment of any taxes in connection with a United States real property interest. The committee report, accompanying the new legislation, partially clarifies the meaning of this term and states that the I.R.S. definition of necessary security will depend on individual facts and circumstances. The report provides illustration. A foreign corporation, whose only asset is a

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59. Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), Pub. L. No. 96-499, § 1125, 94 Stat. 2690.

60. *Id.* § 1123, 94 Stat. 2687.

61. I.R.C. § 6039C(b)(1).

62. *Id.* §§ 6039C(b)(4)(B) (i) & (ii).

63. *Id.* §§ 6039C(b)(1)(A), (B) & (C).

64. *Id.* §§ 6039C(b)(3)(A), (B) & (C).



tract of undeveloped United States real property, might be required to provide the I.R.S. with a recorded mortgage giving it a security interest in the property or provide a guarantee of payment by a person who would pay the tax in the event that the foreign corporation did not. Where a corporation issues bearer shares, or the trustee refuses to disclose the identity of beneficial interest owners, the foreign corporation would be required to provide the necessary security. This provision may be used by foreign investors who are unwilling to disclose their participation in United States real property investments but who are willing to be taxed by the United States on the disposition of such property.

Failure to report the above information when required will result in penalties up to \$25,000 per calendar year, until the information is provided.<sup>65</sup> Willful failure to file a return or supply information is a misdemeanor and the offender will be subject to a maximum fine of \$10,000 and one year in prison.<sup>66</sup>

### Conclusion

The provisions of FIRPTA and ERTA seem to diminish the attractiveness of investment in real estate by foreigners. Absent a novel approach, the utilization of an N.V. as a primary vehicle for foreign investment in Florida real estate is no longer advisable where income tax considerations are a prominent part of the investment decision.

Although most of the obvious tax advantages once associated with an N.V. are gone, there are several reasons foreign investment in Florida real estate will not diminish as rapidly as legislators believe. First, the United States is a stable democratic nation where real estate is unlikely to suffer great decreases in value. Second, it is unlikely that the United States government would take privately owned property without just compensation to the owner. These factors are attractive to foreign investors, who may fear political instability affecting property value, or uncompensated governmental takings, in their own countries. Finally, while the disparate tax treatment given local and foreign treaty investors has been minimized, United States real estate remains an ex-

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65. *Id.* § 6652(g).

66. *Id.* § 7203.

cellent tax avoidance device for an investor, since United States tax law encourages investment in real estate.

*Marty Patrick*

## Hurricane Losses: Mandatory Practice and Taxpayer Options

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The United States has sustained more than twelve billion dollars in hurricane damage since 1900.<sup>1</sup> This country experiences an average of three hurricanes, two of which are major,<sup>2</sup> every two years. The most vulnerable areas lie along the Gulf Coast—Florida, Alabama, Mississippi, Louisiana, and Texas.<sup>3</sup> In order to mitigate hurricane damage, hurricane losses are accepted by the Internal Revenue Service as a deductible casualty loss under I.R.C. § 165(c).

This article will discuss both the mandatory practice established by federal tax laws, and the options of property owners with respect to establishing the extent of their losses, compensation and gains.

### Measuring the Amount of the Loss

As a general rule, the taxpayer may deduct a hurricane loss equal to the lesser of the adjusted basis of the property<sup>4</sup> or the difference between the fair market value of the property immediately before and immediately after the casualty.<sup>5</sup> However, a deductible hurricane loss will only be allowed to the extent that the loss is uncompensated by "insurance or otherwise."<sup>6</sup>

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1. *Hurricane*, 158 NATIONAL GEOGRAPHIC 346 (1980).

2. A hurricane whether it be considered major or minor causes tremendous damage. The taxpayer need not be concerned with the classification of a hurricane but rather with the impact it has on their property. *When Hurricanes Hit, "Complacency" Can Kill You* U.S. NEWS & WORLD REPORT, Aug. 18, 1980, at 56 (Interview with Richard A. Flank, Administrator, National Oceanic and Atmospheric Administration).

3. *Id.*

4. The property's adjusted basis equals its original basis adjusted to the date of damage or destruction. I.R.C. § 1011(a); Treas. Reg. § 1.011, T.D. 6265, 1957-2 C.B. 469.

5. *Solomon v. Commissioner*, 39 T.C.M. (CCH) 1282 (1980); Treas. Reg. § 165-7(b)(1), T.D. 6445, 1960-1 C.B. 106.

6. *Gee v. Commissioner*, 41 T.C.M. (CCH) 1366 (1981), I.R.C. § 165(a). See section of this note titled compensation for interpretation of phrase "insurance or

If business property or property held for production of profit is completely destroyed, the hurricane loss deduction is equal to the adjusted basis of the property at the time of the occurrence of the casualty.<sup>7</sup> If a taxpayer is a tenant, and is liable to the lessor to return the real property in the same condition as received, the tenant may claim a casualty deduction but only to the extent of his repair obligation.<sup>8</sup>

### Basis

The basis of the property depends to a great extent on the manner in which the property was acquired. Usually, a taxpayer acquires property by purchasing it, or, in other words, at cost.<sup>9</sup> However, the property may have been acquired by a different route, as by gift, inheritance, or conversion of property from personal use to business use.<sup>10</sup>

To compute the property's adjusted basis, the taxpayer begins with the cost, or the original basis at the date of acquisition for property acquired by gift, inheritance, or conversion.<sup>11</sup> To that he must add all items chargeable to the capital additions account,<sup>12</sup> and from that subtract items considered to be capital recoveries.<sup>13</sup> The regulations define capital additions or expenditures as expenditures which add to the value or prolong the life of property, or adapt the property to a new or different use.<sup>14</sup> These expenditures include improvements, purchase commissions, legal costs for defending or perfecting title (including title insurance) and recording fees.<sup>15</sup> The capital recoveries which must be subtracted include depreciation, depletion, obsolescence, tax-free dividends, recognized losses on involuntary conversions and deductible cas-

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otherwise."

7. *Shroyer v. Commissioner*, 42 T.C.M. (CCH) \_\_\_, Nos. 1981-327 (June 24, 1981); Treas. Reg. § 1.165-7(b)(1)(ii), T.D. 6445, 1960-1 C.B. 106.

8. INTERNAL REVENUE SERVICE, PUB. NO. 547 TAX INFORMATION ON DISASTERS, CASUALTIES, AND THEFTS (1980) [hereinafter TAX INFORMATION ON DISASTERS].

9. I.R.C. § 1012.

10. Only cost basis will be discussed further. For basis determination on property acquired by gift, inheritance, or conversion *see* I.R.C. § 1.165-9(b)(2).

11. I.R.C. § 1011(a).

12. I.R.C. § 1.1016(a)(1); Treas. Reg. § 1.1016-2(a) (1957).

13. I.R.C. § 1016(a)(2); Treas. Reg. § 1.1016-3(a)(1)(i) (1957).

14. Treas. Reg. § 1.263(a)-1(b), T.D. 6500, 1960-2 C.B. 107.

15. FEDERAL TAX HANDBOOK 167 (1980).

ualty losses. A depreciation deduction is allowed only for business property or property held for the production of income.<sup>16</sup> The depreciable property's basis must be reduced by the depreciation allowed,<sup>17</sup> which may not be less than the allowable amount.<sup>18</sup> Regardless of the extent of capital recoveries, the adjusted basis may not drop below zero.<sup>19</sup>

### Type of Property

The way a taxpayer computes his hurricane loss depends on the type of property damaged or destroyed. The casualty loss deduction allowed property held for personal use is computed according to the general rule stated above except for one limitation: a \$100 statutory floor reduces the deductible amount.<sup>20</sup> The \$100 deduction limit applies to the entire loss and is subtracted once for each casualty.<sup>21</sup> However, if husband and wife file separate tax returns, the \$100 limitation applies separately to each individual's loss.<sup>22</sup>

Personal property includes both real and personal property. The calculation involved for each varies slightly. Real property includes land, plants and trees that grow on land, and buildings thereon. Personal property may be defined as any property that is not real estate.<sup>23</sup> A taxpayer, when determining his hurricane loss deduction for personally used real property, should consider all items together. In other words, the adjusted basis and decrease in fair market value should be calculated for the entire property—land, plants and buildings together.<sup>24</sup> For example, an oceanfront home, which costs \$80,000 (including \$10,000 for the land) several years ago, was partially destroyed

16. I.R.C. § 167(a); Treas. Reg. § 1.167(a)-1(a), T.D. 6182, 1956-1 C.B. 99.

17. The amount the taxpayer actually deducts is called the allowed depreciation. I.R.C. § 1016(a)(2)(B); Treas. Reg. § 1.1016-3(a)(1)(i) (1957).

