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## Affirmation of the Purchaser-Seller Limitation: Blue Chip Stamps v. Manor Drug Stores

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# NOTES

## Affirmation of the Purchaser-Seller Limitation: Blue Chip Stamps v. Manor Drug Stores

In 1963 the United States brought a civil antitrust action against Blue Chip Stamp Company, charging the company with monopolization of the trading stamp business in California. In 1967 the district court entered a consent decree which required Blue Chip Stamp Company to be merged into a new company—Blue Chip Stamps.<sup>1</sup> Under the reorganization plan the holdings of the majority stockholders in Blue Chip Stamp Company were to be reduced and Blue Chip Stamps was required to offer a substantial number of its shares to retail users of the stamp service who had not owned shares in the old company. In 1970 plaintiff-retailer filed the present class suit in the United States District Court for the Central District of California against the old and new companies, eight of the nine shareholders having majority control of Blue Chip Stamp Company, and the directors of Blue Chip Stamps. Plaintiffs alleged that defendants had violated the antifraud provisions of SEC rule 10b-5 by including an overly pessimistic appraisal of the company in the prospectus circulated pursuant to the consent decree, in order to dissuade the plaintiff class from accepting what was intended to be a bargain offer, so that the rejected shares might be offered to the public at a higher price. The complaint further alleged that class members had failed to purchase the offered shares in reliance upon these false and misleading statements. The district court dismissed the complaint for failure to state a claim upon which relief might be granted.<sup>2</sup> The United States Court of Appeals for the Ninth Circuit agreed with the plaintiffs' position and reversed the district court.<sup>3</sup> *Held, reversed*: In order for plaintiffs to maintain a private action for damages under section 10(b) and rule 10b-5, they must be actual purchasers or sellers of securities. *Blue Chip Stamps v. Manor Drug Stores*, 95 S. Ct. 1917, 44 L. Ed. 2d 539 (1975).

### I. THE BIRNBAUM DOCTRINE

An implied private right of civil recovery exists for violation of section 10(b)<sup>4</sup> of the Securities Exchange Act of 1934 and for violation of rule 10b-

1. *United States v. Blue Chip Stamp Co.*, 272 F. Supp. 432 (C.D. Cal. 1967).
2. *Manor Drug Stores v. Blue Chip Stamps*, 339 F. Supp. 35 (C.D. Cal. 1971).
3. *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136 (9th Cir. 1973).
4. Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1970) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

5<sup>5</sup> promulgated under that Act by the Securities Exchange Commission.<sup>6</sup> *Birnbaum v. Newport Steel Corp.*<sup>7</sup> established the requirement that the plaintiff in a private action for damages under section 10(b) and rule 10b-5 be a purchaser or seller of securities. In *Birnbaum* minority stockholders of the corporation brought a derivative action under section 10(b) and rule 10b-5 against the corporation and its president and controlling stockholder, alleging that the defendant-president had rejected a highly profitable merger offer and instead had sold his controlling interest at a premium. The plaintiffs contended that misrepresentations made by the defendant to the stockholders concerning the sale constituted fraudulent practices in connection with the sale of securities, thereby violating section 10(b) and rule 10b-5. The Second Circuit dismissed the action, stating that section 10(b) was directed solely at that type of fraudulent practice usually associated with the purchase or sale of securities rather than at fraudulent mismanagement of corporate affairs, and that rule 10b-5 "extended protection only to the defrauded purchaser or seller."<sup>8</sup> The corporation was not a party to the sale of control and, therefore, did not fall within either protected class.

*Expansion of the Purchaser-Seller Limitation.* To allow redress for victims of fraudulent schemes in securities transactions the courts have devised flexible interpretations of the restrictive purchaser-seller limitation announced in *Birnbaum*. Indeed, the doctrine was interpreted so liberally by some courts that other courts were led to believe that *Birnbaum* had been completely abrogated.<sup>9</sup>

One method of expansion was to allow plaintiffs to bring actions under section 10(b) and rule 10b-5 as "forced sellers." This exception is exemplified by the case of *Vine v. Beneficial Finance Co.*<sup>10</sup> where a plaintiff-stockholder in a corporation acquired by short form merger was considered a "forced seller" since his only alternative to selling his stock at a discount was to hold stock in a non-existent corporation.<sup>11</sup> In another case applying this

5. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1975) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading,

(c) To engage in any act, practice, or course of business which operates or which would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

6. Although neither § 10(b) nor rule 10b-5 expressly provides a civil remedy for its violation, the courts have interpreted its language to imply a private right of action. See, e.g., *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). See generally 1 A. BROMBERG, SECURITIES LAW: FRAUD, § 2.4, at 27-40 (1974); 3 L. LOSS, SECURITIES REGULATION 1763 (2d ed. 1961); Comment, *The Prospects for Rule X-10b-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120 (1950).

7. 193 F.2d 461 (2d Cir. 1952).

8. *Id.* at 464.

9. See, e.g., *Entel v. Allen*, 270 F. Supp. 60, 69 (S.D.N.Y. 1967); cf. *Symington Wayne Corp. v. Dresser Indus., Inc.*, 383 F.2d 840, 842 (2d Cir. 1967).

10. 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967).

11. The court remarked that "[s]ince in order to realize any value for his stock [the plaintiff] must exchange the shares for money from [defendant], as a practical matter

exception, *Mutual Shares Corp. v. Genesco, Inc.*,<sup>12</sup> the court granted injunctive relief under section 10(b) and rule 10b-5 to minority shareholders who alleged that the majority stockholder was engaging in market manipulation in order to drive the price of the stocks down and force plaintiffs to sell their holdings at depressed prices.<sup>13</sup>

An exception to the purchaser-seller requirement has also been recognized in cases where the plaintiffs were aborted or delayed purchasers or sellers. In one such case plaintiff-stockholder was allowed to maintain a cause of action by alleging that defendant-stockbroker had fraudulently induced him to refrain from selling his stocks until the market price had declined. The fraud alleged was not in the actual sale—but in the aborted sale.<sup>14</sup> In *Travis v. Anthes Imperial Ltd.*<sup>15</sup> defendant-tender-offeror fraudulently induced American shareholders to hold their shares, while it acquired controlling interest in the corporation from foreign stockholders. Later, after defendant controlled the market for the stock, the American shareholders sold at a substantially lower price than that of the original offer. The court found it unnecessary to expand the coverage of section 10(b) and rule 10b-5 because it was of the opinion that the alleged fraud was connected with the sale of securities.<sup>16</sup> In a similar case, a plaintiff was allowed to maintain an action under section 10(b) and rule 10b-5 as the holder of an irrevocable ninety-day option to purchase securities on grounds that he had been influenced by

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[plaintiff] must eventually become a party to a 'sale,' as that term has always been used." *Id.* at 634. See also *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir.), cert. denied, *Bard v. Dasho*, 389 U.S. 977 (1967), in which the court was of the opinion that "an acquisition or disposition of securities in exchange for other securities falls within the statutory definitions [of 'purchase' and 'sale'] and that this reasoning applies to the case of merger." *Id.* at 266. A similar rationale was used by the Supreme Court in *SEC v. National Sec., Inc.*, 393 U.S. 453 (1969). The Court allowed a cause of action under § 10(b) and rule 10b-5 where plaintiff shareholders of a new corporation formed by merger had "purchased" shares in the corporation by exchanging them for their old stock. *Id.* at 467.

12. 384 F.2d 540 (2d Cir.), cert. denied, 389 U.S. 970 (1967).

13. There is serious doubt in this case as to whether the court would have allowed plaintiff's suit if the claim had been for damages. The court noted that the allegations would not support a claim for monetary damages because the causal connection between the alleged fraud and the purchase or sale of any security was slight since the plaintiffs had not sold their stock. But the court was not directly faced with this issue since plaintiff's claim was for equitable relief. The court relied upon *SEC v. Capital Gains Bureau*, 375 U.S. 180, 193 (1963) (not necessary in suit for equitable relief to establish all elements required in suit for monetary damages). 384 F.2d at 547.

14. *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215 (S.D.N.Y. 1965). See also *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967); *Opper v. Hancock Sec. Corp.*, 367 F.2d 157 (2d Cir. 1966); *Commerce Reporting Co. v. Puretec, Inc.*, 290 F. Supp. 715 (S.D.N.Y. 1968). In *Mount Clemens Indus., Inc. v. Bell*, 464 F.2d 339 (9th Cir. 1972), the court attempted to harmonize this line of cases with *Birnbaum* by noting that in each case, though plaintiffs were not actual purchasers or sellers, a contractual relationship existed between the parties which "elevated the plaintiffs to the status of statutory purchasers or sellers." *Id.* at 345. The Securities Exchange Act of 1934, § 3c(a)(13), 15 U.S.C. § 78c(a)(13) (1970) provides: "The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire." Section 3c(a)(14) of the Act, 15 U.S.C. § 78c(a)(14) (1970) provides: "The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of." Though a contract for the purchase or sale of securities is sufficient to satisfy the *Birnbaum* requirement, it is questionable that such contracts existed in these cases.

15. 473 F.2d 515 (8th Cir. 1973).

16. *Id.* at 521. For a discussion concerning interpretation of the "in connection with" clause language, see Comment, *10b-5 Standing Under Birnbaum: The Case of the Missing Remedy*, 24 HASTINGS L.J. 1007, 1019 n.55 (1973).

defendant's misrepresentations not to exercise the option within the ninety-day period.<sup>17</sup>

In cases of unsuccessful tender offers, the courts have reached inconsistent results in determining whether claims of fraud should be allowed under section 10(b) and rule 10b-5.<sup>18</sup> In *Iroquois Industries, Inc. v. Syracuse China Corp.*<sup>19</sup> the court disallowed the claim of an unsuccessful tender offeror who alleged that officers of the target corporation had misrepresented facts to shareholders which induced them to retain their shares.<sup>20</sup> In a similar tender offer case<sup>21</sup> the offeror was allowed to sue under section 10(b) and rule 10b-5 when he made a tender offer to defendant corporation which then allegedly conspired with a third party to purchase defendant's stock on the open market, thereby driving the market price above that of the tender offer.<sup>22</sup>

In the only Supreme Court case which touched upon the purchaser-seller limitation issue, *Superintendent of Insurance v. Banker's Life*,<sup>23</sup> the Court noted that Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed not technically and restrictively, but flexibly, to effectuate its remedial purposes.<sup>24</sup> In accordance with this liberal approach, the Court held that a remedy existed under rule 10b-5 for injury sustained as a result of fraudulent insider activity notwithstanding the fact that an adequate state law remedy existed. This decision seems to modify the substantive holding of *Birnbaum* which has been interpreted as disallowing action against insiders under section 10(b) and rule 10b-5 where an adequate state remedy exists.<sup>25</sup> However, the Court did not discuss the procedural purchaser-seller limitation but instead noted that the corporation was protected by the Act as seller of a security.

*Rejection of the Purchaser-Seller Limitation.* The rigid purchaser-seller limitation on standing to sue has long been criticized by commentators,<sup>26</sup> and

17. *Ashton v. Thornley Realty Co.*, 346 F. Supp. 1294 (S.D.N.Y. 1972), *aff'd*, 471 F.2d 647 (2d Cir. 1973). The court expressed the opinion that the holder of a 90-day irrevocable offer was placed in a "status beyond that of a mere aborted purchaser." 346 F. Supp. at 1299 n.4.

18. The Securities Exchange Act of 1934 was amended in 1968 by § 14(e) which deals with fraudulent practices in tender offers. Case law indicates that standing may be easier to obtain under § 14(e) than under § 10(b) and rule 10b-5. See *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937, 947 (2d Cir. 1969).

19. 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970).

20. The court, following *Birnbaum*, stated that *Iroquois* was not complaining that it was misled by the acts of defendants as to any purchases or sales by it of Syracuse China stock, but instead was complaining that because of the acts of defendants it could not purchase such shares. *Id.* at 967.

21. *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970).

22. *Crane* may be distinguished from *Iroquois* by the fact that *Crane* was forced to sell the shares he did acquire under threat of a divestiture action under the antitrust laws. *Id.* at 798.

23. 404 U.S. 6 (1971). In this case, *Manhattan Corp.* was deceived by one of its officers into selling its U.S. Treasury bonds. The proceeds were not received by the corporation, but instead were fraudulently misappropriated by the defendants.

24. *Id.* at 12.

25. See Comment, *Dumping Birnbaum to Force Analysis of the Standing Requirement under 10b-5*, 6 LOYOLA U. CHI. L.J. 230, 237 n.34 (1975).

26. See, e.g., Boone & McGowan, *Standing To Sue Under SEC Rule 10b-5*, 49 TEXAS L. REV. 617 (1971); Fuller, *Another Demise of the Birnbaum Doctrine: "Tolls*

the SEC has indicated that a less restrictive interpretation would be desirable.<sup>27</sup> Nevertheless, courts refused to abandon *Birnbaum* until 1973 when the Seventh Circuit decided *Eason v. General Motors Acceptance Corp.*<sup>28</sup> In *Eason* the plaintiffs were shareholders of a corporation which issued 7,000 shares of its stock to purchase the assets of a car dealership. The corporation assumed the liabilities of the dealership which included notes payable to GMAC, and GMAC required the corporation personally to guarantee payment of the dealership's obligations. The business failed, and the corporation defaulted on the notes. GMAC brought suit in state court to recover on the guarantees and plaintiffs countered in federal court, alleging misrepresentation of material facts inducing the sale of the dealership in exchange for the corporation's securities. The court refused to apply the *Birnbaum* rule to disallow the plaintiffs' suit and held that the purchaser-seller limitation "is not part of the law of this circuit."<sup>29</sup> Instead, "in each case the plaintiff will have to demonstrate membership in the 'special class' protected by Rule 10b-5 and injury as a direct consequence of the alleged violation."<sup>30</sup>

## II. AFFIRMATION OF THE PURCHASER-SELLER LIMITATION

In *Blue Chip Stamps v. Manor Drug Stores* the Supreme Court affirmed the *Birnbaum* doctrine and held that plaintiffs were not entitled to sue for a violation of rule 10b-5 since they neither purchased nor sold securities.<sup>31</sup> The court based its decision upon five major grounds: (1) the longstanding judicial acceptance of the doctrine, coupled with Congress' failure to reject this interpretation of section 10(b) and rule 10b-5; (2) the fact that when Congress wished to provide statutory remedies to persons other than purchasers and sellers it did so expressly; (3) a fear that vexatious litigation would arise if the doctrine were not followed; (4) the fact that plaintiffs derived no contractual rights under the consent decree and, therefore, occupied the same position as any other disappointed offeree of stock; and (5) the Court's belief that a case-by-case analysis of standing would be an unsatisfactory basis for establishing liability for conduct in business transactions.

