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NOTES

Beyond The Substantial Evidence Rule: Lewis v. Metropolitan Savings & Loan Association

The Gregg County Savings and Loan Association applied to the Savings and Loan Commission of Texas for a charter to establish a new savings and loan association in Gregg County, Texas. Three existing savings and loan associations opposed the establishment of a new association at the administrative hearing. The hearing examiner denied admission of certain evidence they sought to introduce.¹ After the hearing was concluded Lewis, the Savings and Loan Commissioner, issued an order granting the charter to the applicant. Alleging that the exclusion of material evidence was a denial of procedural due process, the opposing associations appealed to a trial court, which sustained the approval order. The Austin court of civil appeals reversed, and remanded the proceeding to the commissioner with instructions to deny the charter application.² The Texas Supreme Court granted writ of error. *Held, modified, and as modified affirmed*: Notwithstanding the fact that the order was supported by substantial evidence, it was invalid because the exclusion of competent and relevant evidence denied the contesting parties due process of law. *Lewis v. Metropolitan Savings & Loan Association*, 550 S.W.2d 11 (Tex. 1977).

I. JUDICIAL REVIEW OF ADMINISTRATIVE ORDERS IN TEXAS

Historically, the Texas courts have devoted little attention to the protection of procedural due process rights in administrative hearings.³ This lack of concern has been rooted in the standards applicable to judicial review made under statutes requiring de novo review of administrative decisions.⁴ Under such procedures, the courts have traditionally inquired into whether any substantial evidence supported the findings of the administrator, but have disregarded the evidence that was actually before the agency.⁵

1. The applicant's expert witness, Dr. Robert Branson, had prepared a study of economic conditions in Gregg County, Texas, which supported the applicant's contention that a new association would be of benefit to Gregg County. In an earlier study using a different methodology, Dr. Branson had compared the economy of Bowie County to that of several other counties, one of which was Gregg County. In the Bowie County study, Dr. Branson concluded that a high buying income per association, combined with low assets per capita and a high ratio of income to assets, indicated a need for a new savings and loan association. Dr. James Vinson, expert witness for the three opposing Savings and Loan Associations, updated the early Bowie County study, and concluded that Gregg County failed to display the characteristics previously found so determinative by Dr. Branson. In fact, Vinson's updated study portrayed Gregg County as a community with a low buying income per association, high assets per capita, and a low ratio of income to assets.

2. *Metropolitan Sav. & Loan Ass'n v. Lewis*, 535 S.W.2d 35 (Tex. Civ. App.—Austin 1976).

3. Reavley, *Substantial Evidence and Insubstantial Review*, 23 Sw. L.J. 239 (1969).

4. *Id.* The statutes required a new trial on review, but failed to define the standards of and procedures for review.

5. *Id.*

The substantial evidence rule was first applied to a statute requiring de novo review in *Shupee v. Railroad Commission*.⁶ The Supreme Court of Texas held that the Commission's order denying the establishment of a bus line could be overturned only if the decision was unreasonable, arbitrary, or had no basis in fact.⁷ In *Trapp v. Shell Oil Co.*⁸ the court set the final parameters of the rule,⁹ and fully developed what has since been called "substantial evidence de novo review."¹⁰ The applicable judicial review statute¹¹ was construed to mean that the courts must provide a trial de novo, but a court could only substitute its findings for that of the administrative agency if the agency's decision was not supported by substantial evidence.

As *Trapp* articulated the rule,¹² the trial court must disregard the evidence heard by the agency, and hear its own relevant evidence. Whether the agency itself heard sufficient evidence is not material. In fact, evidence heard at the agency hearing is admissible at trial only if it accords with the general rules of evidence.¹³ The review trial is held merely to ensure that at the time the agency made its decision, substantial evidence was in existence which would support the order. Judicial reluctance to rely on the agency record was explained in *Trapp*, in which the court said:

A lay agency, unfamiliar with [evidentiary] principles, might reject material evidence and admit and rely on other evidence that was inadmissible. No system has been provided in this State for reviewing the action of the administrative agency for procedural errors committed in the taking of the testimony, nor for remanding the cause to the agency for a rehearing because thereof.¹⁴

Thus, the courts have been unconcerned with the procedure at the administrative hearings, since a new trial is provided on review. Standards of

6. 123 Tex. 521, 73 S.W.2d 505 (1934).

7. *Id.* at 527, 73 S.W.2d at 510. The clearest articulation of this rule is found in the later case of *Phillips v. Brazosport Sav. & Loan Ass'n*, 366 S.W.2d 929, 936 (Tex. 1963): "The order of the Commissioner is presumed to be valid. The courts may not substitute their discretion for that delegated to the Commissioner by the Legislature; thus, the only question before the trial court is whether the Commissioner's decision was arbitrary and made without regard to facts."