18. The allowable depreciation may be defined as the amount the taxpayer should have deducted. Treas. Reg. § 1.1016-3(a)(1)(ii) (1957); I.R.C. § 1016(a)(2); Treas. Reg. § 1.167(a)-10(a) (1956).

19. FEDERAL TAX HANDBOOK 167 (1980).

20. I.R.C. § 165(c)(3).

21. Treas. Reg. § 1.165-7(b)(4)(ii), T.D. 6712, 1964-1 C.B. 103.

22. Treas. Reg. § 1.165-7(b)(2)(iii), T.D. 6712, 1964-1 C.B. 103.

23. TAX INFORMATION ON DISASTERS, *supra* note 8.

24. Treas. Reg. § 1.165-7(b)(1), T.D. 6445, 1960-1 C.B. 106, Rev. Rul. 66-9, 1966-1 C.B. 39.

by a hurricane in August. The value of the property immediately before the hurricane was \$100,000 (\$85,000 for the building and \$15,000 for the land), and the value immediately after the hurricane was \$50,000. The taxpayer collected \$10,000 from his insurance company. His deduction for the hurricane loss is \$39,900, computed as follows:<sup>25</sup>

(1) Value of entire property before hurricane . . . . .	\$100,000
(2) Value of entire property after hurricane . . . . .	<u>50,000</u>
(3) Decrease in fair market value of entire property . . . .	<u>50,000</u>
(4) Basis (cost, in this case) . . . . .	<u>80,000</u>
(5) Amount of loss (lesser of 3 or 4) . . . . .	50,000
(6) Minus: Insurance . . . . .	<u>10,000</u>
(7) Loss after reimbursement . . . . .	40,000
(8) Minus: \$100 . . . . .	<u>100</u>
(9) Hurricane loss deduction . . . . .	39,900

On the other hand, when determining hurricane losses for personal property, each item must be considered independently and then individual losses are grouped for a deductible amount. Each item has its own adjusted basis and decrease in fair market value.<sup>26</sup> For instance: a hurricane hit the taxpayer's home, damaged an upholstered chair and completely destroyed a rug and antique table. There was no insurance. The chair had cost \$150; it had a fair market value of \$75 before the storm and a value of \$10 immediately afterwards. The rug had cost \$200 and had a value of \$50 just before the hurricane. The taxpayer had purchased the table at an auction for \$15 and then discovered it was a valuable antique. It had been appraised at \$350 before the hurricane. His loss on each of these items is computed as follows:<sup>27</sup>

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25. Reproduced from TAX INFORMATION ON DISASTERS, *supra* note 8, at 234. Numbers have been adjusted for ease of mathematics. Fire has been changed to hurricane for reasons of continuity.

26. *Id.*

27. *Id.* Fire has been changed to hurricane for reasons of continuity.

	<u>Chair</u>	<u>Rug</u>	<u>Table</u>
(1) Basis (cost).....	<u>\$150</u>	<u>\$200</u>	<u>\$ 15</u>
(2) Value before hurricane.....	\$ 75	\$ 50	\$350
(3) Value after hurricane.....	<u>\$ 10</u>	<u>\$ 0</u>	<u>\$ 0</u>
(4) Decrease in Value.....	<u>\$ 65</u>	<u>\$ 50</u>	<u>\$350</u>
(5) Loss (lessor of 1 or 4).....	<u>\$ 65</u>	<u>\$ 50</u>	<u>\$ 15</u>
(6) Total loss.....			\$130
(7) Minus \$100.....			<u>\$100</u>
(8) Hurricane loss deduction.....			\$ 30

If the damaged property is business property, the amount of the hurricane loss incurred is computed using the general rule stated above.<sup>28</sup> Property held for the production of income is treated similarly.<sup>29</sup> However the regulations require that the taxpayer figure his loss separately for each item. This rule is termed the single, identifiable property rule. The losses are then combined for one deduction.<sup>30</sup> For example: four years ago the taxpayer bought a house, which he then rented out. He paid \$8,000 for the land, \$25,000 for the building, and \$2,000 for landscaping. During those four years, he was allowed depreciation deductions for the building totalling \$5,688. In August 1981, as a result of a hurricane, the house and landscaping were severely damaged.

Competent appraisers determined that the house was worth \$33,500 before the hurricane, but only \$13,000 afterwards. Trees and shrubs were valued at \$2,500 before but only \$1,500 after. The trees and shrubs were not covered by insurance, but the house was insured for its fair market value. The insurance company paid \$20,500 in full settlement. The taxpayer's gain or loss from the hurricane is computed as follows:<sup>31</sup>

28. Treas. Reg. § 1.165-7(b)(1), T.D. 6445, 1960-1 C.B. 106, Rev. Rul. 66-9, 1966-1 C.B. 39.

29. I.R.C. § 165(c)(1) & (2).

30. Treas. Reg. § 1.165-7(b)(2)(i), T.D. 6445, 1960-1 C.B. 106.

31. Reproduced from TAX INFORMATION ON DISASTERS, *supra* note 8, at 34. The word hurricane has been substituted for the word fire for reasons of continuity.

	<u>Building</u>	<u>Trees and Shrubs</u>
(1) Value before hurricane . . . . .	\$33,500	\$2,500
(2) Value after hurricane . . . . .	<u>\$13,000</u>	<u>\$1,500</u>
(3) Decrease in value . . . . .	<u>\$20,500</u>	<u>\$1,000</u>
(4) Basis (adjusted for depreciation) . . . . .	<u>\$19,312</u>	<u>\$2,000</u>
(5) Amount of loss (lesser of 3 or 4) . . . . .	\$19,312	\$1,000
(6) Minus: Insurance . . . . .	<u>\$20,500</u>	<u>\$ 0</u>
(7) Loss on trees and shrubs . . . . .		\$1,000
(8) Gain from insurance received for house . . . . .	\$1,188	

The single, identifiable property rule tends to weaken a business property owner's position. His allowable hurricane loss deduction will generally be smaller than it would have been had the basis of the entire property (land included) been taken into consideration. For example, if land and timber were taken together the property owner would have a larger deduction. The "timber will usually have appreciated in value far in excess of the basis allocable thereto."<sup>32</sup> Although it may be difficult for a property owner to determine the reduction in the fair market value of an area partially destroyed by a casualty, the court in *Westvaco Corp. v. United States*<sup>33</sup> determined the "single, identifiable

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32. GEER & GILJUN, LOSSES - CASUALTY, 274-2d TAX MNGM'T (BNA) A-21. The court in *Rosenthal v. Commissioner*, 48 T.C. 515 (1967) *aff'd* 416 F.2d 491 (2d Cir. 1969) carried this rule one step further by only allowing recovery for that portion of the timber totally destroyed. The *Rosenthal* court concluded that the adjusted basis and fair market value of the destroyed timber should be separated from the rest of the timber.

A casualty loss to timber, usually, is of great significance to the business property owner for timber is often uninsurable. Additionally, "since a tract of timber is a living, growing entity, damage to the tract may cause a greater loss than the basis of the mature trees damaged." 83 HARV. L. REV. 478, 480. For example, a hurricane loss to one hundred trees may decrease the fair market value of the remaining trees in that section. For further analysis *see id.*

33. 639 F.2d 700 (Ct. Cl. 1980).



property damaged by the casualty is the standing timber, merchantable, in an affected area."<sup>34</sup> The *Westvaco Corp.* court does not agree with the decision reached in *Rosenthal v. Commissioner*.<sup>35</sup> *Rosenthal* held that only the destroyed timber's adjusted basis and fair market value may be taken into account when computing casualty deduction for partially destroyed timber. The court in *Westvaco Corp.* considered the fair market value of both destroyed and other standing timber in an affected block.

If both business and personally used property exist on the taxpayer's land, he must figure his deductions as if two separate casualties occurred.<sup>36</sup> For example: taxpayer owns a building that he constructed on leased land. Half of the building is used in his business and he lives in the other half. The original cost of the building was \$40,000 and he made no further improvements or additions to it. A hurricane damaged the entire building. The fair market value of the building was \$38,000 immediately before the hurricane and \$32,000 afterwards. The insurance company reimbursed the taxpayer \$4,000 for the hurricane damage. Depreciation deductions on the business part of the building totalled \$2,400.