The Court first analyzed the legislative history underlying section 10(b) and rule 10b-5. The majority opinion agreed with the *Birnbaum* court that since both section 10(b) and rule 10b-5 proscribed only fraud "in connec-

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*the Knell of Parting Day?*", 25 U. MIAMI L. REV. 131 (1970); Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968); Whitaker, *The Birnbaum Doctrine: An Assessment*, 23 ALA. L. REV. 543 (1971); Comment, *The Purchaser-Seller Rule: An Archaic Tool for Determining Standing Under Rule 10b-5*, 56 GEO. L.J. 1177 (1968).

27. See, e.g., Brief for SEC as Amicus Curiae at 5-6, *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967).

28. 490 F.2d 654 (7th Cir. 1973), cert. denied, 416 U.S. 960 (1974). See Comment, *Dumping Birnbaum to Force Analysis of the Standing Requirement under 10b-5*, 6 LOYOLA U. CHI. L.J. 230 (1975).

29. *Id.* at 661.

30. *Id.* at 660.

31. The majority opinion by Justice Rehnquist was joined by Chief Justice Burger and Justices White, Powell, Stewart, and Marshall. A separate concurring opinion by Justice Powell was joined by Justices Stewart and Marshall. A dissenting opinion was filed by Justice Blackmun and joined by Justices Douglas and Brennan.

tion with the purchase or sale" of securities, and since the history of section 10(b) revealed no congressional intent to extend a private remedy for money damages to persons other than defrauded purchasers or sellers of securities, in contrast to the express civil remedy provided by section 16(b) of the 1934 Act, Congress intended to limit the plaintiff class in a rule 10b-5 action to actual purchasers and sellers of securities.<sup>32</sup>

As a further ground for its decision, the Court looked to other sections of the 1933 and 1934 Acts which, in the Court's estimation, led to the conclusion that the remedy provided by section 10(b) and rule 10b-5 was available only to purchasers and sellers. For example, section 28(a)<sup>33</sup> of the 1934 Act limits recovery in a private damage action to "actual damages," and a plaintiff who is neither a purchaser nor a seller is likely to be seeking a "largely conjectural and speculative recovery."<sup>34</sup> Also the Court observed that those sections of the 1933 and 1934 Acts which expressly provide for a private civil remedy<sup>35</sup> limit the plaintiff class to purchasers and sellers.<sup>36</sup>

Another important factor in the majority's opinion was the belief that the elimination of the purchaser-seller restriction would result in vexatious litigation by expanding the class of plaintiffs. The Court first observed that the settlement value to the plaintiff of a "strike suit" would likely outweigh the chance for success at trial.<sup>37</sup> However, by applying the *Birnbaum* rule, a spurious claim can be eliminated on a motion to dismiss or a motion for summary judgment if the complaint fails to allege the purchase or sale of a security. The Court also noted that if the purchaser-seller limitation were abolished, the trier of fact would be forced to depend largely upon oral testimony to determine difficult issues of fact. A proposal to remedy this problem was made by the SEC which suggested that in particular cases additional corroboration of testimony could be required. The Court rejected this proposition stating that the very necessity of fashioning supplemental rules of corroboration exemplified the need for retaining the purchaser-seller limitation.<sup>38</sup>

Next, the Court considered the question of whether the status of plaintiffs as offerees of the consent decree placed them in the type of contractual relationship for which section 10(b) and rule 10b-5 provide a remedy.<sup>39</sup> The

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32. 95 S. Ct. at 1923, 44 L. Ed. 2d at 547.

33. 15 U.S.C. § 78bb (1970).

34. 95 S. Ct. at 1925, 44 L. Ed. 2d at 549.

35. The sections discussed are: Securities Act of 1933, § 11(a), 15 U.S.C. § 77k (1970); Securities Act of 1933, § 12, 15 U.S.C. § 77l (1970); Securities Exchange Act of 1934, § 9, 15 U.S.C. § 78i (1970); Securities Exchange Act of 1934, § 18, 15 U.S.C. § 78r (1970).

36. 95 S. Ct. at 1925, 44 L. Ed. 2d at 549.

37. See 492 F.2d 136, 147 n.9 (9th Cir. 1974), where Judge Hufstедler in her dissenting opinion in the court of appeals remarked concerning the settlement value of strike suits: "[A]lthough they are difficult to prove at trial, they are even more difficult to dispose of before trial."

38. 95 S. Ct. at 1930, 44 L. Ed. 2d at 554.

39. The court of appeals decision conceded that members of the plaintiff class could not have enforced the consent decree, but emphasized that plaintiffs were not claiming a breach of duty imposed by the consent decree but instead were claiming a violation of statutory antifraud provisions. 492 F.2d 136, 142 n.14 (9th Cir. 1974). The court of appeals was of the opinion that the consent decree served the "same function" as a contractual relationship in that it provided a reasonable circumscription of defendant's

Court emphasized that only parties to a consent decree may enforce it, and in this case, members of the plaintiff class were merely intended beneficiaries. Therefore, the plaintiff class was in no better position than any other offeree of stock who fails to purchase because of a pessimistic prospectus and later learns he has missed a valuable opportunity.<sup>40</sup> The Court felt that this outcome was consistent with congressional intent concerning limitation of defendants' liability for statements made or omitted in a prospectus in a registered offering.<sup>41</sup>

Finally, the Court rejected the notion of a case-by-case analysis in order to decide if the particular plaintiffs were sufficiently discrete to justify an exception to the purchaser-seller rule. The Court considered this variable, fact-oriented disposition of claims inadequate and instead found the consistent application of the purchaser-seller rule a satisfactory basis for determination of liability in business transactions.

The dissenting opinion of Justice Blackmun criticizes the majority opinion for reliance upon legislative history of the 1933 and 1934 Acts which admittedly is inconclusive, acceptance as precedent of lower court decisions never before examined by the Supreme Court, and resort to policy considerations to distinguish the meritorious rule 10b-5 claim for the meretricious one.<sup>42</sup> The dissent found it inconceivable that Congress intended the broadranging provisions of section 10(b) to be limited by a mechanical rule such as the *Birnbaum* doctrine. According to the dissent, the question in section 10(b) and rule 10b-5 cases is whether fraud was employed by "any person . . . in connection with the purchase or sale of any security."<sup>43</sup> Therefore, the essential test of a valid rule 10b-5 case is the showing of a "logical nexus between the alleged fraud and the sale or purchase of a security."<sup>44</sup>

In analyzing the first major ground relied on by the majority opinion, it appears that the logic of the Court is unsound if it is accepting the purchaser-seller limitation because congressional intent did not show that the purpose of section 10(b) was to extend a remedy to persons other than defrauded purchasers or sellers of securities. Admittedly there is little evidence of congressional intent as to the purpose of section 10(b), but the evidence which is available indicates that it was intended to be expansive.<sup>45</sup> However, justification for the Court's acceptance of the *Birnbaum* doctrine might lie in the fact that Congress, well aware of the restrictive judicial interpretation of section 10(b), had failed to amend its language to provide an express private civil remedy for those who are thwarted in their attempts to purchase or sell securities. It is interesting to note that section 10(b) grants the SEC power to prescribe rules and regulations "necessary or appropriate in the public

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potential liability. *Id.* at 142. The dissent in the court of appeals observed that the consent decree did not serve the "same function" as a binding contract in that it rendered plaintiffs far less able to prove causation and damages. *Id.* at 144.

40. 95 S. Ct. at 1933, 44 L. Ed. 2d at 559-60.

41. *Id.* at 1933, 44 L. Ed. 2d at 559.

42. *Id.* at 1937-38, 44 L. Ed. 2d at 564.

43. *Id.* at 1940, 44 L. Ed. 2d at 567.

44. *Id.* at 1942, 44 L. Ed. 2d at 569.

45. See 1 A. BROMBERG, SECURITIES LAW: FRAUD, § 2.2, at 22.4 (1974).



interest or for the protection of investors."<sup>46</sup> Professor Loss notes that under this clause the Commission presumably could adopt rules to protect the defrauded non-purchaser and non-seller.<sup>47</sup>

After reviewing sections 11(a) and 12 of the 1933 Act and sections 9 and 18 of the 1934 Act<sup>48</sup> which provide express remedies for their violation, the Court concluded that Congress could not have intended that the implied remedy for the violation of section 10(b) and rule 10b-5 should be more expansive than that of these sections.<sup>49</sup> But if consideration is given to the language of these sections compared with that of section 10(b) and rule 10b-5, it is apparent that their relative scopes are different. The availability of a cause of action provided by section 11(a) of the 1933 Act is limited to "any person acquiring the security," while section 12 grants a remedy to the "person purchasing the said security."<sup>50</sup> Section 9 of the 1934 Act, which prohibits various manipulative devices, limits its remedy to "any person who shall purchase or sell any security" in a transaction affected by a violation of the provision, while section 18, which prohibits false statements in securities transactions, limits the remedy for its violation to "any person . . . who . . . shall have purchased or sold a security at a price which was affected by such statement . . . ."<sup>51</sup> In contrast, section 10(b) and rule 10b-5 prohibit fraud by "any person . . . in connection with the purchase or sale of any security."<sup>52</sup> The remedy is not expressly limited to purchasers or sellers as in the above sections, but is limited to those persons defrauded *in connection with* the purchase or sale of any security.

At first glance the purchaser-seller limitation may appear to be a practical approach to the problem of restricting the plaintiff class to prevent vexatious litigation. However, a more thorough analysis reveals that this approach is largely a distortion of principles. Indeed the purchaser-seller limitation will reduce the number of spurious lawsuits, but it will also eliminate a large number of legitimate claims for damages.<sup>53</sup> As the dissent points out: "We should be wary about heeding the seductive call of expediency and about substituting convenience and ease of processing for the more difficult task of separating the genuine claim from the unfounded one."<sup>54</sup> The majority's answer seems to be that the private cause of action implied by the judiciary should be judicially delimited until Congress addresses the question.<sup>55</sup>

### III. CONCLUSION

*In Blue Chip Stamps v. Manor Drug Stores* the Supreme Court confirmed

46. See note 4 *supra*.

47. 3 L. Loss, *supra* note 6, at 1469 n.87.

48. 95 S. Ct. at 1925, 44 L. Ed. 2d at 549.

49. *Id.* at 1925-26, 44 L. Ed. 2d at 549-50.

50. Securities Act of 1933, § 11(a), 15 U.S.C. § 77k (1970); Securities Act of 1933, § 12, 15 U.S.C. § 77l (1970).

51. Securities Exchange Act of 1934, § 9, 15 U.S.C. § 78i (1970); Securities Exchange Act of 1934, § 18, 15 U.S.C. § 78r (1970).

52. See note 5 *supra*.

53. 95 S. Ct. at 1927 n.9, 44 L. Ed. 2d at 551 n.9, where the majority states that this disadvantage of the *Birnbaum* rule is "attenuated to the extent that remedies are available to non-purchasers and non-sellers under state law."

54. *Id.* at 1941-42, 44 L. Ed. 2d at 569.

55. *Id.* at 1931-32, 44 L. Ed. 2d at 557.

the validity of the *Birnbaum* doctrine limiting the plaintiff class in a section 10(b) and rule 10b-5 case to purchasers or sellers of securities. Although the Court's opinion contains some errors in logic, its ultimate decision upholding the purchaser-seller rule most likely will not substantially affect the decisions of the lower federal courts which have been applying the rule liberally for over twenty years. It is likely that the net result of this decision upon the courts will amount to no more than a caution against a too liberal interpretation of the purchaser-seller rule such as that of the court of appeals in *Blue Chip Stamps*. At most, the decision may spark attempts by the SEC or Congress to provide an express remedy for non-purchasers and non-sellers defrauded in securities transactions.

*T. S. Baumgardner*

### Incorporation for the Purpose of Borrowing at an Otherwise Usurious Rate of Interest: *Skeen v. Glenn Justice Mortgage Co.*

Justice Mortgage Investors loaned the Flan Corporation \$600,000 to purchase land. The corporation executed a promissory note secured by deed of trust to Justice Mortgage Investors. To further secure the note, defendants Clyde and Helen Skeen, for a consideration of \$25,000, executed a guaranty in favor of the lender. After the note and guaranty were assigned to plaintiff Glenn Justice Mortgage Company, the mortgaged property was foreclosed upon and sold for \$450,000. Plaintiff sued the guarantors for the \$150,000 deficiency owed on the note and the trial court sustained plaintiff's motion for summary judgment. On appeal the defendants contended that a fact issue was presented by an affidavit which stated that the Flan Corporation was formed at the lender's insistence for the sole purpose of evading Texas usury laws.<sup>1</sup> Therefore, it was argued, the corporation should be disregarded and the loan should be considered usurious.<sup>2</sup> *Held, reversed and remanded on other grounds:* Incorporation for the sole purpose of circumventing Texas usury laws does not render a loan transaction usurious. *Skeen v. Glenn Justice Mortgage Co.*, 526 S.W.2d 252 (Tex. Civ. App.—Dallas 1975, no writ).

#### I. HISTORICAL BACKGROUND

Usury is not of common law heritage<sup>3</sup> but is wholly the creature of legis-

1. TEX. CONST. art. XVI, § 11, and TEX. REV. CIV. STAT. ANN. arts. 5069-1.01 to .06 (1967) (the Texas usury provisions); *id.* art. 1302-2.09 (1974) (The Texas corporate exception statute).

2. TEX. REV. CIV. STAT. ANN. art. 5069-1.02 (1967) provides that except as otherwise provided by law no rate of interest shall be charged in excess of 10% per annum. Under the corporate exception corporations may be charged up to 1½% per month or 18% per annum. TEX. REV. CIV. STAT. ANN. art. 1302-2.09 (1974).

3. See generally J. WEBB, A TREATISE ON THE LAW OF USURY §§ 1-12 (1899).

lation.<sup>4</sup> Derived from Mosaic law and the Christian Medieval tradition, the law of usury is founded upon the moral and religious view that it is wrong to charge another for the use of one's money.<sup>5</sup> The growth of industrial economies and the concomitant necessity for more credit and a freer flow of money led to a gradual relaxation of the moral restraints against the lending of money. Yet the law of usury has survived, supported in large measure by a public policy concern for the unsophisticated borrower.<sup>6</sup>

Although during Reconstruction the Texas Legislature experimented unsuccessfully with allowing unlimited interest,<sup>7</sup> today usury is prohibited by the Texas Constitution<sup>8</sup> and statutes,<sup>9</sup> which impose severe penalties on violators.<sup>10</sup> The popularity of usury laws, which seem to afford protection to the borrower, makes it unlikely that such laws will be eliminated in the near future. However, in a money market in which the usury threshold is often lower than the prime rate of interest, it is expected that more and more borrowers will seek exceptions to the usury laws in order to obtain credit.<sup>11</sup>

## II. THE CORPORATE EXCEPTION

The public policy argument which underlies usury laws for individuals does not apply to corporations.<sup>12</sup> The corporate exception evolved from the policy judgment of legislators that the corporate borrower did not need the same protection afforded the consumer.<sup>13</sup> A corporation generally has more bargaining power, its shareholders have no personal liability, and it seldom borrows for the necessities of life. In short, the assumption is that corporations "expecting high risks and high returns should be familiar with financial arrangements and money's worth."<sup>14</sup>

4. *Missouri K. & T. Trust Co. v. Krumseig*, 172 U.S. 351, 355 (1899).