8. 145 Tex. 323, 198 S.W.2d 424 (1946).

9. Such parameters were needed because three earlier Texas Supreme Court cases were in conflict. *Compare Marris v. Railroad Comm'n*, 142 Tex. 293, 177 S.W.2d 941 (Tex. 1944), and *Railroad Comm'n v. Shell Oil Co.*, 139 Tex. 66, 161 S.W.2d 1022 (1942), with *Land Co. v. Atlantic Ref. Co.*, 134 Tex. 59, 131 S.W.2d 73 (1939). For a good discussion of these cases, see Griffin, *The Growing Substantial Evidence Rule*, 21 TEX. B.J. 721 (1958).

10. See, e.g., Comment, *Judicial Review of Administrative Agency Action—A Need for Texas Reform?*, 40 TEXAS L. REV. 992 (1962). The phrase accurately describes this method of review which is an amalgam of true substantial evidence review and pure de novo review. In true substantial evidence review, the order is not vacated on appeal, the court applies the substantial evidence test to the evidence heard at the administrative hearing, and does not go beyond the record. In pure de novo review, the order is vacated on appeal, the court hears evidence anew, and makes its own findings of fact. For an extensive discussion of these methods of review, see Reavley, *supra* note 3.

11. TEX. REV. CIV. STAT. ANN. art. 6049c, § 8 (Vernon 1962). The statute itself specified only that the burden of proof "should be upon the party complaining of such laws, rule, regulation or order." Actual procedures of review were left to the determination of the judiciary. Thus, substantial evidence de novo review has been a creation of the Texas judiciary.

12. 145 Tex. at 349, 198 S.W.2d at 440.

13. *Railroad Comm'n v. Shell Oil Co.*, 139 Tex. 66, 80, 161 S.W.2d 1022, 1030 (1942).

14. 145 Tex. at 331, 198 S.W.2d at 430 (quoting *Railroad Comm'n v. Shell Oil Co.*, 139 Tex. at 77, 161 S.W.2d at 1028).

procedural due process to be observed during the hearing have not been set by the bench, and agencies themselves have rarely set any safeguards,¹⁵ because appealing parties are entitled to due process on review.¹⁶ The substantial evidence de novo review rule has been extended to apply to all statutes requiring a civil trial on review except when expressly forbidden by the relevant statute.¹⁷

Although this method of review has tended to discourage the development of procedural safeguards, due process rights at agency hearings have not been totally ignored. The right to notice of the administrative hearing and the right to appeal from an agency order have been protected by Texas courts when a party has been in danger of being deprived of a vested property right.¹⁸

Federal courts have long held that due process of law must be protected in agency hearings, and have found a denial of due process in the exclusion of material and relevant evidence.¹⁹ Other state courts have agreed.²⁰ And with the passage of the review statute governing the Savings and Loan Commission, the Texas Legislature seemed to urge the Texas courts to be similarly attentive to the evidence adduced at the agency hearing.²¹

That statute was first interpreted by the Texas Supreme Court in *Gerst v. Nixon*.²² Although one portion of the statute was invalidated,²³ the court upheld the remainder, so that in its final form it reads:

15. That agencies can do so is undisputed. For example, the Railroad Commission has promulgated Rules of Procedure and Practice before its Motor Transportation Division. For a discussion see Bailey, *Motor Vehicle Certificates and Permits in Texas; Procedure Before the Commission*, 21 TEXAS L. REV. 590 (1943).

16. See Walker, *The Application of the Substantial Evidence Rule in Appeals from Orders of the Railroad Commission*, 32 TEXAS L. REV. 639, 649 (1954). In criticizing this method of review, Walker points out that procedural due process may be denied those who choose not to appeal. This type of review has also been criticized for providing insufficient protection from arbitrary agency decision-making, because its practical effect is to give finality to any administrative decision based upon controverted issues of fact. *Id.* at 657.