The taxpayer has a deductible business casualty loss of \$1,000 and a deductible personal casualty loss of \$900, computed as follows:<sup>37</sup>

	<u>Business Loss</u>	<u>Personal Loss</u>
Decrease in value of building: value before hurricane (total \$38,000) . . . . .	\$19,000	\$19,000
Value after hurricane (total \$32,000) ..	<u>\$16,000</u>	<u>\$16,000</u>
	<u>\$ 3,000</u>	<u>\$ 3,000</u>
 Basis of business-use portion of building before hurricane (cost \$20,000 — depreciation \$2,400) . . . . .	 <u>\$17,600</u>	

34. *Id.* at 717.

35. 48 T.C. 515 (1967) *aff'd* 416 F.2d 491 (2d Cir. 1969).

36. Treas. Reg. § 1.165-7(b)(2)(ii), T.D. 6445, 1960-1 C.B. 106.

37. Reproduced from TAX INFORMATION ON DISASTERS, *supra* note 8, at 235. Flood has been changed to hurricane for reasons of continuity.

Personal-use portion (basis equals cost) .....		<u>\$20,000</u>
Amount of loss (lesser of basis or decrease in fair market value) .....	\$ 3,000	\$ 3,000
Minus: Insurance .....	<u>\$ 2,000</u>	<u>\$ 2,000</u>
Loss after reimbursement .....	\$ 1,000	\$ 1,000
Minus: \$100 on property owned for personal-use .....	<u>none</u>	<u>\$ 100</u>
Deductible business loss .....	\$ 1,000	
Deductible personal loss .....		\$ 900

### When to Report a Loss

As a general rule the hurricane loss is deducted in the year the casualty occurred.<sup>38</sup> There are exceptions, however. If the taxpayer is a lessee and is subsequently liable to a lessor for casualty damage, he deducts the loss in the year the liability is eliminated.<sup>39</sup> If a taxpayer puts in a claim for reimbursement, and it can be "ascertained with reasonable certainty"<sup>40</sup> that the claim will ultimately be received or honored, then the reimbursement must be subtracted from the casualty loss in the year the loss was sustained.<sup>41</sup> However, if at any future date the taxpayer receives less, he deducts the difference in the year of reimbursement. If on the other hand, he receives more, the additional amount is to be included in income in the year of its receipt.<sup>42</sup>

The taxpayer is given an option to treat the loss as if it occurred in

38. I.R.C. § 165(h) (1974).

39. TAX INFORMATION ON DISASTERS, *supra* note 8.

40. A reasonable prospect of recovery exists when the taxpayer has bona fide claims for recoupment from third parties or otherwise, and when there is a substantial possibility that such claims will be decided in his favor. The standard for making this determination is an objective one, under which [the] Court must determine what was a "reasonable expectation" as of the close of the taxable year for which the deduction is claimed.

Ramsay Scarlett & Co., Inc., v. Commissioner, 61 T.C. 795, 811 (1974) (citations omitted).

41. *Id.* See also Johnson v. Commissioner, 41 T.C.M. (CCH) 849 (1981). Treas. Reg. § 1.165-1(d)(2)(i) & (ii), T.D. 6445, 1960-1 C.B. 96.

42. TAX INFORMATION ON DISASTERS, *supra* note 8.

the preceding year, thereby deducting the amount in that year, if the President of the United States designates the area of hurricane damage as a disaster area.<sup>43</sup> Such an election allows the taxpayer to save taxes immediately, rather than waiting until the end of the year in which the casualty was sustained. However, assuming the tax rates do not drop,<sup>44</sup> if his taxable income is greater in the year the hurricane loss was sustained, he would pay less overall taxes if the deduction were taken in the year of the hurricane.<sup>45</sup>

Alternatively, a hurricane loss may create a net operating loss.<sup>46</sup> The Internal Revenue Service permits the taxpayer to offset losses against previous or subsequent taxable years if in the year of the loss he does not have enough taxable income to use up the deduction.<sup>47</sup> The loss is applied initially to the three preceding years, and if not completely used up, the taxpayer may carry the loss forward up to seven<sup>48</sup> years or until used up, whichever comes first.<sup>49</sup>

However, the taxpayer may elect not to carry back the net operating loss. He may, alternatively, carry forward the loss, if the loss was sustained after 1975.<sup>50</sup> Assuming the tax rates do not drop, if taxable income is greater during post casualty years, he would pay less overall taxes if net operating loss were carried forward.

### Burden of Proof

Frequently, the Internal Revenue Service refuses taxpayer hurri-

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43. I.R.C. § 165(h) (1974), Treas. Reg. § 1.165-11(a), T.D. 7522 1977-2 C.B. 64.

44. The tax rates are currently scheduled to drop under the Economic Recovery Tax Act of 1981.

45. TAX INFORMATION ON DISASTERS, *supra* note 8.

46. Net operating loss may be defined as the excess of deductions over gross income. I.R.C. § 172(c).

47. I.R.C. § 172(d)(4)(c); Treas. Reg. § 1.172-3(a)(3)(iii), T.D. 6192, 1956-2 C.B. 138.

48. The Economic Recovery Tax Act of 1981 substitutes 15 years in the place of 7 years. The 15 year carry forward applies to taxable years ending after December 31, 1975. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, §§ 207(a)(1)&(2), 95 Stat. 225.

49. I.R.C. §§ 172(b)(1) & (2) (1980).

50. I.R.C. § 172(b)(1)(B).

cane loss deductions, characteristically because taxpayers fail to meet their burden of proof. An income tax deduction is a right granted only to taxpayers who meet this burden.<sup>51</sup> The essential elements which must be met have been outlined by the Internal Revenue Service:

A deduction is allowed . . . for damages to or losses of property owned by you. You must substantiate the amount of any casualty loss and be prepared to submit evidence showing:

- (1) The nature of the casualty and when it occurred;
- (2) That the loss was the direct result of the casualty;
- (3) That you were the owner of the property or were contractually liable to the owner of the property for damage to property leased by you.<sup>52</sup>
- (4) The cost or other [adjusted] basis of the property, evidenced by purchase contract, [checks, receipts,] etc;
- (5) The depreciation allowed or allowable if any;
- (6) The values before and after the casualty (pictures and appraisals before and after the casualty are pertinent evidence); and
- (7) The amount of insurance or other compensation received or expected to be received, including the value of repairs, restoration, and clean-up provided without cost by disaster relief agencies or others.<sup>53</sup>

Generally, to claim a casualty deduction, the property must have sustained actual, physical damage. But in *Stowers v. United States*,<sup>54</sup> the taxpayer, was allowed a casualty loss deduction even though his property was only indirectly damaged. In *Stowers*, access to and from the taxpayer's home was obstructed as a result of neighboring landslides. The court based its decision on the fact that the property was valueless in the hands of the property owner.

However, a taxpayer will not be permitted to take a casualty deduction when the decline in market value is solely attributable to "ad-

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51. *Interstate Transit Lines v. Commissioner of Internal Revenue*, 319 U.S. 590 (1943), *appeal denied* 320 U.S. 809 (1943).

52. A tenant may claim a casualty deduction for "leasehold improvements" erected by him, if damaged or destroyed. Rev. Rul. 73-41, 1973-1 C.B. 74.

53. INTERNAL REVENUE SERVICE, PUB. NO. 334, TAX GUIDE FOR SMALL BUSINESS 113 (1979).

54. 169 F. Supp. 246 (S.D. Miss. 1958).

verse buyer resistance."<sup>55</sup> For instance, future buyers may shy away from homes which are located in highly vulnerable hurricane areas. If this resistance is the sole reason for decrease in market value no deduction is allowable.

In determining the decrease in fair market value, the property owner has several options. If it is possible, the fair market value of the property before and after the hurricane should be ascertained by competent appraisal. "This appraisal must recognize the effects of any general market decline affecting undamaged as well as damaged property which may occur simultaneously within the casualty, in order that any deduction under this section shall be limited to the actual loss resulting from damage to the property."<sup>56</sup> The appraiser should be experienced, reliable and familiar with the taxpayer's property both before and after the hurricane.<sup>57</sup> Appraisals must be substantiated and are subject to reassessment by the court.<sup>58</sup> The taxpayer's own testimony is acceptable evidence, but is also subject to reassessment.<sup>59</sup> The purchase price of property, purchased shortly before a hurricane, can be used to establish its fair market value.<sup>60</sup>

If the taxpayer chooses to repair or restore damaged property, rather than await appraisal, he may not deduct the repair or replacement cost. This cost may, however, be an indication of the fair market value of the property.

The cost of repairs to the property damaged is acceptable as evidence of the loss of value if the taxpayer shows that (a) the repairs are necessary to restore the property to its condition immediately before the casualty, (b) the amount spent for such repairs is not excessive, (c) the repairs do not care for more than the damage suffered and (d) the value of the property does not as a result of the repairs exceed the value of the property immediately before the

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55. *Corby v. Commissioner*, 40 T.C.M. (CCH) 21 (1980).