5. See generally S. HOMER, *A HISTORY OF INTEREST RATES* 82-88 (1963); Comment, *Usury Implications of Front-End Interest and Interest in Advance*, 29 Sw. L.J. 748 (1975).

6. See generally Comment, *Using a "Dummy" Corporation Creates Usury and Tax Difficulties*, 28 Sw. L.J. 437 (1974); *Baske v. Russell*, 67 Wash. 2d 268, 273, 407 P.2d 434, 437 (1965), where the Washington Supreme Court expressed the view that usury statutes are "designed to protect those who by adversity and necessity are driven to borrow money at any cost. The protection granted is based on the fact that many borrowers are powerless to resist the avarice of money lenders."

7. TEX. CONST. art. XII, § 44 (1869). See also Pearce & Williams, *Punitive Past to Current Convenience—A Study of the Texas Law of Usury*, 22 Sw. L.J. 233, 235 (1968).

8. TEX. CONST. art. XVI, § 11.

9. TEX. REV. CIV. STAT. ANN. arts. 5069-1.01 to .06 (1967).

10. *Id.* art. 5069-1.06 (one who contracts for, charges, or receives a greater rate of interest than that allowed by law shall forfeit twice the amount of interest; if the interest is more than twice the allowable rate, all principal is forfeited as well, and a misdemeanor fine of \$1,000 may be imposed). For one court's application of these penalty provisions see *Johns v. Jaeb*, 518 S.W.2d 857 (Tex. Civ. App.—Dallas 1974, no writ).

11. See generally Benfield, *Money, Mortgages and Migraine*, 19 CASE W. RES. L. REV. 819 (1968).

12. See *Carozza v. Federal Fin. & Credit Co.*, 149 Md. 233, 131 A. 332, 342 (1926), in which the court stated that a corporation "is organized for commercial or other purposes which are best subserved by the advantages given through the corporate powers conferred by the state of which it is a creature. It has no sensations, and cannot be coerced by its necessities into any legal obligations beyond its defined and limited corporate powers."

13. See Katz, *Usury Laws and the Corporate Exception*, 23 MD. L. REV. 51, 55 (1963).

14. *Sparkman & McLean Co. v. Govan Inv. Trust*, 78 Wash. 584, 478 P.2d 232, 236 (1970).

The first American experience with statutes excepting corporations from the usury defense was the New York General Business Law statute of 1850,<sup>15</sup> passed in response to a case in which an experienced borrower, a bank, abused the usury defense to avoid payment of a sizeable debt.<sup>16</sup> While New York courts at first gave the corporate exception a literal and unyielding application,<sup>17</sup> later interpretations were more flexible and looked more to the circumstances of each transaction. If it appeared on close examination that in reality no money was loaned to the corporation, but was instead loaned to an individual, the usury defense was available. The corporate form would then be disregarded and the lender subjected to the penalties for usury.<sup>18</sup>

The New York trend was reversed in the 1930 case of *Jenkins v. Moyse*.<sup>19</sup> The borrower, told that he would have to incorporate to obtain a loan, later sought to have an accompanying mortgage nullified on grounds that the loan was usurious. The trial court found that the corporate form was used for concealment of usurious practices and invalidated the loan. The court of appeals reversed, stating that because the law had been followed meticulously, the otherwise usurious loans were valid, even though incorporation had been at the request of the lender.<sup>20</sup> The New York rule has been expressly followed or given great weight in a number of other jurisdictions.<sup>21</sup>

Some states, however, employ a more flexible interpretation of the corporate exception and will scrutinize the facts surrounding the transaction to decide whether or not a corporate shell was used to conceal a usurious loan to an individual. These question-of-fact jurisdictions tend to favor the unwary borrower and to ignore the corporate form. For example, in *Gelber v. Kugel's Tavern, Inc.*<sup>22</sup> the New Jersey Supreme Court held that where a lender told a borrower, "if you don't incorporate, we will not loan you money,"<sup>23</sup> a jury could decide whether or not the subsequently formed corporation was a device to evade the usury statute. This rule has been applied to a case of overreaching,<sup>24</sup> and to a case in which the lender was aware that the loan was not for a true business purpose.<sup>25</sup> Still, the standard in

15. Act of 1850, ch. 172, §§ 1, 2, *as amended*, N.Y. GEN. OBLIG. LAW § 5-521 (McKinney 1964).

16. *Dry Dock Bank v. American Life Ins. & Trust Co.*, 3 N.Y. 344 (1850).

17. *See, e.g.*, *Southern Life Ins. v. Packer*, 17 N.Y. 51 (1858).

18. *See, e.g.*, *First Nat'l Bank v. American Near East & Black Sea Line, Inc.*, 119 Misc. 650, 197 N.Y.S. 856 (Sup. Ct. 1922); *Granniss v. Stevens*, 216 N.Y. 583, 111 N.E. 263 (1916).

19. 254 N.Y. 319, 172 N.E. 521 (1930).

20. *Id.* at 321, 172 N.E. at 522.

21. *See, e.g.*, *Holland v. Gross*, 89 So. 2d 255 (Fla. 1956); *Rabinowich v. Eliasberg*, 159 Md. 655, 152 A. 437 (1930); *Dahmes v. Industrial Credit Co.*, 261 Minn. 26, 110 N.W.2d 484 (1961); *Country Motors v. Friendly Fin. Corp.*, 13 Wis. 2d 473, 481, 109 N.W.2d 137, 140 (1961).

22. 10 N.J. 191, 89 A.2d 654 (1952).

23. *Id.* at 657.

24. *In re Greenberg*, 21 N.J. 213, 121 A.2d 520 (1956). An attorney here advised an inexperienced borrower to incorporate and then procured for her a loan of \$2,852.95. A bonus of \$1,000 was charged and legal fees were \$647.05. To give New Jersey usury laws a "sympathetic sweep," the corporate form was disregarded. The procurer of the loan was suspended from practicing law for one year. *See note 27 infra.*

25. *Lesser v. Strubbe*, 56 N.J. Super. 274, 152 A.2d 409 (1959), *rev'd on other grounds*, 67 N.J. Super. 537, 171 A.2d 114 (App. Div. 1961), *aff'd per curiam*, 39 N.J. 90, 187 A.2d 705 (1963).

*Gelber* is uncertain, and it is unclear exactly how far the courts will go in allowing an examination of the circumstances surrounding the loan.<sup>26</sup> Indeed, in some New Jersey cases it seems that, even without "piercing the corporate veil," courts have nullified or modified loans because of unconscionability or deceptive lending practices.<sup>27</sup>

Although New Jersey has not set out hard and fast guidelines to determine if its usury laws have been evaded, some general factors for jury consideration have evolved. The voluntariness of incorporation, the adequacy of the corporation's financial basis, the purpose of the loan, and the experience of the borrower are all relevant in determining if the loan was actually made to an individual.<sup>28</sup> Other states following the New Jersey question-of-fact approach to the corporate exception have similarly failed to set forth rules as to which facts are controlling, but rather proceed on a case-by-case basis in determining if the usury law has been evaded.<sup>29</sup>

The main difficulty in question-of-fact jurisdictions is achievement of consistent results. Some courts, though refusing to establish rules as to which fact patterns will trigger application of the usury laws to corporate loans, nevertheless seem to rely heavily on the business experience of the borrower as an indication of whether the transaction was at arm's length.<sup>30</sup> The difference among question-of-fact jurisdictions is apparently rooted in the extent to which each subscribes to the public policy argument against usury or favors the corporate exception as restorative of the common law and advantageous to commerce.<sup>31</sup>

### III. SKEEN V. GLENN JUSTICE MORTGAGE CO.

*In Skeen v. Glenn Justice Mortgage Co.* the Dallas court of civil appeals

26. In *Gelber* Justice Brennan stated the rule that: "It is generally recognized that an individual may recover usurious payments on loans made in fact to the individual though in form disguised as loans to a corporation and evidenced by obligations executed by it to hide the fact that the lender has exacted an illegal rate of interest from the real borrower." *Gelber v. Kugel's Tavern, Inc.*, 10 N.J. 191, 89 A.2d 654, 656 (1956). Ironically, Brennan cited as authority for this generally recognized principle a number of cases which had been overruled by *Jenkins v. Moyse*, 254 N.Y. 319, 172 N.E. 521 (1930).

27. See, e.g., *In re Greenberg*, 21 N.J. 213, 121 A.2d 520 (1959), in which an attorney failed to apprise an unsophisticated borrower of the fact that he also represented the lender. See also *Spiotta v. William H. Wilson, Inc.*, 72 N.J. Super. 572, 579, 179 A.2d 49, 53 (1962); *Feller v. Architects Display Bldgs., Inc.*, 54 N.J. Super. 205, 148 A.2d 634, 639 (App. Div. 1959) ("It is the general rule in the case of the corporate borrower that it is not illegal to provide for a higher rate of interest than the legal rate after maturity, but if such rate is unconscionable it will be unenforceable because it amounts to a penalty.").

28. See Note, *Stemming Abuses of Corporate Exemptions from the Usury Laws: A Legislative and Judicial Analysis*, 59 IOWA L. REV. 91, 105 (1973).

29. See, e.g., *Securities Inv. Co. v. Indian Waters Dev. Corp.*, 501 F.2d 662, 665 (5th Cir. 1974); *Atlas Subsidiaries of Florida, Inc. v. O. & O. Inc.*, 166 So. 2d 458 (Fla. Dist. Ct. App. 1964); *Walnut Discount Co. v. Weiss*, 205 Pa. Super. 161, 208 A.2d 26 (1965).

30. See, e.g., *Monmouth Capital Corp. v. Holmdel Village Shops, Inc.*, 92 N.J. Super. 480, 224 A.2d 35 (1966), where the court denied the defense of usury to a newly-formed corporation. The court expressed the view that the lender's policy of dealing only with corporations was legitimate, and, in finding that the corporation was not a cloak, cited the facts that the incorporated borrower had a bank account, adopted corporate resolutions with respect to other borrowers, paid real estate taxes, entered into leases with tenants, and was represented by competent counsel.

31. *Id.* at 39.

was faced with deciding whether a court should look beneath the surface of an apparently lawful loan to a corporation with the possibility of finding a usurious loan to an individual. An affidavit presented by the defendant stated that the borrower, Flan Corporation, was formed at the insistence of the lender for the sole purpose of evading the usury statute. No evidence was presented as to the purpose of the loan. The court held that because "no facts, or even conclusions"<sup>32</sup> had been established which would indicate that the corporation had been formed as a cloak or cover for a fraudulent or illegal transaction,<sup>33</sup> the corporate form could not be disregarded and the loan would have to be treated as lawful.

By its holding, the court of civil appeals appears to have fallen in line with the New York rule which stresses formalistic adherence to the corporate exception. Quoting *Jenkins v. Moyse*,<sup>34</sup> the court held that "the law has not been evaded but has been followed meticulously in order to accomplish a result which all parties desired and which the law does not forbid."<sup>35</sup> In a narrower sense, the opinion in *Skeen* only speaks to the situation in which the lender makes incorporation a requirement for a commercial loan. The court in dictum appears to have left open the possibility that if sufficient facts establishing "fraud or some other transaction tainted with illegality" had been shown, the corporate entity would have been disregarded.<sup>36</sup> This dictum is disturbing because it seems to follow a line of Texas cases which have held that courts would look beneath the surface of a contract and "if from all the facts its essence is found to be the receiving or contracting for a greater rate of interest than is allowed by law, the statutory consequences must be visited upon it."<sup>37</sup> In the past Texas courts have also held that a contract valid on its face could not be used to avoid the usury laws,<sup>38</sup> and have pierced the corporate veil where a corporation appeared to have no real separate existence from its shareholders.<sup>39</sup> The *Skeen* decision is not, however, inconsistent with the New York rule. In *418 Trading Corp. v. Oconefsky*,<sup>40</sup> where

32. *Skeen v. Glenn Justice Mortgage Co.*, 526 S.W.2d 252, 256 (Tex. Civ. App.—Dallas 1975, no writ).

33. *Id.*

34. 254 N.Y. 319, 172 N.E. 521, 522 (1930).

35. 526 S.W.2d at 256.

36. The court in *Skeen* points out that with a showing of fraud or illegality, the corporate entity could be disregarded. However, they state that "such is not the situation in this instance," leaving it unclear what additional facts would be sufficient to make such a showing. *Id.* at 256. As this statement is unnecessary to the instant case, it constitutes dictum.

37. *Pickrell v. Alpha Pipe & Steel, Inc.*, 406 S.W.2d 956, 959 (Tex. Civ. App.—Amarillo 1966, writ ref'd n.r.e.); *Independent Lumber Co. v. Gulf State Bank*, 299 S.W. 939, 942 (Tex. Civ. App.—Galveston 1927, writ ref'd).

38. *Commercial Sec. Co. v. Rea*, 78 S.W.2d 707, 712 (Tex. Civ. App.—Galveston 1934), *aff'd*, 130 Tex. 11, 105 S.W.2d 872 (1937).

39. *First Nat'l Bank v. Gamble*, 134 Tex. 112, 119-20, 132 S.W.2d 100, 103 (1939).

40. 37 Misc. 2d 745, 234 N.Y.S.2d 747 (Sup. Ct. 1962), *aff'd*, 19 App. Div. 2d 593, 240 N.Y.2d 956 (1963), *aff'd*, 14 N.Y.2d 676, 198 N.E.2d 907 (1964). The supreme court followed *Jenkins v. Moyse*, quoting that "the test of whether this loan is usurious is whether it was in fact made to the plaintiff. Doubtless at times loans are made in fact to an individual though in form they are made to a corporation to hide the fact that the lender has exacted an illegal rate of interest from the real borrower." *Jenkins v. Moyse*, 254 N.Y. 319, 324, 172 N.E. 521, 522 (1930). The court went on to distinguish its fact situation from that in *Jenkins*. Here a loan was made for the purchase of a one-family residence and the lender knew of the purpose. Also, the court could

an individual incorporated in order to borrow for the purchase of a one-family residence, the New York Court of Appeals disregarded the corporate exception to give effect to its usury law.