17. *Id.* at 656. Even when the relevant statutory language seemed to dictate pure de novo review, the court refused to broaden the scope of judicial review beyond the substantial evidence test. See *Walker v. City of Lubbock*, 160 Tex. 38, 326 S.W.2d 699 (1959); *Southern Canal Co. v. Board of Water Eng'rs*, 159 Tex. 227, 318 S.W.2d 619 (1958); *Board of Water Eng'rs v. Colorado River Mun. Water Dist.*, 152 Tex. 77, 254 S.W.2d 369 (1953). In fact, only where the particular agency engaged in quasi-judicial action, *Key W. Life Ins. Co. v. State Bd. of Ins.*, 163 Tex. 11, 350 S.W.2d 839 (1961), or when a rate-making decision was reviewed, *Lone Star Gas Co. v. State*, 137 Tex. 279, 153 S.W.2d 681 (1941), would the court comply with legislative directive and provide a broader standard of review. For a good discussion of the court's reasoning in these cases see Werkenhain & Mitchell, *History of Judicial Review*, in PROFESSIONAL DEVELOPMENT PROGRAM, STATE BAR OF TEXAS, ADMINISTRATIVE LAW AND PROCEDURE H-1, at H-10 to -20 (1976).

18. See, e.g., *Brazosport Sav. & Loan Ass'n v. American Sav. & Loan Ass'n*, 161 Tex. 543, 342 S.W.2d 747 (1961); *Francisco v. Board of Dental Examiners*, 149 S.W.2d 619 (Tex. Civ. App.—Austin 1941, writ ref'd).

19. See, e.g., *Donnelly Garment Co. v. NLRB*, 123 F.2d 215 (8th Cir. 1941).

20. See, e.g., *Gallant's Case*, 326 Mass. 507, 95 N.E.2d 536 (1950) (material evidence held wrongfully excluded from hearing before Workmen's Compensation Board).

21. TEX. REV. CIV. STAT. ANN. art. 852a, § 11.12 (Vernon 1964). This is probably the first judicial review statute in Texas limiting the courts to review of the agency record. *McCalla, The Administrative Procedure and Texas Register Act*, 28 BAYLOR L. REV. 445 (1976).

22. 411 S.W.2d 350 (Tex. 1966).

23. That portion read, "and all fact issues material to the validity of the Act, order, ruling, decision or of any rule or regulation complained of shall be redetermined in such trial on the preponderance of the competent evidence." This section was invalidated for violation of the separation of powers provision of the Texas Constitution. *Id.* at 353-54.

The review of any other act, order, ruling or decision of the Commissioner or of any rule or regulation shall be tried by the court without a jury in the same manner as civil actions generally . . . , but no evidence shall be admissible which was not adduced at the hearing on the matter before the Commissioner or officially noticed in the records of such hearing.²⁴

The statute clearly states that judicial review should be based on evidence adduced at the hearing, and not upon evidence heard for the first time at the trial. Other provisions requiring the hearing examiner to make a formal record of the hearing, and to certify the record to the reviewing district court,²⁵ demonstrate that the legislative intent was to limit the review to the agency record.²⁶ Therefore, the commissioner's order rests solely upon the evidence adduced at the hearing. From this record the district court determines whether the commissioner's decision was arbitrary, that is, whether it was supported by substantial evidence. This is in accord with pure substantial evidence review.²⁷

Thus, in contrast to substantial evidence de novo review, the proceedings at the agency hearing become of paramount importance. The court in *Gerst*, however, did not specifically address the problem of procedural due process, although it noted that the admission of unreliable evidence at the hearing should be considered by the trial court in determining if the order was based on substantial evidence.²⁸

Following the decision in *Gerst v. Nixon*, orders promulgated by the Savings and Loan Commissioner were upset only when they were not based on substantial evidence in the record. In *Benson v. San Antonio Savings Association*,²⁹ for example, the unsuccessful applicant contended that the commissioner's exclusion of evidence from the record was grounds for reversal. The court, however, said that the excluded evidence would not have subtracted from the substantial evidence that was in the record, and the order was upheld.³⁰ *Lewis v. Southmore Savings Association*³¹ reiterated the position that where there was substantial evidence in the record to support the order, irregularities in the exclusion or admission of evidence were immaterial.³²

24. TEX. REV. CIV. STAT. ANN. art 852a, § 11.12(5)(b) (Vernon 1964).

25. *Id.* art. 852a §§ 11.11, .12(4).

26. The passage of the Administrative Procedure and Texas Register Act, TEX. REV. CIV. STAT. ANN. art. 6252-13a (Vernon Supp. 1976-77), which limits review to either pure substantial evidence review or pure de novo review, also indicates legislative impatience with substantial evidence de novo review, and a desire either to limit the reviewing court to the record or to provide pure de novo review.

27. See McCalla, *supra* note 21.

28. 411 S.W.2d at 357.

29. 374 S.W.2d 423 (Tex. 1963).

30. *Id.* at 429.

31. 480 S.W.2d 180 (Tex. 1972).

32. In *Southmore*, however, the court refused to reverse an order based on substantial evidence in the record where the alleged error consisted of the *admission* of evidence. *Id.* at 187-88.