56. *Treas. Reg. § 1.165-7(a)(2)(i)*, T.D. 6445, 1960-1 C.B. 105.

57. *TAX INFORMATION ON DISASTERS*, *supra* note 8.

58. In *Breon v. Commissioner*, 41 T.C.M. (CCH) 1621 (1981), the court determined the appraisals performed by local real estate agents (although highly qualified) failed to show support for their appraisal.

59. *Id.*; *Guilbeau v. Commissioner*, 40 T.C.M. (CCH) 323 (1980); *Corby v. Commissioner*, 40 T.C.M. (CCH) 21 (1980).

60. *Kahl v. Commissioner*, 41 T.C.M. (CCH) 1433 (1981).

casualty.<sup>61</sup>

The taxpayer is not permitted to submit estimates for repairs but rather is required to submit evidence of repairs actually made. In *Bidelspacher v. Commissioner*,<sup>62</sup> the tax court construed § 1.165-7 as requiring evidence of repairs actually made. The court rejected the use of estimates in an effort to “guar[d] against possible abuse that would result from the use of flexible or inflated estimates of repairs, particularly in situations where the repairs are never made.”<sup>63</sup>

In addition, taxpayers do not have the option of deducting the amount spent on preventive measures to mitigate hurricane damage. In *Austin v. Commissioner*, the court determined that chopping down trees as a preventive measure cannot be used as a casualty deduction. Similarly, the purchase and installation of hurricane shutters is also not deductible.<sup>64</sup>

It is important to stress that, despite occasional broad interpretation as in *Stowers v. United States*,<sup>65</sup> the Internal Revenue Service tends to limit taxpayer options in the area of hurricane losses.

### Compensation

When a taxpayer figures his deduction, reimbursements received, whether “insurance or otherwise,” must be subtracted from the casualty loss amount.<sup>66</sup> Recently, the tax court, has determined the meaning of the phrase “insurance or otherwise” within I.R.C. § 165(a). In *Estate of Bryan v. Commissioner*,<sup>67</sup> the court held the phrase indicated a form of compensation received by the taxpayer which is structured to replace what was lost.<sup>68</sup> The burden of proof was placed on the taxpayer to establish his right to a deduction. Furthermore, the absence of

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61. Treas. Reg. § 1.165-7(a)(ii), T.D., 6445, 1960-1 C.B. 105, *Gee v. Commissioner*, 41 T.C.M. (CCH) 1366, (1981); *Shroyer v. Commissioner*, 42 T.C.M. (CCH) —, Nos. 1981-327 (June 24, 1981).

62. 41 T.C.M. (CCH) 477 (1980).

63. *Id.*, at 483; *Gee v. Commissioner*, 41 T.C.M. (CCH) 1366 (1981).

64. 74 T.C. 1334, No. 98 (1980).

65. 169 F. Supp. 246 (S.D. Miss. 1958).

66. I.R.C. § 165(a).

67. 74 T.C. 725 (1980).

68. *Id.* at 727.

any "legal or moral obligation" resting with the agency making payment does not prevent the payment from being characterized as insurance.<sup>69</sup> Thus, it appears that a payment by an agency, in an attempt to compensate a taxpayer for hurricane destroyed property, will clearly constitute compensation under the "insurance or otherwise" language.<sup>70</sup>

Another issue, recently litigated, concerned the taxpayer's election to deduct a casualty loss rather than file a claim with his insurance company for reimbursement. The Internal Revenue Service takes this position:

If you have insurance that would cover all or part of a casualty . . . but you do not put in a claim for reimbursement, your deduction must be reduced by any amount that you could have received from the insurance company if you had put in a claim. Your failure to put in a claim is the cause of that part of your loss, not the casualty . . . .<sup>71</sup>

The courts, however, apply this policy inconsistently. In *Miller v. Commissioner*,<sup>72</sup> the court adhered to the Internal Revenue Service position. However, in *Hills v. Commissioner*,<sup>73</sup> the court held if "a taxpayer fails to pursue a right of insurance recovery, his economic loss is nonetheless sustained and a deduction should be allowed."<sup>74</sup>

As mentioned above, insurance is not the only form of reimbursement. For example, if a taxpayer falls under the Disaster Relief Act<sup>75</sup> the amount of the loan that is forgiven is considered reimbursement.<sup>76</sup> Similarly, the amount of a Small Business Association loan forgiven is considered reimbursement.<sup>77</sup> Repairs, restoration, and clean-up services

69. *Id.*

70. *Smith v. Commissioner*, 76 T.C. \_\_\_, No. 39 (1981); *Spak v. Commissioner*, 76 T.C. \_\_\_, No. 40 (1981).

71. TAX INFORMATION ON DISASTERS, *supra* note 8, at 233.

72. 41 T.C.M. (CCH) 528 (1980). *See also* *Bartlett v. United States*, 397 F. Supp. 216 (D. Md. 1975).

73. 76 T.C. \_\_\_, No. 42 (1981).

74. *Id.*

75. Pub. L. No. 91-606, 84 Stat. 1744 Rev. Rul. 71-160, 1971-1 C.B. 75.

76. TAX INFORMATION ON DISASTERS, *supra* note 8.

77. *Gee v. Commissioner*, 41 T.C.M. (CCH) 1366 (1981).

provided by relief agencies are considered reimbursement.<sup>78</sup> Relocation payments can, when warranted, be considered compensation.<sup>79</sup>

Aside from the types of reimbursement mentioned above, grants, gifts and other payments received after a casualty, for the purpose of getting the taxpayer back on his feet, are only considered compensation if "specifically earmarked to repair or replace property."<sup>80</sup> Even where the property owner applies payments received to replace property, payments will not be considered compensation absent appropriate conditions on their use.<sup>81</sup>

### Gain

If a property owner receives compensation and it is more than his basis in the destroyed or damaged property, there is a gain from the casualty. This gain can be reported in the year the reimbursement was received, or reporting may be postponed.<sup>82</sup>

If the taxpayer receives a reimbursement in the form of property which is similar or related in service to his damaged property, postponement of gain recognition is mandatory.<sup>83</sup> The meaning of the phrase "similar or related in service" depends on whether the taxpayer is an owner-user or an owner-investor. If the taxpayer is an owner-user, the "replacement property must function the same as the property it replaces."<sup>84</sup> On the other hand, if the taxpayer is an owner-investor, "any replacement property must have the same relationship of services or uses to [the taxpayer] as the property it replaced."<sup>85</sup> This may be

78. TAX INFORMATION ON DISASTERS, *supra* note 8.

79. Relocation payments if made for the purpose of reimbursing the taxpayer for casualty losses must be considered compensation, however, if there is not a direct relationship between relocation payment and casualty loss the taxpayer will not have to subtract payment from loss. *Spak v. Commissioner*, 76 T.C. \_\_\_, No. 40 (Mar. 26, 1981).

80. TAX INFORMATION ON DISASTERS, *supra* note 8, at 233.

81. *Id.*

82. *Id.*

83. I.R.C. §§ 1033(a)(1)&(b) (1978); Treas. Reg. § 1.1033(a)-2(b), T.D. 6222 1957-1 C.B. 249.

84. I.R.C. § 1033(a) (1978); Treas. Reg. § 1.1033(a)-1, T.D. 6222 1957-1 C.B., 249.

85. INTERNAL REVENUE SERVICE, PUB. NO. 334, TAX GUIDE FOR SMALL BUSI-



done by determining; (1) whether the properties are of similar service, (2) the nature of the business risks connected with the properties, and (3) what the properties demand of the taxpayer in the way of management, service, and relations to tenants.<sup>86</sup>

The taxpayer may also postpone the gain if he purchases replacement property<sup>87</sup> which is similar or related in use to property damaged by the hurricane.<sup>88</sup> The taxpayer can postpone all of the gain if the replacement property's cost is equal to or greater than the net proceeds.<sup>89</sup> Otherwise the property owner must recognize some or all of the gain immediately.

The property owner faces a time limitation if he desires to purchase replacement property with net proceeds. The replacement period begins on the date the hurricane damaged or destroyed the property. The taxpayer has until two years after the close of the taxable year in which any gain is realized from the involuntary conversion to replace the property.<sup>90</sup>

### Conclusion

The preceding sections are all interrelated and therefore must all be dealt with. In closing, the purpose of this paper is two-fold—to make the taxpayer aware both of his responsibilities as claimant, as well as the responsibility of the federal government as stated in the Internal Revenue Code, Treasury Regulations and case law. The most recent cases reveal both the basic stance of the Internal Revenue Service and the occasional, subtle shifting of their perspective. Although property losses due to hurricanes can be severe, there are ways to miti-

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NESS 116 (1979).