For reasons of public policy, if the purpose of a corporate loan were known to be personal and necessitous, it is not unlikely that Texas courts would ignore the corporate form and find usury. *Skeen* does not encompass every situation in which a borrower is faced with an incorporation prerequisite. If the borrower has been wronged, he must establish fraud or illegality in order to avoid the transaction.<sup>41</sup> *Skeen* may be criticized because, with the accessibility of incorporation, a deception might be worked against an inexperienced borrower. A closer reading, however, should reveal that judicial discretion has not been pre-empted and that the unwary borrower is not without protection. Incorporation as a lender's requirement for a loan is tacitly approved.<sup>42</sup>

#### IV. CONCLUSION

The decision in *Skeen* is sound on two counts. First, it is easy to apply and should render more consistent results. This should in turn give lenders the security of knowing what treatment the courts will give to incorporation loan requirements. Secondly, it does not leave the incorporating borrower without any protection but avoids the effect of otherwise taking individuals out of the credit market when prevalent interest rates are high.

The impact of *Skeen v. Glenn Justice Mortgage Co.* should be clearer after Texas courts have the opportunity to decide a case in which an individual is obliged to incorporate in order to borrow money for personal needs. Perhaps in this situation it will be found that the usury law has been illegally evaded. It should not be necessary that Texas apply the corporate exception in an unyielding manner, only that it modify the rule to fulfill the policy goals of both the usury provisions and the corporate exception.

*Michael R. Boulden*

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have rested its decision on the 1955 amendment to the New York corporate exception law, N.Y. GEN. OBLIG. LAW § 5-521 (McKinney 1964), denying application of the corporate exception to a corporation, "the principal asset of which shall be the ownership of a one- or two-family dwelling."

41. See note 27 *supra*.

42. The *Skeen* decision, like that in *Jenkins v. Moyse*, suggests an element of estoppel in the court's reasoning. If the lender relied on the borrower's false representation that the loan was being received by a corporation, and that the corporation was a separate entity from its shareholders, justice might be furthered by disallowing the defense of usury. See RESTATEMENT (SECOND) OF CONTRACTS § 90 (1973). In the public policy context of usury, however, estoppel is not well applied. See *Texas Trinity Fire Ins. Co. v. Kerrville Hotel Co.*, 129 Tex. 310, 323, 103 S.W.2d 121, 127 (1937), where the court said that to give the lender the benefit of estoppel would be to "circumvent the public policy of the State" as expressed in its usury laws. However, the court applied estoppel where, after the consummation of the transaction, the borrower acted in a manner sufficient to raise an estoppel in pais.

**Privileges and Immunities—Tax  
Discriminating Against Nonresidents Not Cured by  
Existing Tax Provisions of Neighboring States—  
Austin v. New Hampshire**

Appellants were residents of Maine who worked in New Hampshire during the 1970 tax year. New Hampshire imposed upon nonresidents a tax of four percent on New Hampshire-derived income in excess of \$2,000,<sup>1</sup> with the proviso that if the nonresident's home state would have imposed a lesser tax had the income been earned in that state, the New Hampshire tax would accordingly be reduced by that amount. New Hampshire imposed no tax on residents' incomes regardless of where earned. Appellants petitioned the New Hampshire Superior Court for a declaration that the tax violated the privileges and immunities clauses of the constitutions of New Hampshire and of the United States. The cause was transferred directly to the New Hampshire Supreme Court, which upheld the tax, and the nonresidents appealed to the United States Supreme Court.<sup>2</sup> *Held, reversed:* Under the rule requiring substantial equality of treatment for the citizens of the taxing state and nonresident taxpayers, the New Hampshire Commuters Income Tax violates the privileges and immunities clause of article IV, section 2 of the United States Constitution, since it falls exclusively on nonresidents' incomes and is not offset even approximately by other taxes imposed upon residents alone. *Austin v. New Hampshire*, 420 U.S. 656 (1975).

I. GENERAL BACKGROUND OF THE PRIVILEGES AND IMMUNITIES CLAUSE

Article IV, section 2 of the United States Constitution provides: "The Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States."<sup>3</sup> The progenitor of this clause was the fourth of the Articles of Confederation<sup>4</sup> which attempted to create a free trade area among the states and to reconcile the authority of the national government with the sovereignty of the states.

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1. N.H. REV. STAT. ANN. § 77-B: 2 II (1970).

2. *Austin v. New Hampshire*, 419 U.S. 822 (1974) (noting probable jurisdiction).

3. This clause is often referred to as the "interstate privileges and immunities clause" to distinguish it from the privileges and immunities clause of the fourteenth amendment, which prohibits states from abridging the privileges and immunities of national citizenship. *See Slaughter House Cases*, 83 U.S. (16 Wall.) 36 (1873); P. KAUPER, CONSTITUTIONAL LAW 691 (4th ed. 1972).

4. The fourth of the Articles of Confederation reads:

The better to secure and perpetuate mutual friendship and intercourse among the people of the different States in this Union, the free inhabitants of each of these States, paupers, vagabonds and fugitives from justice excepted, shall be entitled to all the privileges and immunities of free citizens in the several States; and the people of each State shall have free ingress and regress to and from any other State, and shall enjoy therein all the privileges of trade and commerce, subject to the same duties, impositions, and restrictions as the inhabitants thereof respectively . . . .

*See* 3 M. FARRAND, RECORDS OF THE FEDERAL CONVENTION 112 (rev. ed. 1937) for Charles Pinckney's assurance to the Convention that the version now found in article IV, § 2 "is formed exactly upon the principles of the 4th article of the present Confederation . . . ." Pinckney drafted the present version of the privileges and immunities clause.



The privileges and immunities clause was initially interpreted to include those privileges and immunities which are in their nature fundamental and inherent in all free governments.<sup>5</sup> This interpretation was later narrowed in *Paul v. Virginia*,<sup>6</sup> where the privileges and immunities possessed by a citizen of one state sojourning in a second state were restricted to those rights which the second state afforded its citizens. This is the view commonly accepted by the courts today.<sup>7</sup> Rights to *ferae naturae* are not considered among the privileges and immunities guaranteed to nonresidents.<sup>8</sup> Article IV does not guarantee to nonresidents the political privileges of state citizenship, such as voting or holding public office.<sup>9</sup> Nor is complete procedural equality guaranteed.<sup>10</sup>

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5. The classical exposition of the scope of the privileges and immunities clause is contained in Circuit Justice Washington's opinion in *Corfield v. Coryell*, 6 F. Cas. 546, 551 (No. 3,230) (C.C.E.D. Pa. 1825). Justice Washington noted that the clause comprehended protection by the government, enjoyment of life and liberty, the right to acquire and possess property, and the right to pursue happiness and safety. Nonresidents had the right to pass through or reside in any state, to avail themselves of the state courts and the writ of habeas corpus, to hold real or personal property, and to be exempt from higher taxes than were paid by residents of the state.

6. 75 U.S. (8 Wall.) 168 (1869) (upholding a Virginia statute requiring as a condition of doing business that a foreign insurance company deposit with the state treasurer thirty to fifty thousand dollars).

7. See *Toomer v. Witsell*, 334 U.S. 385 (1948); *Travis v. Yale & Towne Mfg. Co.*, 252 U.S. 60 (1920); *Slaughter House Cases*, 83 U.S. (16 Wall.) 36 (1873) (Louisiana act granting to a corporation the exclusive right for twenty-five years to maintain slaughter houses in certain Louisiana parishes was a proper exercise of the state police power); *Paul v. Virginia*, 75 U.S. (8 Wall.) 168 (1869).

The restrictive interpretation by Justice Field in *Paul v. Virginia* is believed by Professor Antieau to be a perversion of the privileges and immunities clause. Antieau argues that Field himself soon saw the error of his ways and reverted to the fundamental interpretation in his dissenting opinion in the *Slaughter House Cases*. Antieau, *Paul's Perverted Privileges or the True Meaning of the Privileges and Immunities Clause of Article Four*, 9 WM. & MARY L. REV. 1 (1967). For a more general discussion of article IV, section 2 by the same author see 1 C. ANTIEAU, MODERN CONSTITUTIONAL LAW §§ 9.13-22 (1969).

8. The natural resources of a state are deemed to be held in trust by the state for the benefit of its inhabitants, whose common property the resources are. *McCready v. Virginia*, 94 U.S. 391 (1876) (upholding the power of a state to limit to its own citizens the right to plant oysters in public waters). See *Corfield v. Coryell*, 6 F. Cas. 546 (No. 3,230) (C.C.E.D. Pa. 1825) (New Jersey statute forbidding nonresidents to gather oysters upheld). But the Court has held that this reasoning may not be extended to permit a state to impose a discriminatory license tax on nonresidents engaged in the business of fishing for shrimp in the marginal sea since this business is regarded as a common calling protected under the privileges and immunities clause. *Toomer v. Witsell*, 334 U.S. 385 (1948). For more thorough discussion of rights to *ferae naturae* see E. BARRETT, JR., P. BRUTON, & J. HONNOLD, CONSTITUTIONAL LAW 398-400 (3d ed. 1968). See also Note, *The Equal Privileges and Immunities Clause of the Federal Constitution*, 28 COLUM. L. REV. 347 (1928).

9. *Blake v. McClung*, 172 U.S. 239 (1898), in which Mr. Justice Harlan, speaking for the Court, said that a state need not accord a nonresident every privilege that it gives to its own citizens, so long as such denial does not in essence reduce the nonresident to a condition of alienage with respect to that state. See generally C. ANTIEAU, COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES 160-63 (1960).

10. The states may impose some discrimination against nonresidents in access to state courts as long as the terms of access are reasonable. See, e.g., *Douglas v. New York, N.H. & H.R.R.*, 279 U.S. 377 (1929) (actions by nonresidents against foreign corporations doing business in the state are subject to dismissal at discretion of the Court); *Terral v. Burke Constr. Co.*, 257 U.S. 529 (1922) (invalidating an Arkansas law which revoked the license of a foreign corporation doing only domestic business within the state when the corporation resorted to the federal court of the state); *Canadian N. Ry. v. Eggen*, 252 U.S. 553 (1920) (upholding a Minnesota law that barred a nonresident from maintaining suit in Minnesota when the cause of action had arisen outside the state and when the action would have been barred by lapse of time in the place where it arose).

It is well settled that one of the privileges which the clause guarantees to nonresidents is that of doing business on terms of substantial equality with residents.<sup>11</sup> However, the term "citizens" as used in the clause has been held not to include corporations<sup>12</sup> or business trusts.<sup>13</sup> Therefore, since a state may refuse to admit a foreign corporation to do business in the state, it may also impose conditions on the privilege of doing business so long as the conditions themselves are not unconstitutional.<sup>14</sup>

Attempts to impose higher taxes on nonresidents have generally been held unconstitutional.<sup>15</sup> Where a business tax operates to deny to a noncitizen entering a state for the purpose of doing business an equal footing with citizens, the tax has been held invalid.<sup>16</sup> However, a state may tax income derived by a noncitizen from sources within the state;<sup>17</sup> and, though nonresidents may not be denied personal exemptions granted to residents,<sup>18</sup> a state may limit deductions to expenses incurred on business within the state, while permitting residents to deduct all losses regardless of where they were incurred.<sup>19</sup> Where different methods of taxing residents and nonresidents re-

11. *Shaffer v. Carter*, 252 U.S. 37, 52-53 (1920); *Chalker v. Birmingham & N.W.R.R.*, 249 U.S. 522 (1919); *Ward v. Maryland*, 79 U.S. (12 Wall.) 418 (1870). For a discussion of developments in the related area of state taxation of interstate travel see Note, *State Taxation of Interstate Travel: Alternative Constitutional Limitations*, 5 U. RICHMOND L. REV. 167 (1970).

12. *Paul v. Virginia*, 75 U.S. (8 Wall.) 168 (1869) (corporations are not citizens within the meaning of the privileges and immunities clause; thus, they must depend upon the assent of the states for enforcement of their contracts).

13. See, e.g., *Hemphill v. Orloff*, 277 U.S. 537 (1928), which held that a Massachusetts trust or common law trust, as in the case of a corporation, cannot claim for itself the privileges and immunities guaranteed to the associates as individuals by article IV, § 2.

14. *Blake v. McClung*, 172 U.S. 239 (1898). The Court held invalid a Tennessee statute which permitted foreign mining and manufacturing corporations to do business within the state but gave priority in the distribution of assets to resident creditors. Harlan, J., speaking for the Court, said that a state may not "when establishing regulations for the conduct of private business . . . give its own citizens essential privileges connected with that business which it denies to citizens of different States." *Id.* at 252. Cf. *La Fourette v. McMaster*, 248 U.S. 465 (1919), upholding a South Carolina statute allowing only two-year residents to be licensed insurance brokers. This indicates that a state statute discriminating in favor of residents against nonresidents will be upheld where citizens of the enacting state who reside outside its boundaries are included in the class discriminated against.

15. See, e.g., *Mullaney v. Anderson*, 342 U.S. 415 (1952) (commercial fishing license); *Smith v. Loughman* (tax on transfers by will or intestate succession of nonresidents' property); *Chalker v. Birmingham & N.W.R.R.*, 249 U.S. 522 (1919) (tax on privilege of doing railroad construction work); *Travellers' Ins. Co. v. Connecticut*, 185 U.S. 364 (1902) (tax on stock); *Ward v. Maryland*, 79 U.S. (12 Wall.) 418 (1870) (trader's license). *But cf.* *Madden v. Kentucky*, 309 U.S. 83 (1940) (higher tax on deposits made in banks outside the state consistent with due process, equal protection, and privileges and immunities clause of the fourteenth amendment).

16. *Chalker v. Birmingham & N.W.R.R.*, 249 U.S. 522 (1919) (Tennessee statute making the amount of annual tax for privilege of doing railroad construction work depend on whether the person taxed had his chief office in the state); cf. *Spector Motor Serv. v. O'Connor*, 340 U.S. 602 (1951), which held invalid under the commerce clause a tax imposed upon interstate trucking for privilege of doing business in state; *Western Union Tel. Co. v. Kansas*, 216 U.S. 1 (1910) (tax on invested capital both within and outside Kansas as condition of doing business).

17. *Travis v. Yale & Towne Mfg. Co.*, 252 U.S. 60, 75 (1920); *Shaffer v. Carter*, 252 U.S. 37, 53-56 (1920); 29 YALE L.J. 799 (1920).

18. *Travis v. Yale & Towne Mfg. Co.*, 252 U.S. 60, 80 (1920); 18 MICH. L. REV. 547 (1920).