II. LEWIS V. METROPOLITAN SAVINGS & LOAN ASSOCIATION

In *Lewis v. Metropolitan Savings & Loan Association* the Texas Supreme Court determined that the substantial evidence test alone was no longer enough to prevent arbitrary agency action. An additional standard to ensure against such arbitrariness was formulated: not only must the order be based upon substantial evidence found in the record, but the agency hearing that produced the record must comply with due process of law.³³ Further, the court recognized that among the most important due process rights is the right to have all material and competent evidence admitted into the record.³⁴

In *Lewis* the court found the excluded evidence to be both competent and relevant.³⁵ The evidentiary function of the excluded evidence was not merely cumulative of other testimony but tended to impeach the testimony of the opposing party.³⁶ Thus, the testimony was admissible into evidence, and was wrongfully excluded.

The fact that there was no way of determining the influence the excluded evidence might have had on the commissioner's decision-making process was considered irrelevant. The court recognized that it is rarely possible for the reviewing court to determine the potential effect excluded evidence might have had if admitted.³⁷ For this reason, the court adopted the liberal standard of review set by the Eighth Circuit in *Donnelly Garment Co. v. NLRB*:

That the Board would or might have reached no different conclusion had the rejected evidence been received, is entirely beside the point. The truth is that a controversy tried before a court or before an administrative agency is not ripe for decision until all competent and material evidence proffered by the parties has been received and considered.³⁸

Nevertheless, while the court recognized that the commissioner cannot be held to judicial standards of evidence or conduct,³⁹ it failed to articulate fully an alternative standard to guide the agency in admitting evidence. This failure may lead to the admission of evidence that would be inadmissible in jury trial.⁴⁰ In this respect, however, the court's decision follows the continuing trend in both state and federal agency procedure away from the technical rules which limit admissibility.⁴¹

33. 550 S.W.2d at 14.

34. *Id.* The court noted that legal scholars have long advocated the establishment of a standard of procedural due process at administrative hearings. Berger, *Administrative Arbitrariness and Judicial Review*, 65 COLUM. L. REV. 55 (1965); Jaffe, *The Right to Judicial Review*, 71 HARV. L. REV. 401 (1958).

35. 550 S.W.2d at 13. See note 1 *supra* for a description of the excluded evidence.

36. 550 S.W.2d at 13.

37. See F. COOPER, STATE ADMINISTRATIVE LAW 403-04 (1965). The court agreed with Cooper that in the usual case exclusion of proper testimony almost inevitably voids the administrative order. 550 S.W.2d at 15.

38. 123 F.2d 215, 224 (8th Cir. 1941).

39. 550 S.W.2d at 14.

40. Nevertheless, orders of federal agencies have rarely been vacated because legally incompetent evidence has been admitted at the hearing. See C. MCCORMICK, HANDBOOK OF THE LAW OF EVIDENCE § 3349, at 838 (2d. ed. 1972). Significantly, orders of the federal agencies issued after formal hearings are subject to the same type of review as orders from the Texas Savings and Loan Commissioner in that the review is limited to the agency record. 5 U.S.C. § 706 (1970).

41. In the states both the legislatures and the judiciary have followed the trend. C. MCCORMICK, *supra* note 40, § 3350, at 840. The Federal Administrative Procedure Act, 5

Indeed, the court in *Lewis* seemed to be following the legislative intent expressed in the Administrative Procedure and Texas Register Act,⁴² although it made no explicit reference to the Act in rendering its opinion.⁴³ In setting forth the rules of evidence to be applied in contested cases⁴⁴ before any agency,⁴⁵ the Act significantly broadens the category of admissible evidence by providing:

In contested cases, irrelevant, immaterial, or unduly repetitious evidence shall be excluded. The rules of evidence as applied in nonjury civil cases in the district courts of this state shall be followed. When necessary to ascertain facts not reasonably susceptible of proof under those rules, evidence not admissible thereunder may be admitted, except where precluded by statute, if it is a type commonly relied upon by reasonably prudent men in the conduct of their affairs.⁴⁶

This liberality towards admission of potentially important evidence, at the risk of including legally inadmissible evidence, affords greater protection to the contesting parties because it ensures the opportunity for the fullest possible hearing.