86. Rev. Rul. 64-237, 1964-2 C.B. 319.

87. TAX INFORMATION ON DISASTERS, *supra* note 8. Property acquired by gift or inheritance does not qualify as replacement property.

88. I.R.C. § 1033(a) (1978); Treas. Reg. § 1.1033(a)-1, T.D. 6222, 1957-1 C.B. 249.

89. Net proceeds equal the money plus the fair market value of unlike property you receive in exchange for the damaged property less expenses incurred in obtaining them. I.R.C. § 1033(a)(2)(A); Treas. Reg. § 1.1033(a)-2(c)(1), T.D. 6222, 1957-1 C.B. 249.

90. I.R.C. § 1033(a)(2)(B); Treas. Reg. § 1.1033(a)-2(c)(3), T.D. 7075, 1970-2 C.B. 160.

gate some of the losses. Corrupting an old adage, "Let the Taxpayer Beware." The burden of proof is on the taxpayer: he should follow the guidelines, know his options and be prepared.

*Gregory Ritter*

## *Zapata Corp. v. Maldonado*: “Steering a Middle Course” May Spell Deep Water for Business Judgment Application in Shareholder Derivative Suits

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In an attempt to strike a balance between the rights of an individual shareholder in his efforts to protect the corporation, and the rights of the board of directors to control the litigation in which the corporation is involved, the Supreme Court of Delaware, in *Zapata Corp. v. Maldonado*,<sup>1</sup> developed a new set of game plans for shareholder derivative suits. While *Zapata* is important because of its impact on procedural elements of shareholder derivative actions,<sup>2</sup> what makes it so noteworthy is the impact it may have on future applications of the business judgment rule<sup>3</sup> in such actions.

This comment will focus on the three cases that set the framework for the *Zapata* decision. They are: *Maldonado v. Flynn*<sup>4</sup> [*Maldonado I*], *Maldonado v. Flynn*<sup>5</sup> [*Maldonado II*], and *Maher v. Zapata Corporation*.<sup>6</sup> All three cases arose from similar transactions by the *Zapata* board of directors, and in each the court faced a common issue: whether the board of directors could compel dismissal of a shareholder's derivative suit after an independent committee, appointed by the board, determined that the suit was not in the best interest of *Zapata Corporation*. In analyzing the courts' decisions, this comment will survey general principles governing shareholder derivative actions, and consider the business judgment rule as it pertains to such actions.

### The Trilogy - A Review of the Related Cases

In 1970, the board of directors of *Zapata Corporation*, a Delaware

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1. 430 A.2d 779 (Del. 1981).
  2. For a discussion of procedures, see text at 6 *infra*.
  3. For a discussion of “business judgment” rule, see text at 10 *infra*.
  4. 413 A.2d 1251 (Del. Ch. 1980).
  5. 485 F. Supp. 274 (S.D.N.Y. 1980).
  6. 490 F. Supp. 348 (S.D. Tex. 1980).

firm, approved a stock option plan for certain officers and directors of the corporation. The options were to be exercised during five installment periods from 1971 to 1974. Under the plan eligible officers and directors could exercise their options to purchase Zapata's common stock at \$12.15 per share. Zapata Corporation stockholders approved the stock option plan in 1971.<sup>7</sup>

In 1974, the board of directors voted to accelerate the last option date from July 14, 1974, to July 2, 1974.<sup>8</sup> At that time most of Zapata's directors were eligible to participate in the 1970 stock option plan.<sup>9</sup> By accelerating the date, the option holders expected to reduce their anticipated tax liability.<sup>10</sup> Therefore, on July 2, eligible participants exercised their final option.<sup>11</sup>

William Maldonado, a Zapata stockholder, initiated a shareholder's derivative suit in the Delaware Court of Chancery in June of 1975.<sup>12</sup> He alleged ten corporate officers and directors breached their fiduciary duty by accelerating the option date. This "deprived Zapata of a federal tax deduction in an amount equal to that saved by the optionees. This occurred because the options were exercised [early], when the price of Zapata stock was \$18.8125, rather than on July 14, 1974, when the price of Zapata stock was [approximately] \$24.50."<sup>13</sup>

In 1977, Maldonado brought a second shareholder's derivative suit in the United States District Court for the Southern District of New York,<sup>14</sup> against nine of Zapata's past and current directors for alleged

7. 413 A.2d at 1254.

8. *Id.*

9. *Id.*

10. Vice Chancellor Hartnett in his opinion explained:

This was so because the amount of capital gain for federal income tax purposes to the optionees would have been an amount equal to the difference between the \$12.15 option price and the price on the date of the exercise of the option: \$18-19 if the options were exercised prior to the tender offer announcement or nearly \$25 if the options were exercised immediately after the announcement.

*Id.* at 1254.

11. *Id.*

12. Maldonado I, 413 A.2d 1251.

13. *Id.* at 1255.

14. Maldonado v. Flynn, 448 F. Supp. 1032 (S.D.N.Y. 1978).

violations of the Securities and Exchange Act of 1934.<sup>15</sup> Finding Maldonado had failed to state a cause of action, the district court dismissed his complaint but granted him leave to amend.<sup>16</sup> Maldonado appealed the decision, and the Court of Appeals for the Second Circuit remanded the case.<sup>17</sup> He then filed an amended complaint in the district court.<sup>18</sup> A third shareholder's derivative suit was filed against Zapata by John F. Maher and other stockholders in the United States District Court for the Southern District of Texas,<sup>19</sup> also alleging violations of the Securities and Exchange Act of 1934<sup>20</sup> by several Zapata board members.

Four of the defendant directors had left Zapata's board by June of 1979.<sup>21</sup> To fill those vacancies, the remaining directors appointed two new directors from outside the corporation.<sup>22</sup> After the appointment, the board created an Independent Investigation Committee<sup>23</sup> "authorized to investigate the claims asserted in [the three suits] and to take any course of action it deemed appropriate in view of its findings."<sup>24</sup>

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15. *Id.*

16. *Id.* at 1034. Maldonado's initial filing alleged

that defendants (1) violated § 10(b) of the Act [Securities and Exchange Act of 1934], 15 U.S.C. § 78j(b) and Rule 10b-5 by modifying the stock option plan without obtaining stockholders' approval, resulting in certain directors using inside information to gain substantial personal benefits at the Corporation's expense, and (2) violated § 14(a) of the Act, 15 U.S.C. § 78n(a) and Rule 14a-9 thereunder by making statements in proxy solicitations issued to the shareholders by the Corporation in 1975, 1976, and 1977, for the election of directors of the Corporation that were materially misleading with respect to the earlier modification of the stock option plan and the directors' exercise of their options thereunder.

*Maldonado v. Flynn*, 597 F.2d 789 (2d Cir. 1979).

17. *Id.*

18. *Maldonado II*, 485 F. Supp. at 277. "The amended complaint [sought] to nullify the elections of directors from 1975-1979; an injunction against further misleading proxy statements; and to recover from the defendants on behalf of Zapata damages allegedly flowing from the issuance of the claimed deceptive proxy materials." *Id.*

19. . 490 F. Supp. 348 (S.D. Tex. 1980).

20. *Id.* at 349.

21. 430 A.2d at 781.

22. *Id.* at 781.

23. 413 A.2d at 1255.

24. *Id.*

This committee was composed exclusively of the two new directors.<sup>25</sup>

After conducting its investigation “the Committee concluded, in September, 1979, that each action should have [been] dismissed forthwith as their continued maintenance [was] inimical to the Company’s best interest. . . .”<sup>26</sup> Accordingly, the Committee “instructed Counsel for Zapata to seek dismissal of all the pending suits.”<sup>27</sup> The following January, on remand, the District Court for the Southern District of New York granted Zapata’s motion for summary judgment dismissing the *Maldonado II* action.<sup>28</sup> The basis for the decision, district court Judge Edward Weinfeld stated, was “that the Committee, composed of independent and disinterested directors, conducted a proper review of the matters before it, considered a variety of factors and reached, in good faith, a business judgment that the action was not in the best interest of Zapata.”<sup>29</sup> Maldonado appealed to the Second Circuit Court of Appeals.<sup>30</sup>

Zapata’s attorneys were not as successful in opposing Maldonado’s state action, *Maldonado I*. The Delaware Court of Chancery ruled that “nothing in [the business judgment rule] grants any independent power to a corporation board of directors to terminate a derivative suit.”<sup>31</sup> As a result, the Court of Chancery denied Zapata’s motion to dismiss the suit.<sup>32</sup> Zapata filed an interlocutory appeal with the Supreme Court of Delaware which was accepted for review in *Zapata Corporation v. Maldonado*.<sup>33</sup> Before the appeal was accepted, however, the chancery court applied the holding of the New York federal district court in *Maldonado II* and dismissed *Maldonado I* on *res judicata* principles.<sup>34</sup> The *Maldonado I* dismissal was contingent upon the Second Circuit’s affirmance of the district court’s decision in *Maldonado II*.<sup>35</sup> The Dela-

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25. *Id.*

26. 430 A.2d at 781.