19. *Shaffer v. Carter*, 252 U.S. 37 (1920); 18 MICH. L. REV. 547-48 (1920).

sult in an approximately equal burden upon each class, the tax scheme is permissible.<sup>20</sup>

## II. STATE TAXATION UNDER THE PRIVILEGES AND IMMUNITIES CLAUSE

In reviewing state laws dealing with taxation, the Court has generally accorded the states wide latitude, paying deference to the states' sovereign powers in fiscal matters.<sup>21</sup> Only where the scheme of taxation violates constitutional guarantees<sup>22</sup> or is disruptive of the concept of federalism must the tax fall.<sup>23</sup>

In *Travellers Insurance Co. v. Connecticut*<sup>24</sup> the Court considered a Connecticut statute that on its face discriminated against nonresidents in that it assessed the stock held by nonresidents at market value without allowing any deduction for taxes paid by the corporation on real estate, while permitting such a deduction to resident shareholders. The Court, however, took into account the entire taxing system of the state in deciding whether nonresidents were unduly burdened. The Court found that nonresidents paid no local property taxes, while residents paid those taxes at an average rate approximating or exceeding the rate imposed by the state on nonresidents' stock. Thus, while greater equality of the tax burden might have been achieved, it was "enough that the State has secured a reasonably fair distribution of burdens, and that no intentional discrimination has been made against nonresidents."<sup>25</sup>

The landmark cases in the area of state income tax are *Shaffer v. Carter*<sup>26</sup> and *Travis v. Yale & Towne Manufacturing Co.*,<sup>27</sup> both announced the same day. *Shaffer* held that Oklahoma might tax locally derived income of a nonresident where it also taxed the income, from whatever source, of its own residents. The fact that Oklahoma permitted residents to deduct from their gross income losses sustained outside, as well as those sustained within the state, while nonresidents were allowed to deduct only those expenses occurring within the state, was held not repugnant to article IV, section 2. The

20. *Travellers' Ins. Co. v. Connecticut*, 185 U.S. 364 (1902). See also *Travis v. Yale & Towne Mfg. Co.*, 252 U.S. 60, 81 (1920).

21. *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356 (1973). An Illinois constitutional provision subjecting corporations, but not individuals, to ad valorem taxes on personalty was held to comport with equal protection requirements. Cf. *Ward v. Maryland*, 79 U.S. (12 Wall.) 418, 427 (1870). See also *Heim v. McCall*, 239 U.S. 175 (1915), which upheld under article IV, § 2 a New York provision giving preference to residents for the purpose of employment on public works.

22. See, e.g., *Michigan-Wisconsin Pipe Line Co. v. Calvert*, 347 U.S. 157, 164 (1954) (Texas tax on "gathering gas" as applied to an interstate gas pipeline company invalid under the commerce clause); *Grosjean v. American Press Co.*, 297 U.S. 233 (1936) (holding violative of due process a Louisiana license tax on newspapers with a circulation of over 20,000 copies per week).

23. See, e.g., *Ward v. Maryland*, 79 U.S. (12 Wall.) 418 (1870), holding void a Maryland tax that required nonresident traders to pay \$300 for a license, as compared to a fee of from \$15 to \$150 for resident traders. Mr. Justice Clifford emphasized that the privileges and immunities clause "plainly . . . secures the right of a citizen of one State . . . to be exempt from any higher taxes . . . than are imposed by the State upon its own citizens." *Id.* at 430.

24. 185 U.S. 364 (1902).

25. *Id.* at 371.

26. 252 U.S. 37 (1920).

27. 252 U.S. 60 (1920).

Court reasoned that the "practical effect and operation" of the tax was such that residents were subjected to at least the same burden as nonresidents.<sup>28</sup>

In *Travis* the Court considered a New York income tax law that granted to a resident a personal exemption for himself and each dependent, but allowed no such exemption to a nonresident. The state comptroller argued that any disparity on the face of the statute was counterbalanced by a provision excluding from taxable income of nonresidents any annuities, interest, or dividends not part of income from a local business or occupation subject to the tax. The Court rejected this argument, because the provision excluding annuities, interest, and dividends did not benefit nonresidents to a degree corresponding to the discrimination against them, and the assumption that nonresidents received additional income from outside sources equivalent to the amount of exemptions denied them was deemed "rash." Since there was no reasonable ground for the diversity in treatment, the Court held that the New York law abridged the privileges and immunities clause. Also rejected was the idea that the possibility of retaliatory tax provisions by adjoining states was palliative of the discrimination against nonresidents. The Court would review the statute only with respect to its effect in the existing situation. In any case, retaliation would not cure the constitutional defect of a discriminatory provision.<sup>29</sup> It was just such retaliation that the founding fathers had sought to eradicate by adopting the Constitution.<sup>30</sup>

### III. AUSTIN V. NEW HAMPSHIRE

In *Austin v. New Hampshire* the state contended that the New Hampshire Commuters Income Tax did not unduly burden nonresidents because their total tax liability was unchanged once the tax credit received from their state of residence (Maine) was taken into account. The Court, however, balked at applying the reasoning of *Travellers Insurance Co.* to this set of facts.<sup>31</sup> New Hampshire's argument involved reliance on the tax laws of not only the taxing state, as in *Travellers Insurance Co.*, but those of another state as well, in reaching the asserted substantial equality between residents and nonresidents.

In *Travis* the Court had roundly refused to take into account any possible, but as yet non-existent, tax provisions of adjoining states, characterizing such provisions as "wholly speculative." While the facts of *Travis* did not call for a holding on whether the Court would consider the effect of an *existing* tax provision of an adjoining state, language in the case implied that the Court would not consider such a provision in assessing constitutionality.<sup>32</sup> *Austin*

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28. The Court also based its decision upon the jurisdictional factor. Since the state's jurisdiction over nonresidents extended only to property or trade within the state, the state had no obligation to accord nonresidents a deduction for losses incurred outside the state. 252 U.S. at 57.

29. 252 U.S. at 82.

30. See *Paul v. Virginia*, 75 U.S. (8 Wall.) 168 (1869); *Lemmon v. The People*, 20 N.Y. 562 (1860).

31. 420 U.S. at 659 n.4, 666.

32. *Travis* contained *dictum* stating that the establishment of retaliatory discrimination would not cure the constitutional defect, thus giving rise to a strong inference that even an existing provision would not be considered by the Court. 252 U.S. at 82.

clearly says that the constitutionality of one state's statutes affecting nonresidents cannot depend upon the present configuration of the statutes of another state.<sup>33</sup>

New Hampshire also contended that Maine, the appellant taxpayers' state of residence, could shield its residents from the New Hampshire tax by amending its credit provisions. In considering this argument, the Court followed *Travis*, both in rejecting the contention that retaliation could cure a statute that would otherwise be constitutionally defective, and in finding that retaliation was in fact so at odds with the constitutional mandate as to compound, rather than cure, the defect.<sup>34</sup>

On the threshold point of standing, the Court found that even nonresident taxpayers whose total tax liability was unchanged by the tax had standing to challenge the New Hampshire statute. Although the withholding requirement was not in itself unconstitutional,<sup>35</sup> it was sufficient to confer standing in that it deprived the taxpayer of the use value of the excess withheld over his ultimate tax liability.<sup>36</sup>

The problem before the Court in *Austin* was essentially the same one that had faced the Court in *Travis*, and the opinion in *Austin* is in accord with prior treatment. *Austin* did extend the rule of *Travis* to cover the effect of existing, as well as potential, tax provisions of neighboring states, but the extension was not sweeping and was clearly foretold in *Travis*. That the Court again saw fit to deal with the effect of tax provisions of adjacent states on the privileges and immunities of nonresidents is indicative of the importance the Court attached to the matter. The Court's concern for maintaining the integrity of the federalist concept by avoiding a network of retaliatory state tax laws that would strangle commerce and discriminate against nonresidents is manifest in not just the wording, but the very existence, of the opinion.

#### IV. CONCLUSION

*Austin v. New Hampshire* makes clear that the Court will not consider the effect of existing tax provisions of neighboring states when reviewing a state tax statute for conformity with the privileges and immunities clause. Beyond this extension of *Travis*, the Court reworked old ground; *i.e.*, the possibility of retaliation by a neighboring state will not be considered as an ameliorative factor, and a tax falling exclusively on income of nonresidents must be approximately offset by other taxes imposed on residents alone. The Court also reiterated its dedication to the principle that a primary purpose of the priv-

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33. 420 U.S. at 668. Nor will the reciprocal nature of the tax statute alter this. *Id.* at 659 n.4.

34. *Id.* at 666-67.

35. *Travis v. Yale & Towne Mfg. Co.*, 252 U.S. 60 (1920). The withholding provision does not increase the tax burden of nonresidents. It merely recognizes the fact that as to them the state imposes no personal liability, and adopts a convenient substitute for it. *Id.* at 76; *cf.* *Bell's Gap R.R. v. Pennsylvania*, 134 U.S. 232, 239 (1890).

36. 420 U.S. at 659 n.4. The Court found this adequate to establish such a taxpayer as a party adversely affected by the state's tax laws, thus making him one who has a "direct stake in the outcome" of the litigation. *Sierra Club v. Morton*, 405 U.S. 727, 740 (1972) (*Sierra Club* denied standing in suit for injunction against a skiing development, for failure to assert and show irreparable harm to itself or its members).

ileges and immunities clause is to eliminate barriers to the free flow of commerce between the states. These factors would all seem to restrict effectively any further attempts by a state to tax nonresidents' incomes under circumstances where residents' incomes are not taxed, and where the taxes imposed on the residents alone do not approximately offset the tax on nonresidents. Furthermore, the giving of standing to even those taxpayers whose ultimate tax liability is unchanged tends to assure that a state will not be able to borrow a nonresident taxpayer's funds interest-free under the guise of the withholding process.

Marilyn H. Elam

### The Right of Self-Representation in Criminal Proceedings: Faretta v. California

Anthony Faretta was charged in the Superior Court of Los Angeles County with grand theft. In a preliminary ruling the trial judge granted Faretta's request to represent himself. After a hearing was conducted to ascertain defendant's ability to conduct his own defense, the preliminary ruling was reversed and a public defender was appointed. The judge ruled that defendant's waiver of counsel had not been made knowingly and intelligently and that defendant did not have a constitutional right to conduct his own defense. At trial the jury found defendant guilty as charged; the California Court of Appeals affirmed both trial court rulings and the conviction. The United State Supreme Court granted certiorari.<sup>1</sup> *Held, reversed*: Implied in the sixth amendment is an independent constitutional right of self-representation which a defendant in a criminal trial may exercise if his election is voluntary and intelligent. *Faretta v. California*, 95 S. Ct. 2525, 45 L. Ed. 2d 562 (1975).

#### I. RIGHT TO COUNSEL AND THE ROLE OF SELF-REPRESENTATION

The sixth amendment of the United States Constitution<sup>2</sup> provides that, "[I]n all criminal prosecutions, the accused shall enjoy the right . . . to have the assistance of counsel for his defense."<sup>3</sup> Through a series of decisions, commencing with *Powell v. Alabama*,<sup>4</sup> the United States Supreme Court has recognized that any criminal defendant, regardless of financial resources, has an absolute right to representation by counsel in any proceeding which may result in incarceration.<sup>5</sup>

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1. 415 U.S. 975 (1974).

2. The sixth amendment is applicable to the states through the fourteenth amendment. *Gideon v. Wainwright*, 372 U.S. 335 (1963); *Johnson v. Zerbst*, 304 U.S. 458 (1938).

3. U.S. CONST. amend. VI.

4. 287 U.S. 45 (1932).

5. See *Argersinger v. Hamlin*, 407 U.S. 25 (1972); *Gideon v. Wainwright*, 372 U.S. 335 (1963); *In re Oliver*, 333 U.S. 257 (1948); *Johnson v. Zerbst*, 304 U.S. 458

An accused may waive his right to counsel and proceed *pro se* if the court finds that his waiver is made knowingly and intelligently.<sup>6</sup> Whether such waiver may be asserted as a matter of constitutional right has been an area of disagreement among the circuit courts of appeals.<sup>7</sup>

### A. *The Historical Role of Self-Representation*

English common law held self-representation to be the general rule, with assistance of counsel the exception,<sup>8</sup> while early American legal history evidenced a conscious trend toward allowing criminal defendants a choice of proceeding either *pro se* or through counsel.<sup>9</sup> Consideration of the rigid English practice strongly suggests that this trend was directed toward expanding the flexibility of self-representation by allowing the assistance of counsel.<sup>10</sup> Although assistance became more readily available to the defendant, it appears that this development was not intended as a limitation on the availability of self-representation.<sup>11</sup> Indeed, many of the colonies included the right of self-representation within their charters and declarations of rights, and later, upon achieving statehood, within their constitutions.<sup>12</sup>

The First Congress directly addressed the issue by establishing the statutory right to proceed *pro se* in federal criminal prosecutions through section 35 of the Judiciary Act of 1789.<sup>13</sup> It is analytically important, however, that the sixth amendment, proposed one day after Congress enacted the Judiciary Act, is silent with respect to any right to self-representation, while it affirmatively grants the right to assistance of counsel. Arguably, this silence could indicate either an intent to disallow constitutional protection to the

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(1938). For more extensive treatment see W. BEANEY, *THE RIGHT TO COUNSEL IN AMERICAN COURTS*, *passim* (1955) [hereinafter cited as BEANEY]; Jones, *Criminal Law and Procedure, Annual Survey of Texas Law*, 27 Sw. L.J. 227, 238-43 (1973); Steele, *The Doctrine of Right to Counsel: Its Impact on the Administration of Criminal Justice and the Legal Profession*, 23 Sw. L.J. 488 (1969).

A defendant has an absolute right to retain counsel of his choice. *Chandler v. Fretag*, 348 U.S. 3 (1954); *Glasser v. United States*, 315 U.S. 60 (1942). For discussion of the right to counsel in "critical stages" see, *e.g.*, *United States v. Ash*, 413 U.S. 300 (1973); *United States v. Wade*, 388 U.S. 218 (1967).

6. *Johnson v. Zerbst*, 304 U.S. 458 (1938). See also Note, *Winters v. Cook: Effective Assistance of Counsel and the Waiver Doctrine*, 28 Sw. L.J. 805 (1974).

7. See notes 22-24 *infra* and accompanying text.

8. 1 F. POLLOCK & F. MATTLAND, *THE HISTORY OF ENGLISH LAW* 211 (2d ed. 1898).

9. *People v. Sharp*, 7 Cal. 3d 448, 453, 499 P.2d 489, 492, 103 Cal. Rptr. 233, 236 (1972), *cert. denied*, 410 U.S. 944 (1973); see BEANEY 14-22; Note, *Where Is the Constitutional Right to Self Representation and Why Is the California Supreme Court Saying All Those Terrible Things About It?*, 10 CALIF. W.L. REV. 196, 199 (1973).