The dissenting justices in *Lewis*, however, disagreed with this view.⁴⁷ They feared that the majority's failure to articulate a standard by which hearing examiners may guide their conduct could lead the hearing examiners to admit all contested evidence for fear of reversal on appeal. This, in turn, would lead to more voluminous records, prolonged hearings, and might even lead to reversal for admission of incompetent evidence. If the court follows the trend of other state and federal courts, however, admission of incompetent evidence will not be grounds for reversal unless there is no other competent evidence in the record to support an order.⁴⁸

Although the dissent conceded that in some situations the wrongful actions of the hearing officer would be so detrimental to the presentation of a party's position that it would violate due process of law, such was not the

U.S.C. § 556(d) (1970), provides that "any oral or documentary evidence may be received, but the agency as a matter of policy shall provide for the exclusion of irrelevant, immaterial, or unduly repetitious evidence." Thus, no explicit provision is made for the exclusion of hearsay evidence; the Act merely sets the policy, but does not require, that irrelevant, immaterial, or incompetent evidence be excluded. C. McCORMICK, *supra* note 40, § 3350, at 840.

42. TEX. REV. CIV. STAT. ANN. art. 6252-13a (Vernon Supp. 1976-77). For a discussion of the legislative intent see note 26 *supra*.

43. The Act, which became effective January 1, 1976, was not applicable here because the administrative hearings were held in September and November of 1973, and the order was entered in January of 1974.

44. "Contested case," as defined in the Act, would apply to licenses issued by the Savings and Loan Commissioner, which are issued after notice and hearing under TEX. REV. CIV. STAT. ANN. art. 852a (Vernon Supp. 1976-77).

45. "Agency" means any state board, commission, department, or officer having statewide jurisdiction that makes rules or determines contested cases other than an agency wholly financed by federal funds, the legislature, the courts, the Industrial Accident Board, and institutions of higher learning. TEX. REV. CIV. STAT. ANN. art. 6252-13a, § 3(1) (Vernon Supp. 1976-77).

46. *Id.* § 14.

47. 550 S.W.2d at 16 (Greenhill, C.J., McGee & Denton, JJ., dissenting).

48. See note 38 *supra*. In the past, however, the court has implied in dictum that the admission of hearsay evidence may lead to reversal on appeal. See *Lewis v. Southmore Sav. Ass'n*, 480 S.W.2d 180 (Tex. 1972). But see TEX. REV. CIV. STAT. ANN. art. 6252-13a, § 14 (Vernon Supp. 1976-77). Since the majority expressly states that the hearing examiner is not held to judicial standards of evidence, it would be inconsistent to reverse an order because the admission of evidence had not been governed by these same non-applicable standards.

case here.⁴⁹ They argued that the excluded evidence served no evidentiary function, as it could not be used to impeach the testimony of the opposing expert witness,⁵⁰ and was merely cumulative of other evidence already introduced.⁵¹

At what point due process of law would be violated by a wrongful action of the hearing officer was not made clear by the dissent. In fact the reliance upon the holding in *Benson v. San Antonio Savings Association*⁵² indicates that the dissent believed that exclusion of evidence would be reversible error only when the evidence could show that the commissioner's rejection of the application was not based on substantial evidence. Such a narrow view of grounds for reversible error, however, is in clear contravention of the policy expressed by the legislature in the Administrative Procedure and Texas Register Act.⁵³

III. CONCLUSION

In both the Administrative Procedure and Texas Register Act and the Savings and Loan Commission's review statute the legislature directed the courts to be more attentive to the conduct of agency hearings. The court in *Lewis* followed the lead set by the legislature by holding that the exclusion of admissible evidence in a hearing of the Savings and Loan Commission was a violation of due process which required reversal. In view of this legislation and the court's disposition to examine the agency proceedings more closely, it appears that the trend in Texas will be towards stricter review of agency hearings. The holding in *Lewis* should provide important new safeguards to contesting parties by assuring a full hearing for all parties. The limits to the new rule, if any, will have to be set by later judicial interpretation.

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49. 550 S.W.2d at 15.

50. The studies presented by Dr. Vinson and Dr. Branson had in fact utilized different methodologies in their evaluation of Gregg County, making the two studies virtually incomparable.

51. The study showed that in Gregg County the source of savings was small, that the current demand for savings and loan associations was met by existing associations, that the potential for new customers was small, and put these facts in a ratio form. Other testimony had already been introduced in another form to prove the same facts contained in the excluded study.

52. 374 S.W.2d 423 (Tex. 1963).

53. The Act provides that except in cases requiring review de novo an order may be reversed or remanded not only when not based on substantial evidence in the record, but also when the parties have been prejudiced because the administrative findings or decisions are in violation of constitutional or statutory provisions, are in excess of the statutory authority of the agency, are made upon unlawful procedure, or are affected by other areas of law. On the other hand, where the agency statute authorizes appeal by trial de novo, the courts shall try the case as any other civil case, and as though there had been no intervening agency action or decision. TEX. REV. CIV. STAT. ANN. art. 6252-13a, § 19(e) (Vernon Supp. 1976-77).