27. 413 A.2d at 1255.

28. 485 F. Supp. 274.

29. *Id.* at 286-87.

30. 430 A.2d 779.

31. 413 A.2d at 1257.

32. *Id.*

33. 430 A.2d 779.

34. *Maldonado v. Flynn*, 417 A.2d 378, 384-85 (Del. Ch. 1980).

35. *Id.*

ware Supreme Court in *Zapata* stated, "the Second Circuit Appeal was ordered stayed . . . pending this Court's resolution of the appeal from April 19th Court of Chancery order denying dismissal and summary judgment."<sup>36</sup>

In *Maher*, *Zapata* filed a motion to dismiss which the Texas federal district court denied in a decision similar to that in *Maldonado I*.<sup>37</sup> The federal district court in *Maher* held that the business judgment rule did not grant a committee authority to compel dismissal of a shareholder derivative suit in situations in which no demand is made on the board of directors to initiate an action.<sup>38</sup>

Courts in various jurisdictions have distinguished those situations where the shareholder is required to demand that the corporate board file suit, from those situations when the shareholder is excused from making such a demand prior to initiating a derivative suit. The distinctions between "demand" and "no demand" conditions significantly impact on the procedures and guidelines which are employed in a suit.<sup>39</sup> In the *Zapata* trilogy none of the plaintiffs demanded the board of directors to file suit against any of the defendants, prior to initiating his individual action. The board's own interest in the subject matter of the litigation would have made demand futile.

The central issue interwoven among each of the three cases was whether the independent committee had the power to compel dismissal of the shareholder derivative actions, especially when many of the directors who appointed the committee were named defendants. Each court had to deal with questions about the interpretation and application of the business judgment rule; this led to divergent results in *Maldonado I* and *II*.

Because of these variations in interpretation and application of Delaware corporate law, the proper framework (and no doubt, urgency) for resolution of the issues existed. The Supreme Court of Delaware acknowledged and resolved them in *Zapata*:<sup>40</sup> it set new guidelines for Delaware courts to use in ruling on a corporation's motion to

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36. 430 A.2d at 781.

37. 490 F. Supp. at 352-53.

38. *Id.* at 348.

39. The distinctions between demand and no demand are discussed in text at 198-200, *infra*.

40. 430 A.2d at 781.

dismiss a derivative suit where demand has been excused. However, because of the resulting impact the *Zapata* decision may have on application of the business judgment rule in shareholder derivative suits, the holding in *Zapata* most probably was not what some knowledgeable commentators had anticipated.<sup>41</sup>

### Shareholder Derivative Actions

A corporation is a unique entity providing investors an opportunity to share in business ownership and profits, while minimizing an investor's financial exposure and involvement in the day to day management of the firm.<sup>42</sup> Management functions traditionally are delegated to the directors of the corporation after their election to the board by the stockholders. This separation between ownership and management is not without pitfalls. The stockholder, "having surrendered individual control over his investment for the opportunity of corporate profit, . . . entrusts his fortunes to a board of directors who may well invest poorly, or worse, engage in self dealing."<sup>43</sup>

The problems created by this separation between ownership and management become more apparent when a minority stockholder has serious and well-founded concerns with the quality and/or integrity of the board's management decisions. A director or an officer of a corporation has a fiduciary duty to that business.<sup>44</sup> A breach of that duty gives rise to a cause of action by the corporation against that director or officer.<sup>45</sup> Similarly, the corporation may have claims against third persons for wrongs unrelated to corporate management.<sup>46</sup> Whether internally or externally created, the result of the injury is damage to the value of the corporation and, correspondingly, diminution in value of

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41. See discussion on commentators in text at 206, *infra*.

42. For a discussion of the attributes of the corporation entity as compared with other business structures, see H. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS* ch. 2 (West 2d ed. 1970).

43. Stegemoeller, *Derivative Actions and the Business Judgment Rule: Directorial Power to Compel Dismissal*, 69 ILL. B.J. 338 (1981).

44. Steinberg, *The Use of Special Litigation Committees to Terminate Shareholder Derivative Suits*, 35 U. OF MIAMI L. REV. 1, 3 (1980); HENN, *supra* note 42, at 457-58.

45. HENN, *supra* note 42, at 95.

46. *Id.* at 740.



shareholders' interests.<sup>47</sup> However, since it is the corporation that directly suffers from the loss, it is the corporation that has a direct cause of action - not the individual stockholder.<sup>48</sup> Generally, the individual stockholder lacks sufficient voting strength to directly influence board decisions to file suit or compel the ouster of an errant director. Lacking the ability to force the corporation to sue in its own behalf, the stockholder may be doomed to watch his investment dwindle, or perhaps gush, away.

When the corporation has a valid claim which it refuses to litigate, the individual stockholder theoretically has no legal remedy.<sup>49</sup> In the past, the stockholder was considered to be without standing to initiate a suit on behalf of the corporation.<sup>50</sup> Seeing the minority shareholder in this dilemma, equity courts developed the shareholder's derivative action.<sup>51</sup> They found this right to bring the suit derived from ownership of an equitable or beneficial interest in the corporation and the corporation's failure to initiate a suit on its own behalf.<sup>52</sup> "In legal effect a stockholder's [derivative] suit is one by the corporation conducted by the stockholder as its representative. The stockholder is only a nominal plaintiff, the corporation being the real party in interest."<sup>53</sup> In essence, the shareholder is a catalyst for the corporation to take action against one of its own officers or a third party, if either is endangering the corporation and its board of directors has not taken action.

The threshold question to be determined in most shareholder derivative actions is whether the right to sue on behalf of the corporation has vested in the shareholder. As a rule, state statutes regulate shareholder derivative suits.<sup>54</sup> Typically, these statutes require the stockholder, *inter alia*, to have "contemporaneous ownership of shares in order to maintain the suit . . ." and that the plaintiff "allege his efforts

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47. 13 FLETCHER CYC. CORP. § 5941.1 (Callaghan Rev. per. ed. 1980).

48. *Id.* § 5944.

49. *Id.*

50. *Id.*

51. *Id.* § 5940.

52. *Id.* § 5941.

53. *Id.* § 5939. The corporation "enters the litigation as a nominal party defendant because of its failure to enforce the claim in its own rights." HENN, *supra* note 42, at 777.

54. FLETCHER, *supra* note 47.

to obtain relief within the corporation before bringing his suit.”<sup>55</sup>

Delaware’s Chancery Court Rules are in harmony with these requirements.<sup>56</sup> The courts in Delaware have construed the chancery court rules as creating two different types of shareholder derivative actions: those where a demand to initiate suit must be made on the corporate board,<sup>57</sup> and those where the demand requirement is excused.<sup>58</sup>

Generally a demand is considered to be a condition precedent to a shareholder’s right to initiate a derivative suit.<sup>59</sup> The purpose of the demand is to give “the management of the corporation an opportunity to consider the merits of the dispute and to determine in the interests of the corporation and the shareholders whether it might be disposed of without the expense and delay of litigation.”<sup>60</sup>

There are a number of perfectly legitimate reasons why a board of directors, or an independent investigation committee acting in its stead, may find it undesirable to litigate corporate claims. The probability of success in trial, a cost-benefit analysis of the suit, and the effect on a company’s image and its employees’ morale are factors bearing on a decision to litigate.<sup>61</sup>

There may be instances when, after proper demand, the board agrees to litigate.<sup>62</sup> This decision would obviate the need for a share-

55. *Id.*

56. DEL. CODE ANN. Chancery Court Rules § 23.1 (1980). This rule provides:

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an incorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall allege that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and the reasons for his failure to obtain the action or for not making the effort.

57. *See generally* 413 A.2d 1262.

58. *See generally* 430 A.2d 779.

59. FLETCHER, *supra* note 47, § 4961.

60. *Id.* § 4963.

61. Steinberg, *supra* note 44, at 2. *See also* Note, *Corporations - The Shareholder’s Independent Right to Sue Derivatively - Maldonado v. Flynn and Its Progeny*, 29 U. OF KAN. L. REV. 135 (1980).