10. See note 9 *supra*.

11. BEANEY 14-22.

12. For example, the Massachusetts Body of Liberties of 1641 provided: "Every man that findeth himselfe unfit to plead his owne cause in any Court shall have Libertie to employ any man against whom the Court doth not except, to helpe him." Similarly, the Consessions and Agreements of West New Jersey, in 1677, provided "that no person shall be compelled to fee any attorney or councciller to plead his cause, but that all persons have free liberty to plead his own cause, if he please." *Faretta v. California*, 95 S. Ct. 2525, 2537 n.37, 45 L. Ed. 2d 562, 578 n.37 (1975). See also *Betts v. Brady*, 316 U.S. 455 (1942).

13. 1 Stat. 73, 92 (1789) (codified at 28 U.S.C. § 1654 (1970)): "In all courts of the United States the parties may plead and conduct their own cases personally or by counsel as, by the rules of such courts, respectively, are permitted to manage and conduct causes therein."

right of self-representation,<sup>14</sup> or that the right was considered to be implied and the inclusion of the right to the assistance of counsel was intended to supplement the other rights granted a criminal defendant.<sup>15</sup> It is precisely this omission which has given rise to the conflict as to whether or not this right is constitutionally grounded.<sup>16</sup>

### B. *The Status of Prior Authority*

Before *Faretta v. California* the United States Supreme Court addressed the issue of a constitutional right to self-representation only by way of dicta. In *Adams v. United States ex rel. McCann*<sup>17</sup> the Court spoke of the right to assistance of counsel and the "correlative" right to dispense with a lawyer's aid,<sup>18</sup> further stating that, "[t]he Constitution does not force a lawyer upon a defendant."<sup>19</sup> This reference to a "correlative" right has been held to indicate the Court's recognition of the existence of a right to self-representation.<sup>20</sup> In other decisions, the Court has referred to this "correlative" right in terms of the fifth amendment's due process clause, as well as the sixth amendment.<sup>21</sup>

Circuit courts of appeals have not been consistent in interpreting and applying this Supreme Court dicta; although four circuits have held the right of self-representation to be constitutionally protected,<sup>22</sup> three circuits have denied such recognition.<sup>23</sup> The primary case supporting the existence of the constitutional right is *United States v. Plattner*,<sup>24</sup> in which the Second Circuit held that the right of the accused to manage and conduct his own defense in a criminal case is implicit in both the fifth and sixth amendments. In thirty-seven states a criminal defendant has the constitutional right to conduct his own defense, appear through counsel, or both.<sup>25</sup> Many state decisions have gone further, holding that the right is founded not only upon their respective state constitutions, but upon the sixth and fourteenth amendments to the United States Constitution.<sup>26</sup>

14. *Faretta v. California*, 95 S. Ct. 2525, 45 L. Ed. 2d 562 (1975).

15. See *United States v. Plattner*, 330 F.2d 271, 273-74 (2d Cir. 1964).

16. See notes 22-26 *infra* and accompanying text.

17. 317 U.S. 269 (1942).

18. "The right to assistance of counsel and the *correlative* right to dispense with a lawyer's help are not legal formalisms. They rest on considerations that go to the substance of an accused's position before the law." *Id.* at 277 (emphasis added).

19. *Id.* at 279.

20. *United States v. Plattner*, 330 F.2d 271 (2d Cir. 1964).

21. See *Illinois v. Allen*, 397 U.S. 337, 350-51 (1970) (Brennan, J., concurring); *Moore v. Michigan*, 355 U.S. 155, 161 (1957); *Carter v. Illinois*, 329 U.S. 173, 174 (1946).

22. See, e.g., *United States v. Conder*, 423 F.2d 904, 907 (6th Cir. 1970); *Lowe v. United States*, 418 F.2d 100, 103 (7th Cir. 1969); *Arnold v. United States*, 414 F.2d 1056, 1058 (9th Cir. 1969); *United States v. Plattner*, 330 F.2d 271, 273 (2d Cir. 1964).

23. See, e.g., *Van Nattan v. United States*, 357 F.2d 161 (10th Cir. 1966); *Butler v. United States*, 317 F.2d 249 (8th Cir. 1963); *Brown v. United States*, 264 F.2d 363 (D.C. Cir. 1959).

24. 330 F.2d 271 (2d Cir. 1964).

25. For classification of and citations to provisions in the 37 state constitutions, see *United States v. Plattner*, 330 F.2d 271, 275 nn.6-8 (2d Cir. 1964). See also BEANEY 209, 237.

26. See, e.g., *Lockhard v. State*, 92 Idaho 813, 451 P.2d 1014 (1969); *People v. Nelson*, 47 Ill. 2d 570, 268 N.E.2d 2 (1971); *Blanton v. State*, 229 Ind. 701, 98 N.E.2d 186 (1951); *State v. Mems*, 281 N.C. 658, 190 S.E.2d 164 (1972); *State v. Verna*, 9 Ore. App. 620, 498 P.2d 793 (1972).



A defendant's opportunity to manage and conduct his own defense has thus depended upon the view of the right of self-representation espoused by the particular jurisdiction in control.<sup>27</sup> In addition, the status attributed to the right necessarily controlled the manner in which it was applied. Where the right was deemed constitutionally protected,<sup>28</sup> the trial court must have informed the defendant of his choice between self-representation or representation by a lawyer<sup>29</sup> and advised him why the latter alternative was preferable.<sup>30</sup> Further, upon election to defend without counsel, a hearing had to be held to satisfy the court that the defendant was capable of making an intelligent choice;<sup>31</sup> once capability was established, denial of the right of self-representation required reversal. In federal courts holding the right to be only statutory in character,<sup>32</sup> notice of the right was not required to be given by the court,<sup>33</sup> use of the right was subject to the court's discretion once the trial had commenced,<sup>34</sup> and prejudice was required to be shown in order to reverse a wrongful denial.<sup>35</sup>

In those jurisdictions which have not recognized the right of self-representation under federal or state law the traditional rules governing waiver of the right to counsel have applied.<sup>36</sup> Protection of the accused's con-

27. The positions of the courts in reaching divergent stands upon the issue of a constitutional right to self-representation warrants mention. United States Supreme Court dictum has declared the right to dispense with counsel to be "correlative" to the right to the assistance thereof. *Adams v. United States ex rel. McCann*, 317 U.S. 269, 279 (1942). Further, the Court stated that "the Constitution does not force a lawyer upon a defendant," and the accused may waive his right to counsel so long as he "knows what he is doing and his choice is made with eyes open." *Id.* at 279. Decisions advancing this dictum as evidence of the right's constitutional stature include *Moore v. Michigan*, 355 U.S. 155, 161 (1957); *Carter v. Illinois*, 329 U.S. 173, 174-75 (1946); *Arnold v. United States*, 414 F.2d 1056, 1058 (9th Cir. 1969); *United States v. Plattner*, 330 F.2d 271, 275 (2d Cir. 1964).

It has been held that the right to defend is personal; that although conducting one's own defense may be detrimental, the choice must be honored out of "that respect for the individual which is the lifeblood of the law." *Illinois v. Allen*, 397 U.S. 337, 350-51 (1970). Moreover, respect for individual autonomy has been held to require a defendant to "go to jail under his own banner if he so desires and if he makes the choice 'with eyes open.'" *United States ex rel. Maldonado v. Denno*, 348 F.2d 12, 15 (2d Cir. 1965), *cert. denied*, 384 U.S. 1007 (1966).

The Second Circuit Court of Appeals, viewing the sixth amendment guarantees as personal to the accused, reasoned that the right to counsel was intended as a supplementary aid, not as an impairment of "the absolute and primary right to conduct one's own defense." *United States v. Plattner*, 330 F.2d 271, 274 (2d Cir. 1964).

In *United States v. Davis*, 260 F. Supp. 1009 (E.D. Tenn. 1966), the court, after reviewing Supreme Court dicta, concluded that the sixth amendment did not "prohibit" the right of self-representation. *Id.* at 1019. The District of Columbia Circuit Court of Appeals, in holding the right to proceed *pro se* under 28 U.S.C. § 1654 (1970) to be only statutory in character, noted that, although the Supreme Court had "recognized" the right in dicta, it had never given it constitutional stature. *Brown v. United States*, 264 F.2d 363 (D.C. Cir. 1959). *See also* *Butler v. United States*, 317 F.2d 249 (8th Cir. 1963).

28. *United States v. Plattner*, 330 F.2d 271, 273 (2d Cir. 1964).

29. *Id.*; *see* *Miranda v. Arizona*, 384 U.S. 436 (1966).

30. *United States v. Plattner*, 330 F.2d 271, 276 (2d Cir. 1964).

31. *Id.*

32. *See, e.g.*, 28 U.S.C. § 1654 (1974); *see* note 13 *supra*.

33. *Juelich v. United States*, 342 F.2d 29, 32 (5th Cir. 1965).

34. *Butler v. United States*, 317 F.2d 249, 258 (8th Cir. 1963).

35. *United States v. Cantor*, 217 F.2d 536, 538 (2d Cir. 1954). *See also* *Brown v. United States*, 264 F.2d 363, 366 (D.C. Cir. 1959).

36. *Johnson v. Zerbst*, 304 U.S. 458 (1938).

stitutional right to counsel imposed a duty upon the trial judge to determine the competency of an attempted waiver of such right.<sup>37</sup> *Johnson v. Zerbst* established the proposition that a waiver is valid if it is made "knowingly and intelligently,"<sup>38</sup> and acceptance of an ineffective waiver, if challenged, required reversal.<sup>39</sup> Scrutinization of a waiver of counsel thus invoked a balancing of the defendant's interest to proceed *pro se* and society's interest in achieving justice in the form of a fair trial.

The "power" to waive the right to the assistance of counsel has often been discussed in terms of the right to self-representation.<sup>40</sup> In *People v. Sharp*,<sup>41</sup> however, the California Supreme Court construed dictum in *Adams v. United States ex rel. McCann*<sup>42</sup> as indicative of only a *conditional* right to waive the constitutional right to counsel,<sup>43</sup> stating further that the right to waive a constitutional right is not necessarily a right of constitutional dimension,<sup>44</sup> relying for support upon *Singer v. United States*.<sup>45</sup>

Even where the right to self-representation has been held to be constitutionally grounded, acceptance of the defendant's waiver of counsel and election to proceed *pro se* has been conditional upon a finding that his choice was knowingly and intelligently made.<sup>46</sup> The power to waive counsel and the right to self-representation might, therefore, appear to be substantially equivalent, differentiated only by the fact that, as a constitutional right, the trial court must inform the defendant of his right to choose, and a wrongful denial results in reversal.<sup>47</sup>

The question of whether there exists a constitutional right to self-representation has been in need of Supreme Court resolution. The Court recognized that need in accepting *Faretta v. California*.

37. *Id.* at 465.

38. *Id.* at 464:

A waiver is ordinarily an intentional relinquishment or abandonment of a known right or privilege. The determination of whether there has been an intelligent waiver of right to counsel must depend, in each case, upon the particular facts and circumstances surrounding that case, including the background, experience, and conduct of the accused.

39. *Id.* at 468.

40. *United States v. Plattner*, 330 F.2d 271, 276 (2d Cir. 1964): "The right to counsel and the right to defend *pro se* in criminal cases form a single, inseparable bundle of rights, two faces of the same coin . . . . The choice between the two [is] sometimes discussed in terms of a waiver of the right to counsel, and sometimes in terms of an election to have a lawyer or to defend *pro se*." See *Moore v. Michigan*, 355 U.S. 155 (1957); *Carter v. Illinois*, 329 U.S. 173 (1946); *Adams v. United States ex rel. McCann*, 317 U.S. 269 (1942).

41. 7 Cal. 3d 448, 499 P.2d 489, 103 Cal. Rptr. 233 (1972), *cert. denied*, 410 U.S. 944 (1973).

42. 317 U.S. 269 (1942).

43. 499 P.2d at 493, 103 Cal. Rptr. at 237.

44. *Id.*

45. 380 U.S. 24 (1965). The Court stated: "The ability to waive a constitutional right does not ordinarily carry with it the right to insist upon the opposite of that right." *Id.* at 34. In *Singer* the Court did not address the right to counsel, but rather the right to waive trial by jury. The difference in the amendment language between the granting of the right to jury trial and the right to assistance of counsel poses a significant problem in drawing a direct analogy: "Trial of all Crimes . . . shall be by Jury . . . . In all criminal prosecutions, the accused shall enjoy the right . . . to have the Assistance of Counsel for his defense." U.S. CONST. amend. VI.

46. *United States v. Plattner*, 330 F.2d 271, 276 (2d Cir. 1964). See also *Arnold v. United States*, 414 F.2d 1056, 1058-59 (9th Cir. 1969).

47. See notes 31-46 *supra* and accompanying text.

## II. FARETTA V. CALIFORNIA

In *Faretta* the Supreme Court held that the sixth amendment, applicable to the states through the fourteenth amendment,<sup>48</sup> guarantees a defendant an independent constitutional right of self-representation in a state criminal trial.<sup>49</sup> The Court noted that although a defendant cannot be convicted and imprisoned unless he has been accorded the right to counsel, it is a quite different thing to say that a state may "force" unwanted counsel upon a defendant. While recognizing that in most criminal prosecutions a better defense could be presented with a lawyer's assistance, the Court reasoned that the benefits of legal assistance would be jeopardized where the assistance was neither desired nor accepted.<sup>50</sup> Justice Stewart, writing for the majority, considered the right to defend to be "personal" to the accused, as it is he who bears the consequences of a conviction.<sup>51</sup> The defendant must, therefore, be free to choose between representation by counsel or defending *pro se*; although conducting one's own defense may prove to be detrimental, such choice is to be honored out of "the respect for the individual which is the lifeblood of the law."<sup>52</sup>

In reaching its conclusion the majority relied heavily upon the structure of the sixth amendment and the legal history preceding that amendment's adoption.<sup>53</sup> The amendment was read as granting to the accused the right to make his defense personally, with the right to have the assistance of counsel as a supplementary aid, when so desired.<sup>54</sup> Thus, an independent right of self-representation was said to arise through implication.<sup>55</sup> In support of this conclusion a review of English and early American legal treatment of the *pro se* defendant and his gradually developing right to counsel was relied upon to show that, since self-representation was the general practice when the sixth amendment was proposed, the framers intended the right to counsel to be an optional aid to a defendant in the presentation of his defense, rather than an "organ of the state" forced upon him in derogation of his right to defend himself.<sup>56</sup> The Court also cited prior dicta, circuit court decisions, and the many state constitutional provisions, as evidencing a general consensus that the right is fundamentally integrated within the criminal justice system.<sup>57</sup>

While declaring the right to self-representation to be of constitutional stature, the Court qualified its use by requiring that the defendant knowingly

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48. See note 2 *supra*.

49. 95 S. Ct. at 2533, 45 L. Ed. 2d at 572-73.

50. *Id.* at 2533-34, 45 L. Ed. 2d at 573-74.

51. *Id.* at 2533, 45 L. Ed. 2d at 572-73.

52. *Id.* at 2541, 45 L. Ed. 2d at 581, citing *Illinois v. Allen*, 397 U.S. 337, 350-51 (1970) (Brennan, J., concurring).

53. 95 S. Ct. at 2532-40, 45 L. Ed. 2d at 572-80.

54. *Id.* at 2532-34, 45 L. Ed. 2d at 572-74.

55. *Id.* at 2534, 45 L. Ed. 2d at 574. Further, the Court distinguished an *independent* right from an inferred *mechanical* right. The right does not arise mechanically from a defendant's power to waive his right to the assistance of counsel, but rather, is found independently in the structure and history of the constitutional text. *Id.* at 2533 n.15, 45 L. Ed. 2d at 572-73 n.15.

56. *Id.* at 2533, 45 L. Ed. 2d at 573.

57. *Id.* at 2532-33, 45 L. Ed. 2d at 569-72.

and intelligently forego the benefits normally attributed to the right to counsel,<sup>58</sup> citing *Johnson v. Zerbst*<sup>59</sup> as controlling authority. This qualification apparently is based upon an attempt to strike a balance between the constitutional right to counsel with the right to proceed *pro se*. The Court explained that in order for the defendant to make a "competent and intelligent" choice, he must be made aware of the "dangers and disadvantages of self-representation."<sup>60</sup> In this manner, should he decide to defend *pro se*, the record will reflect the fact that "he knows what he is doing and his choice is made with eyes open."<sup>61</sup>

While granting the right to proceed *pro se* to all defendants in all courts, the Court was silent with respect to the procedural ramifications incident to the exercise of that right. Presumably, consistency with the treatment of other fundamental rights will require that a defendant be informed of this right by the court.<sup>62</sup> The issues of whether the right may be invoked *during* the trial, whether or not a defendant is limited to an "either-or" decision,<sup>63</sup> and on what grounds appellate relief will be granted are left for future determination. Albeit of constitutional stature, the right might be forfeited if consciously abused to disrupt the orderly proceedings of trial.<sup>64</sup> To the extent that these issues and others<sup>65</sup> remain undetermined, the *pro se* defendant travels a precarious road in pursuing his right of self-representation.

Chief Justice Burger dissented, viewing the recognition of a constitutional right as a perversion of the protection guaranteed by the right to counsel, and as fundamentally conflicting with fair trial considerations.<sup>66</sup> Further, the Court's reliance on past dicta and circuit court authority was considered misguided and irrelevant.<sup>67</sup> As indicated above, however, the majority decision

58. *Id.* at 2541, 45 L. Ed. 2d at 581-82. In using the word "forego" an effort seems to be made to distinguish this release of right from that of a "waiver." However, in citing *Johnson* and *Adams* as authority and using the quotations in such context, the implication arises that in "foregoing" the benefits of counsel, a valid waiver of the right to counsel is effectuated. Taking the Court's treatment of this issue as a whole, it is suggested that whether one will be adjudged to have "knowingly and intelligently" "foregone" the benefits of counsel will depend upon his being found able "competently and intelligently" to make such a choice, understanding fully the consequences of his doing so. This qualification is, in form, that which has been applied in cases dealing with a "waiver" of the right to counsel. Practically applied then, the standard to be invoked in determining competency in either case would appear the same.

The Court stated further that the defendant's choice to proceed *pro se* was a competent exercise of "informed free will." It is a necessary implication of the Court's citation of language from the *Johnson* and *Adams* cases that a defendant need only be "aware" of the consequences and be exercising his "informed free will." Once established as competent, in terms of awareness, the defendant's informed choice becomes cloaked with constitutional protection.

59. 304 U.S. 458, 464-65 (1938).

60. 95 S. Ct. at 2541, 45 L. Ed. 2d at 581-82, citing *Adams v. United States ex rel. McCann*, 317 U.S. 269, 270 (1942).

61. *Adams v. United States ex rel. McCann*, 317 U.S. 269, 279 (1942).

62. *Cf. Miranda v. Arizona*, 384 U.S. 436, 468-69 (1966); *United States v. Plattner*, 330 F.2d 271, 276 (2d Cir. 1964).

63. See Grano, *The Right to Counsel: Collateral Issues Affecting Due Process*, 54 MINN. L. REV. 1175, 1181-84 (1970). See also Comment, *Self-Representation in Criminal Trials: The Dilemma of the Pro Se Defendant*, 59 CALIF. L. REV. 1479 (1971).

64. See Grano, note 63 *supra*, at 1182; Comment, note 63 *supra*, at 1493. See also *Illinois v. Allen*, 397 U.S. 337, 342-43 (1970).

65. 95 S. Ct. at 2549-50, 45 L. Ed. 2d at 591-92.

66. *Id.* at 2542-44, 45 L. Ed. 2d at 583-84.

67. *Id.* at 2544-45, 45 L. Ed. 2d at 585-86.

held that the right is not absolute and may be denied where a defendant is found incompetent to appreciate his choice.<sup>68</sup> As to the competent defendant, his freedom of choice appears to be of primary consideration. Both Chief Justice Burger and Justice Blackmun, in separate dissents, attacked the majority's reliance on the history of the right of self-representation as being inconclusive authority for the implication of such right in the sixth amendment.<sup>69</sup> Blackmun further contended that the right stands in diametric opposition to the interest of the state that justice be achieved in all criminal trials.<sup>70</sup> Emphasis was placed upon the infinite procedural questions which the decision creates but leaves unanswered.<sup>71</sup>

### III. CONCLUSION

In recognizing a constitutional right of self-representation the Supreme Court leaves much to speculation as to its practical implementation and overall effect upon the quality of justice to be achieved in criminal trials where such right is asserted. While leaving the development of ground rules to future case law, the Court's decision permits the "competent" defendant to exercise true freedom of choice in determining the direction his defense will take. In essence, the Court has established that while the assistance of counsel is usually essential to guarantee the fairness of a criminal proceeding, it is the accused's fundamental choice whether or not to avail himself of such protection. Conditioning use of the right upon a defendant's "knowingly and intelligently" relinquishing the benefits of the right to counsel balances the interest of the accused in conducting his own defense with the integrity of the judicial system as a truth-determining process and promotes the ultimate goal of fairness in the criminal justice system.

*James L. Deem*

### State v. Southwestern Bell Telephone Co.: Utilities Regulation in the Public Interest by the Texas Attorney General

On January 30, 1975, defendant Southwestern Bell announced an increase in its long-distance intrastate telephone rates, effective March 1, 1975. Within one week the Texas Attorney General sought to enjoin Bell from implementing the announced increase on the ground that it was unreasonably high.<sup>1</sup> The district court granted the state's motion for a temporary injunc-

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68. See note 65 *supra*.

69. 95 S. Ct. at 2545-48, 45 L. Ed. 2d at 586-87, 590-91.

70. See *Brady v. Maryland*, 373 U.S. 83, 87 (1963); *Burger v. United States*, 295 U.S. 78, 88 (1935). See also *Johnson v. Zerbst*, 304 U.S. 458, 465 (1938).

71. 95 S. Ct. at 2549-50, 45 L. Ed. 2d at 591-92.

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1. The announced rate increase was designed to yield an additional \$45 million annually in revenue from Southwestern Bell's Texas intrastate operations.

tion, restraining Bell from implementing *any* rate increase. The Austin court of civil appeals dissolved the temporary injunction, holding that the separation of powers doctrine was violated when the district court, in determining whether a rate increase was unreasonably high, had determined what a reasonably high increase would be and had, thereby, exercised a purely legislative function.<sup>2</sup> The state's petition for writ of error to the Texas Supreme Court was granted. *Held, reversed and modified*: The attorney general may sue in the public interest to enjoin an unreasonable rate increase. In entertaining such suits courts do not exercise a legislative function since the determination of allegations of unreasonableness is not tantamount to rate making. The trial court's order was modified to the extent that only the proposed rate increase was prohibited by the injunction. *State v. Southwestern Bell Telephone Co.*, 526 S.W.2d 526 (Tex. 1975).

### 1. CONSTITUTIONAL POWERS OF THE ATTORNEY GENERAL

Article IV, section 22 of the Texas Constitution and subsequent statutory law grant the attorney general the power to "represent the State in all suits and pleas in the Supreme Court of the State in which the State may be a party . . . [and] take such action in the courts as may be proper and necessary to prevent any private corporation from exercising any power or demanding or collecting any species of taxes, tolls, freight or wharfage not authorized by law."<sup>3</sup> This power has been held exclusive and sufficient to sustain an action falling within the parameters of the provision.<sup>4</sup> The section, however, presents two major areas of difficulty: (1) its arguable conflict with article V, section 21 of the state constitution<sup>5</sup> which provides that county and district attorneys shall represent the state in the district and inferior courts, and (2) its application to corporate regulation.

#### A. *Relative Powers of the Attorney General and County and District Attorneys*

The tension between article IV, section 22<sup>6</sup> and article V, section 21<sup>7</sup>

2. *Southwestern Bell Tel. Co. v. State*, 523 S.W.2d 67 (Tex. Civ. App.—Austin 1975, writ granted), *construing* TEX. CONST. art. II, § 1.

3. TEX. CONST. art. IV, § 22. TEX. REV. CIV. STAT. ANN. art. 4409 (1966) is substantially the same.

4. *State v. International & G.N. R.R.*, 89 Tex. 562, 35 S.W. 1067 (1896); *State ex rel. Clement v. Paris Ry.*, 55 Tex. 76 (1881); *Security State Bank v. State*, 169 S.W.2d 554 (Tex. Civ. App.—Austin 1943, writ ref'd); *American Liberty Pipe Line Co. v. Agey*, 167 S.W.2d 580 (Tex. Civ. App.—Austin 1942, no writ).

5. TEX. CONST. art. V, § 21 provides: "The County Attorney shall represent the State in all cases in the District and inferior courts in their respective counties; but if any county shall be included in a district in which there shall be a District Attorney, the respective duties of the District Attorneys and County Attorneys shall in such counties be regulated by the Legislature."

6. TEX. CONST. art. IV, § 22, *construed in* *Brady v. Brooks*, 99 Tex. 366, 89 S.W. 1052 (1905); *Day Land & Cattle Co. v. State*, 68 Tex. 526, 4 S.W. 865 (1887); *State v. Moore*, 57 Tex. 307 (1882).

7. TEX. CONST. art. V, § 21, *construed in* *Garcia v. Laughlin*, 155 Tex. 261, 285 S.W.2d 191 (1955); *State v. Reagan County Purchasing Co.*, 186 S.W.2d 128 (Tex. Civ. App.—El Paso 1944, writ ref'd w.o.m.); *State ex rel. Downs v. Harney*, 164 S.W.2d 55 (Tex. Civ. App.—San Antonio 1942, writ ref'd w.o.m.). *See also* TEX. REV. CIV. STAT. ANN. art. 4395 (1966).

results from attempts by Texas courts to balance the respective provisions. The leading case, *Brady v. Brooks*,<sup>8</sup> concerned a legislative grant of authority empowering the attorney general to bring actions for the collection of specified railroad, personal, and corporate income taxes. The authority of the attorney general was challenged by the county and district attorneys, who were not joined in the actions, on the ground that the statute was violative of article V, section 21. In making its decision the court was faced with its prior decision in *State v. Moore*<sup>9</sup> which involved a challenge by the county attorney of the attorney general's power to sue in accordance with a statute to collect defaulted bond money.<sup>10</sup> In *Moore* the county attorneys had prevailed on the theory that article IV, section 22 bestowed only appellate authority on the attorney general. The *Brady* court determined that the decision in *Moore* on the priority of the county attorney to institute suit was dictum in that the holding was not necessary to the result in the case.<sup>11</sup> The court further held that the legislature could empower the attorney general to undertake actions in the lower courts.<sup>12</sup> Therefore, where the legislature specifically authorizes suits by the attorney general, such authorization will ordinarily stand against constitutional challenge premised upon article V, section 21.

Absent a statute allocating the power to bring suit, courts have held that the attorney general must bring the suit so long as the nature of the suit is "important", *i.e.*, where the public interest is involved and the action, if unrestrained, may harm that interest.<sup>13</sup> It was held by the Texas Supreme Court,

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8. 99 Tex. 366, 89 S.W. 1052 (1905).

9. 57 Tex. 307 (1882).

10. 99 Tex. at 374, 89 S.W. at 1054. Subsequent to the filing of suit by the attorney general, the county attorney sought to prosecute the action in lieu of the attorney general. This motion was granted by the trial court. The county attorney collected the funds, withheld his alleged statutory commission and remitted the balance to the attorney general. The attorney general then brought suit for the amount of commissions withheld.

11. *Id.* at 375, 89 S.W. at 1054. The *Brady* court argued that since the *Moore* court found that there was no statutory authority permitting the county attorney to withhold commissions, the decision concerning the construction of art. IV, § 22 need not have been decided, the former finding being sufficient to return the withheld funds to the attorney general. Moreover, the decision on art. IV, § 22 could not stand by itself since, for the county attorney to prevail, there must exist a statute approving his conduct. The court also stated that if its analysis on the question of dicta was inaccurate, then it would decline to follow the precedent established in *Moore*.

12. *Id.* at 378, 89 S.W. at 1056. The court held that the structure of the two sections allowed the legislature to distribute the authority of the attorney general and county and district attorneys so long as neither office was so deprived of its duties as to practically destroy the office. The court further looked to the main function of county attorneys at the time of constitutional enactment and found they were primarily engaged in criminal prosecutions, intimating, without holding, that art. V, § 21 might be applicable solely to district and county attorney authorization in criminal cases. *Id.*; see note 67 *infra*.

13. *State v. Farmers' Loan & Trust Co.*, 81 Tex. 530, 17 S.W. 60 (1891); *State ex rel. Clement v. Paris Ry.*, 55 Tex. 76 (1881); *Wexler v. State*, 241 S.W. 231 (Tex. Civ. App.—Galveston 1922, no writ); *Queen Ins. Co. v. State*, 22 S.W. 1048 (Tex. Civ. App.), *rev'd on other grounds*, 86 Tex. 250, 24 S.W. 397 (1893). In *Wexler* the court said: "The distinction between the granting of authority to represent the state in all cases in the district and inferior courts, and the authority to institute important litigation in the name of the state, is, we think, clear, and such distinction has been recognized in the decisions of our appellate courts." 241 S.W. at 233. See also *Looscan v. County of Harris*, 58 Tex. 511 (1883); *Goar v. City of Rosenberg*, 53 Tex. Civ. App. 218, 115 S.W. 653 (1909); *Duncan v. State*, 28 Tex. Civ. App. 447, 67 S.W. 903 (1902).

in *State ex rel. Clement v. Paris Railway*,<sup>14</sup> that this distinction between important litigation in which the state must be involved and less significant suits applied to the regulation of private corporations.<sup>15</sup> And in *City of Carrollton v. Southwestern States Telephone Co.*<sup>16</sup> it was specifically held that a county attorney is not the proper party to challenge intrastate telephone rate increases.