62. *See* HENN *supra* note 42, § 361.

holder's derivative suit because the corporation would be pursuing the action under its own appellation.<sup>63</sup> There are also situations in which a demand has been made properly, and the board refuses to file suit; however, rather than resisting the individual's efforts to initiate a derivative action, the board gives some type of assistance to the stockholder.<sup>64</sup> In *Sohland v. Baker*,<sup>65</sup> a Delaware case, a board refused to file suit, but it financially assisted the stockholder in retaining counsel in order that he could initiate a derivative suit.<sup>66</sup> Assuming the board's refusal to initiate suit rests on an "independen[t], good faith and reasonable investigation"<sup>67</sup> of the shareholder's allegations, the shareholder's right to initiate the derivative action terminates. The shareholder may still be able to initiate the suit if he meets the burden of showing that these good faith elements are lacking.<sup>68</sup> This is a difficult burden to meet since the court will presume the existence of good faith on the part of the board of directors.<sup>69</sup> The board of director's decisions in demand situations are protected under the business judgment rule.<sup>70</sup>

Generally, a shareholder is excused from making a demand if it would be futile;<sup>71</sup> however, "the complainant normally must demonstrate that the directors are either controlled by the alleged wrongdoer, interested in the challenged transaction to a degree which impairs their business judgment, or are participants in the alleged wrong."<sup>72</sup> This was the type of situation encountered in each of the *Zapata* cases: the named defendants/directors constituted a majority of the corporate board.

Recently, the common practice of corporate boards has been to appoint an independent committee to investigate the need or desire for initiating litigation after demand has been made.<sup>73</sup> Similarly, in those

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63. *Id.* at 750.

64. *See id.* § 361.

65. 141 A. 277 (Del. 1927).

66. *See* 430 A.2d at 783 discussing *Sohland*.

67. *Id.* at 787.

68. *Id.* at 784.

69. *Id.*

70. For discussion, *see* text at 200 *infra*.

71. *See generally* Steinberg, *supra* note 44.

72. Stegemoeller, *supra* note 43, at 342.

73. Steinberg, *supra* note 44.

cases where demand is excused, and a derivative suit has been filed, the board appoints a committee to determine whether the suit is in the best interest of the corporation.<sup>74</sup> Typically, the committee finds the suit is not in the corporation's best interest, and, accordingly, seeks to have the suit dismissed.<sup>75</sup> This was the committee's recommendation in the Zapata case.

Courts are faced with a dilemma in these no demand situations when the corporation seeks to have the suit dismissed. If the board determines that the suit is not in the best interest of the corporation, should a minority shareholder override that determination and be able to maintain the suit on the corporation's behalf?<sup>76</sup> There is a presumption that the board of directors and the independent committee have acted in good faith on behalf of the corporation. Therefore, courts have been reluctant to overrule decisions of the board of directors based on their business judgment unless the board or the committee fails to meet the good faith criteria.<sup>77</sup> The courts in both *Maldonado I* and *Maher* determined that the board did not have the authority to terminate demand excused derivative suits under the business judgment rule.<sup>78</sup>

It is appropriate, in this context, to examine the business judgment rule.

### The Business Judgment Rule<sup>79</sup>

"It is well settled that the management of a corporation is en-

74. *Id.*

75. *Id.*

76. 430 A.2d at 785.

77. *Id.* at 784.

78. 413 A.2d at 1257. 490 F. Supp. at 348.

79. The "business judgment" rule has been restated by one author as:

A corporation transaction that involves no self-dealings by, or other personal interest of, the directors who authorized the transaction will not be enjoined or set aside for the directors' failure to satisfy the standards that govern a director's performance of his or her duties, and directors who authorized the transaction will not be held personally liable for resultant damages, unless:

- (1) the directors did not exercise due care to ascertain the relevant and available facts before voting to authorize the transaction; or
- (2) the directors voted to authorize the transaction even though they

trusted to its board of directors, and that business judgments made by the board are not subject to review unless they are made in bad faith."<sup>80</sup> This concept has evolved into the business judgment rule which has provided legal practitioners and scholars fertile ground for debating whether the rule provides a corporation's board of directors with only a shield or with a sword as well.<sup>81</sup> If the business judgment rule is only protective, it merely shields the board from liability arising out of inefficient, albeit, good faith decisions. However, if the board has the authority to initiate legal actions based on its business judgment, the rule becomes a sword as well.

The business judgment rule presumes that a board of directors, in good faith, considers the best interests of the corporation when reaching management decisions.<sup>82</sup> As the court in *Zapata* noted, the business judgment rule was a judicial creation in Delaware "to give recognition and deference to directors' business expertise when exercising their managerial power under § 141(a)" of the Delaware Code.<sup>83</sup>

did not reasonably believe or could not have reasonably believed the transaction to be for the best interest of the corporation; or

(3) in some other way the directors' authorization of the transaction was not in good faith.

Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 111 (1979).

80. 490 F. Supp. at 351.

81. Arsht, *supra* note 79; Steinberg, *supra* note 44; Comment, *Novel Application of the Business Judgment Rule: Independent Directors Are Permitted to Terminate Derivative Actions Against Fellow Interested Directors*, 11 CUM. L. REV. 389 (1980); Legal Times of Washington, Jan. 19, 1981, at 33 (Analysis & Perspective); Johnson & Osborne, *The Role of the Business Judgment Rule in a Litigious Society*, 15 VAL. L. REV. 49 (1980); Note, *supra* note 61. See also *Abbey v. Control Corp.*, 603 F.2d 724 (8th Cir. 1979); *Shlensky v. Wrigley*, 95 Ill. App. 2d 173, 237 N.E.2d 76 (1968); *Zapata v. Maldonado*, 430 A.2d 779 (Del. 1981).

82. HENN, *supra* note 42, at 483.

83. 430 A.2d at 782. The court noted the applicable text of DEL. CODE ANN. tit. 8, § 141(a) (1980) to be:

The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

It follows that if the board of directors has the power to manage the corporation<sup>84</sup> and the authority to appoint an independent committee to act in its behalf,<sup>85</sup> then when the committee makes its good faith business decision regarding suit on behalf of the corporation, its decision as a business judgment should be honored by the courts.<sup>86</sup>

Thus, the shield versus sword debate becomes particularly significant in the context of shareholder derivative actions. In those instances where demand is required prior to commencing the derivative suit, courts have been reluctant to challenge board refusal to sue on the corporation's behalf.<sup>87</sup> As noted earlier, the shareholder's right to sue derivatively terminates once demand has been made and properly refused.<sup>88</sup> Here the board's decision is conspicuously sheltered by the business judgment rule.<sup>89</sup>

However, in those situations where demand is excused, a question arises as to whether the board can compel dismissal of the derivative suit. Initially, the court in *Maldonado II* said yes, and held "that the Committee had the authority under the 'business judgment' rule, to require the termination of the derivative action."<sup>90</sup>

The court in *Zapata* however, rejecting the logic of *Maldonado II*, held the rule should not impede derivative actions where demand on the board was excused.<sup>91</sup>

### *Zapata Corp. v. Maldonado*: The Balance Tips for the Shareholder

The court in *Zapata* addressed a novel issue: whether an independent committee, appointed by the board of directors, had the power to compel dismissal of a shareholder derivative suit when no demand had been made on the board to initiate an action.<sup>92</sup> To answer this question,

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*Id.*

84. 430 A.2d 786.

85. *Id.*

86. *Id.* at 779.

87. *Id.* at 784.

88. See text at 199, *supra*.

89. The rule applies to directors and officers alike. Arsht, *supra* note 81, at 111.

90. 430 A.2d at 781.

91. See generally 430 A.2d 779 and discussion in 202-07 *infra*.

92. In the major case of *Burks v. Lasker*, 441 U.S. 471 (1979), the Supreme

the court examined, separately, three inherent components:

The continuing right of a stockholder to maintain a derivative suit; the corporate power under Delaware law of an authorized board committee to cause dismissal of litigation instituted for the benefit of the corporation; and the role of the Court of Chancery [of Delaware] in resolving conflicts between the stockholder and the committee.<sup>93</sup>

Ultimately the court focused “on the power to speak for the corporation as to whether the lawsuit should be continued or terminated.”<sup>94</sup>

The court stated that “disputes pertaining to control of the suit arise in two contexts.”<sup>95</sup> These contexts are: first, where a stockholder properly demands the board to initiate suit, the board refuses, and the stockholder claims the board’s decision was wrongful; and second, where the stockholder initiates a derivative suit without first making a demand because such demand would be futile.<sup>96</sup>

In determining whether the individual stockholder had an individual right to maintain the suit, the court firmly distinguished the demand required from the demand excused circumstance evidenced in *Zapata*.<sup>97</sup>

“[W]here demand is properly excused, the stockholder does possess the ability to initiate the action on his corporation’s behalf.”<sup>98</sup> But, while acknowledging the shareholder’s right to *initiate*, the court noted that this right did not necessarily translate into shareholder power to exclusively *control* the corporation’s “right throughout the litigation.”<sup>99</sup>

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Court, in developing a two prong test to be applied to similar questions arising in shareholder derivative actions, held that state law was determinative as to whether a committee has the power to compel dismissal of an action. *See also Zolezzi, Director Good Faith Marches On: A California Analysis of Director Termination of Shareholder Derivative Suits Under Burks v. Lasker*, 32 HASTINGS L.J. 519 (1980).

93. 430 A.2d at 782.

94. *Id.*

95. *Id.* at 784.

96. *Id.*

97. The court’s discussion regarding “demand required” situations was dicta, however, it will be very persuasive in future decisions.

98. 430 A.2d at 784.

99. *Id.* at 785.

The court reasoned "that such an inflexible rule would recognize the interest of one person or group to the exclusion of all others within the corporate entity."<sup>100</sup> The court recognized that "[e]ven when demand is excusable, circumstances may arise when continuation of the litigation would not be in the corporation's best interests."<sup>101</sup> Therefore, the court reasoned that if there was not "a permissible procedure under § 141(a) by which a corporation [could] rid itself of detrimental litigation . . . a single stockholder in an extreme case might control the destiny of the entire corporation."<sup>102</sup>

After acknowledging the dangers of allowing a sole stockholder to control derivative litigation, the court addressed the question of whether the independent committee had the authority to seek termination of the suit. The court in *Zapata* held that the power of the board to appoint an independent committee to act in its stead is found in the Delaware statutes.<sup>103</sup> Therefore, since the committee received its authority from the board, the committee "would have the power to move for dismissal or summary judgment if the entire board did."<sup>104</sup> The court further noted that although a majority of *Zapata's* board members were tainted by self-interest, this was not "a legal bar to the delegation of board power to an independent committee composed of disinterested board members."<sup>105</sup>

The court held that in both demand required and demand excused circumstances, the board retained power "to make decisions regarding corporate litigation."<sup>106</sup> Thus, the committee had the authority to seek termination of the suit.

While reaffirming the committee's legal power, the *Zapata* court nevertheless usurped board power to defeat the derivative suit and expressly changed the game plans for suits in demand excused situations. By its promulgation of new guidelines the Delaware Supreme Court appears to have given minority shareholders a distinct advantage in such suits.

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100. *Id.*

101. *Id.*

102. *Id.* See applicable text of statute at note 83, *supra*.

103. 430 A.2d at 785.

104. *Id.*

105. *Id.* at 786.

106. *Id.*



As currently outlined by the *Zapata* court, the requirements for the corporation's pretrial motion to dismiss include submitting "a thorough written record of the investigation and its findings and recommendations. . . . Under appropriate court supervision, akin to proceedings on summary judgment, each side should have an opportunity to make a record on the motion."<sup>107</sup> The moving party, *i.e.*, the corporation, then will have the burden of showing "that there is no genuine issue as to any material fact and that the moving party is entitled to dismiss as a matter of law."<sup>108</sup>

The more important advantage *Zapata* gives shareholders is a two-step test which Delaware courts will be required to apply to that motion. In the first step, "the court should inquire into the independence and good faith of the committee and the bases supporting [the committee's] conclusions."<sup>109</sup> The independence and good faith elements are totally consistent with prior criteria established for reviewing the propriety of a corporation's decisions. However, requiring the court to review the bases of the committee's decision creates a new dimension of inquiry into the committee's good faith.<sup>110</sup>

Prior to *Zapata*, the decisions of a board of directors, under the business judgment rule, were given a presumption of good faith, independence and reasonableness.<sup>111</sup> The burden to prove otherwise was on the shareholder who brought suit. The *Zapata* court now places on the board the burden of proving the existence of those elements. As the court stated, "[t]he corporation should have the burden of proving independence, good faith and reasonableness."<sup>112</sup> The court noted that "[its] approach [was] consistent with the Delaware approach to 'interested director' transactions, where the directors, once the transaction is attacked, have the burden of establishing its 'intrinsic fairness' to a court's careful scrutiny."<sup>113</sup>

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107. 430 A.2d at 788.

108. *Id.*

109. *Id.*

110. The court may now question the reasoning for the decision of the board of directors or its independent committee, not just whether the decision was reached independently and in good faith. *See* 430 A.2d at 789.

111. 430 at A.2d at 782.

112. *Id.* at 788.

113. *Id.* at 788-89.

The second step mandates “[the] trial court [to] determine, applying its own independent business judgment, whether the motion should be granted. This means, of course, that instances could arise where a committee can establish its independence and sound bases for its good faith decisions and still have the corporation’s motion denied.”<sup>114</sup>

Two commentators, Elmer W. Johnson and Robert S. Osborne,<sup>115</sup> felt the decision reached by the lower court in *Maldonado I* was too harsh in terms of its impact on “second tier<sup>116</sup> business judgment dismissals in cases alleging breach of fiduciary duty.”<sup>117</sup>

Johnson and Osborne suggested a middle ground; once the defendant corporation establishes the independence of its special committee, “business judgment rule dismissal of derivative claims should be made available regardless of the nature of the underlying contract.”<sup>118</sup> But the middle ground they sought was a far distance from the landing place of Delaware’s Supreme Court. The court went much further, by permitting the trial court to actually supplant the committee’s business judgment with its own.

The Johnson and Osborne suggestions seem to accord with the theory that power to manage the corporation, and control its litigation, is vested in the directors. If the independence and good faith of the committee’s decisions remain in question after review by the trial court, the court may, appropriately, deny dismissal of the derivative suit.

Allowing the court to delve so deeply into the committee’s decision making process invites judicial overreaching. The court in *Zapata* acknowledged the danger of such overreaching<sup>119</sup> - but determined the trial court’s “fresh view” into the matter was desirable to properly balance the various interests involved.<sup>120</sup> The court specifically envisioned circumstances in which a dismissal, based solely on the corporation’s

114. *Id.* at 789.

115. Johnson & Osborne, *supra* note 81.

116. The authors refer to the first tier as the original business decision made by the board which creates the controversy, and the second tier as that decision made by the committee as to whether or not to sue for injuries resulting from the first decision. *Id.* at 64-68.

117. *Id.* at 68.

118. *Id.*

119. 430 A.2d at 788.

120. *Id.*

ability to show good faith and independence, "would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest."<sup>121</sup>

The court's decision in *Zapata* clearly limits the use of the business judgment rule: the rule is, thus, merely a shield in demand excused derivative suits.<sup>122</sup> The board of directors, or its committee, may, by motion, seek termination of suit if this accords with its business judgment. The motion will be honored or denied at the court's discretion.

### Conclusion

There are compelling policy arguments for protecting the minority shareholder's right to control a derivative suit when controversies arise regarding a board of director's independence or good faith. Similarly, there are strong reasons for protecting the rights of the board to direct corporate litigation. The shareholder, as an owner of the corporation, seeks to maximize his returns and maintain the prestige, goodwill, and value of the corporation. The board shares those concerns, but is also mindful of the need to maintain autonomy as sole decision-maker of the corporation. Because there are often factors considered in business decisions which may not directly translate into dollars and cents, the board of directors should have the flexibility to make those decisions in good faith. Directors should not have the added pressure of finding the court in its board room.

The Supreme Court of Delaware, in *Zapata*, was mindful of the need to carefully balance the interests of the stockholder and the board of directors. The "middle ground" the court struck may ultimately prove to be a fair compromise. However, on its surface the decision in *Zapata* creates cause for concern of possible judicial overreaching in demand excused situations. It is conceivable that the courts, in follow-

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121. *Id.* at 789.

122. The procedures under "demand required" situations in essence remain unchanged. The board still has the power to refuse to sue when demand is required. *Id.* at 785. In fact the court buttressed the sanctity of the board's "business judgment" in those instances where: 1) demand is required, 2) demand is made, and 3) the board, in good faith, reaches a decision not to sue. In those situations the court indicated shareholders will not have standing to sue. *Id.* at 784.

ing *Zapata*, will show little reluctance to carry their own business judgment into demand required situations as well. By attempting to clarify the various interpretations surrounding application of the business judgment rule in derivative actions, the *Zapata* court may have provided Delaware courts with skeleton keys to all of Delaware's board rooms.

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