This conforms with the general rule in most states<sup>17</sup> and with the analysis of commentators<sup>18</sup> that common law powers exist to the extent not superseded by statute.<sup>19</sup> In *Garcia v. Laughlin*<sup>20</sup> and *State ex rel. Downs v. Harney*,<sup>21</sup> the attorney general complained that he had not been joined in actions to remove public officials.<sup>22</sup> He based his complaint on an assertion that a removal action was either an action in quo warranto, in which case only the attorney general would be authorized to bring the action,<sup>23</sup> or, alternatively, that bringing the action was within the inherent common law powers of his office.<sup>24</sup> The courts rejected these arguments. Since a specific statute dealt with the removal of officials<sup>25</sup> the courts held that they may not enlarge the powers and duties of the attorney general prescribed by the constitution and statutes.<sup>26</sup> Further, the quo warranto authority of the attorney general was denied since quo warranto applies where the officer (or corporation) has forfeited his office (or charter) and removal of an official is distinct from a forfeiture.<sup>27</sup> In *State v. Reagan County Purchasing Co.*<sup>28</sup> the attorney general had consented to a prior judgment beyond the authority prescribed by statute. While the court cited the above-referenced language from *Harney*, *Reagan* involved a statutory prohibition against the authority exercised by the attorney general. Where such a prohibition exists, the attorney general presumably would be precluded from asserting inherent common law powers.

14. 55 Tex. 76 (1881).

15. The distinction was originally drawn on the basis of a public nuisance; however, this doctrine has been expanded to cover the general public interest. See note 39 *infra*.

16. 381 S.W.2d 401 (Tex. Civ. App.—Eastland 1964, writ ref'd n.r.c.).

17. See Shepperd, *Common Law Powers and Duties of the Attorney General*, 7 BAYLOR L. REV. 1 (1955) (discussion and citation of authorities in other jurisdictions).

18. *Id.*; Taylor, *Modernizing the Powers of the Attorney General of Texas*, 36 TEX. B.J. 51 (1973).

19. The conceptual basis for the argument is premised on the legislative adoption of the common law in Texas. [1840] Tex. Laws 3, 2 H. GAMMEL, LAWS OF TEXAS 177 (1898), now appearing as TEX. REV. CIV. STAT. ANN. art. 1 (1969). For an excellent discussion see Shepperd, note 17 *supra*.

20. 155 Tex. 261, 285 S.W.2d 191 (1955).

21. 164 S.W.2d 55 (Tex. Civ. App.—San Antonio 1942, writ ref'd w.o.m.).

22. See also *State v. Reagan County Purchasing Co.*, 186 S.W.2d 128 (Tex. Civ. App.—El Paso 1944, writ ref'd w.o.m.).

23. TEX. REV. CIV. STAT. ANN. art. 6253 (1970).

24. *State ex rel. Downs v. Harney*, 164 S.W.2d 55, 57 (Tex. Civ. App.—San Antonio 1942, writ ref'd w.o.m.).

25. TEX. REV. CIV. STAT. ANN. art. 5970 (1962).

26. *State ex rel. Downs v. Harney*, 164 S.W.2d 55, 56 (Tex. Civ. App.—San Antonio 1942, writ ref'd w.o.m.), quoted in *Garcia v. Laughlin*, 155 Tex. at 266, 285 S.W.2d at 194-95. The *Harney* court also noted that the removal of a sheriff is a "purely local action" and as such could be distinguished from "important" litigation. 164 S.W.2d at 58; see note 13 *supra*.

27. *State ex rel. Down v. Harney*, 164 S.W.2d 55 (Tex. Civ. App.—San Antonio 1942, writ ref'd w.o.m.).

28. 186 S.W.2d 128 (Tex. Civ. App.—El Paso 1944, writ ref'd w.o.m.).



### B. Attorney General Powers To Regulate Corporations

Numerous cases have held that the attorney general is charged with the constitutional duty of forfeiting corporate charters whenever he shall determine the existence of sufficient cause notwithstanding prior regulation by an administrative body.<sup>29</sup> Administrative permission is not prerequisite to the institution of such suits.<sup>30</sup> Thus, the need for some degree of independence is vital to permit the execution by the attorney general of his constitutional duty.

Ground for fertile debate lies in that portion of article IV, section 22 which provides that "the Attorney General shall . . . take such action . . . as . . . necessary to prevent any private corporation from exercising any power or demanding . . . taxes, tolls, . . . not authorized by law."<sup>31</sup> In interpreting this section, *Security State Bank v. State*<sup>32</sup> and *Western Union Telegraph v. State*<sup>33</sup> have held, in general terms, that the attorney general is under a duty to bring such actions as necessary to preclude the proposed or continued use of corporate "power . . . not authorized by law."<sup>34</sup> The breadth of these holdings may be explained on the facts, since, in both cases, the subject corporation had violated a Texas statute and the attorney general was seeking to enjoin any further unlawful corporate activity in the state. In *Western Union*, however, the attorney general sought to go beyond the statutory provisions for penalties and to enjoin all corporate activities.<sup>35</sup> It might, therefore, be argued that this case presents authority for vesting broad regulatory powers in the office of the attorney general, at least where the action seeks to bar corporate activity totally.<sup>36</sup>

Two early cases dealing with the attorney general's constitutionally mandated powers support the above interpretation. In *State v. Farmers' Loan & Trust Co.*<sup>37</sup> the court found a constitutional duty on the part of the attorney general to "inquire into the charter rights of all private corporations"<sup>38</sup> when a public injury was to be redressed since the attorney general could not maintain an action when purely private rights were involved. The

29. *Day v. State*, 489 S.W.2d 368 (Tex. Civ. App.—Austin 1972, writ ref'd n.r.e.); *John L. Hammond Life Ins. Co. v. State*, 299 S.W.2d 163 (Tex. Civ. App.—Austin 1957, writ ref'd n.r.e.); *State v. Teachers Annuity Life Ins. Co.*, 149 S.W.2d 318 (Tex. Civ. App.—Beaumont 1941, writ ref'd) (all *construing* TEX. CONST. art. IV, § 22).

30. *See, e.g.*, *Day v. State*, 489 S.W.2d 368, 372 (Tex. Civ. App.—Austin 1972, writ ref'd n.r.e.); *State v. Teachers Annuity Life Ins. Co.*, 149 S.W.2d 318, 320 (Tex. Civ. App.—Beaumont 1941, writ ref'd). While these cases deal with the attorney general vis-à-vis the commissioner of insurance, the holdings and analyses appear applicable to other regulatory agencies in the absence of a specific legislative mandate to the contrary, *i.e.*, state environmental matters under TEX. WATER CODE ANN. § 21.253(c) (1972) and TEX. REV. CIV. STAT. ANN. art. 4477-5, § 4.02 (Supp. 1974). *See also* *Security State Bank v. State*, 169 S.W.2d 554 (Tex. Civ. App.—Austin 1943, writ ref'd w.o.m.) (regulatory power of state banking board).

31. TEX. CONST. art. IV, § 22.

32. 169 S.W.2d 554 (Tex. Civ. App.—Austin 1943, writ ref'd w.o.m.).

33. *Western Union Tel. Co. v. State*, 121 S.W. 194 (Tex. Civ. App. 1909), *construing* TEX. CONST. art. IV, § 22.

34. TEX. CONST. art. IV, § 22.

35. *Western Union Tel. Co. v. State*, 121 S.W. 194 (Tex. Civ. App. 1909).

36. TEX. CONST. art. IV, § 22 requires the attorney general to "especially inquire into the charter rights of all private corporations . . ."

37. 81 Tex. 530, 17 S.W. 60 (1891).

38. *Id.* at 547, 17 S.W. at 64, *construing* TEX. CONST. art. IV, § 22.

case did not involve the rate charged, for that was within the legislative limit, but rather the validity of certain bonds acquired by the defendant which, if determined invalid, might permit the bond issuer (a railroad company) to reduce its rates charged to the public.<sup>39</sup> In upholding the attorney general's constitutional authority to bring suit, the court suggested that "[t]he right of the attorney general, in behalf of the state, through the courts, to prevent any private corporation from exercising any power not conferred by law, when this is hurtful to the public . . . cannot be questioned, and would exist from the nature of the office, in the absence of a constitutional provision expressly conferring it."<sup>40</sup>

In *Queen Insurance Co. v. State*<sup>41</sup> the attorney general sought to prevent a corporate combination which would have created a fire insurance monopoly. The court stated that the attorney general's duty to institute necessary proceedings to protect the public is subject to statutory direction; where there is no such statutory control, the attorney general is free to pursue any remedy suited to the nature of the cause of action.<sup>42</sup>

## II. STATE V. SOUTHWESTERN BELL TELEPHONE CO.

In *State v. Southwestern Bell Telephone Co.* the Texas Supreme Court upheld the right of the attorney general to bring suit in the public interest to enjoin a proposed action not authorized by law by a public utility. Moreover, the court recognized the concomitant jurisdiction of the courts to entertain such suits and to issue necessary orders pursuant to that jurisdiction.

In considering the jurisdictional issue, the court of civil appeals<sup>43</sup> had dealt solely with the issue of judicial review of telephone rates. After distinguishing the propitious list of supporting authorities presented by the attorney general,<sup>44</sup> the court found that, in determining whether a proposed rate was unreasonable, the trial court would be required to hear evidence identical to that considered by an administrator or legislative body in setting the appropriate rate. Thus, it concluded that the district court's action in finding that no rate increase was justified was tantamount to judicial rate making.<sup>45</sup>

39. It was on this point that the Texas Supreme Court reversed, holding that there must be a public benefit as a direct consequence of court action by the attorney general. The company would not have been required to reduce its charges since they were within the legislative rate structure. The mere possibility of savings passed to the consumer was held insufficient to sustain the action.

40. 81 Tex. at 551, 17 S.W. at 66. See also *Boyd v. Frost Nat'l Bank*, 145 Tex. 206, 196 S.W.2d 497 (1946); *Agey v. American Liberty Pipe Line Co.*, 141 Tex. 478, 172 S.W.2d 972 (1943); *Powers v. First Nat'l Bank*, 138 Tex. 604, 161 S.W.2d 273 (1942); *Allred v. Beggs*, 125 Tex. 584, 84 S.W.2d 223 (1935); *Brady v. Brooks*, 99 Tex. 366, 89 S.W. 1052 (1905); *State ex rel. Templeton v. Goodnight*, 70 Tex. 682, 11 S.W. 119 (1888); *Day Land & Cattle Co. v. State*, 68 Tex. 526, 4 S.W. 865 (1887).

41. 22 S.W. 1048 (Tex. Civ. App.), *rev'd on other grounds*, 86 Tex. 250, 24 S.W. 397 (1893).

42. 22 S.W. at 1052.

43. *Southwestern Bell Tel. Co. v. State*, 523 S.W.2d 67 (Tex. Civ. App.—Austin), *rev'd*, 526 S.W.2d 526 (Tex. 1975).

44. *Id.* at 70 n.1. See, e.g., *City of Nassau Bay v. Nassau Bay Tel. Co.*, 517 S.W.2d 613 (Tex. Civ. App.—Houston [1st Dist.] 1974, writ *ref'd n.r.e.*); *General Tel. Co. v. Cities Littlefield*, 498 S.W.2d 375 (Tex. Civ. App.—Amarillo 1973, writ *ref'd n.r.e.*); *City of Carrollton v. Southwestern States Tel. Co.*, 381 S.W.2d 401 (Tex. Civ. App.—Eastland 1964, writ *ref'd n.r.e.*); *City of Houston v. Memorial Bend Util. Co.*, 331 S.W.2d 418 (Tex. Civ. App.—Houston [1st Dist.] 1960, writ *ref'd n.r.e.*).

45. 523 S.W.2d at 70. It is possible to reconcile this holding with that of the su-

The supreme court dealt at length with the jurisdictional issue and reversed, relying on early United States Supreme Court decisions<sup>48</sup> holding that a public utility is, in the absence of regulation, always subject to the dictates of reasonableness, since it is a corporation "affected with a public interest."<sup>47</sup> The most important aspect of the case is the Texas Supreme Court's approval of the attorney general's authority to institute suit. While the decision appears at first glance to extend the attorney general's powers under the article of the Texas Constitution allowing suits against private corporations,<sup>48</sup> the decision is probably based upon a more restrictive view. The court determined from the record that Southwestern Bell was collecting a "toll" for its services and attempting to exact an unreasonable rate which was not authorized by law.<sup>49</sup> Hence, the case fell neatly within the framework of the constitutional provision<sup>50</sup> and the accompanying statute,<sup>51</sup> thereby avoiding the necessity for inquiry into the nature of the powers inherent in the office of the attorney general.

The court approved language in *State v. Farmers' Loan & Trust Co.*<sup>52</sup> that the attorney general may institute suit preventing the exercise by a private corporation of a power not authorized by law if the exercise of such power would be harmful to some interest essentially public.<sup>53</sup> Thus, while plainly not required for the precise holding, the broad language employed by the court provides a springboard for potential advancement of the inherent common law powers theory, particularly since the court distinguished early cases limiting the powers of the office as not germane to the issue presented.<sup>54</sup>

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preme court since the court of civil appeals determined that the district court had restrained all rate increases and had thereby determined "that the existing rate was adequate." If the appeals court decision is limited in this fashion it squares with the supreme court decision modifying the final order by restraining solely the proposed increase. This type of order would determine only that the proposed rate was too high without implying which rates would be considered legally allowable.

46. 526 S.W.2d at 529-30, citing, *inter alia*, *Smyth v. Ames*, 169 U.S. 466 (1898); *ICC v. Railway Co.*, 167 U.S. 479 (1897); *C. & L. Turnpike Rd. v. Sandford*, 164 U.S. 578 (1896); *Reagan v. Farmers' Loan & Trust Co.*, 154 U.S. 362 (1894); *Chicago, M. & St. P. Ry. v. Minnesota*, 134 U.S. 418 (1890) (all distinguishing rate reviewing from rate making; holding only the latter a legislative function).

47. Southwestern Bell placed the court in a rather precarious position by arguing that since the FCC regulated interstate rates and applicable state law permitted regulation of intracity rates by municipal governments, in the absence of legislative regulation the company could legally charge at will for intrastate long distance phone calls without accounting to anyone. If the courts were held without jurisdiction, all remedies would be precluded, even those of private individuals, as well as class action measures under TEX. R. CIV. P. 42. The court referred to the Public Utilities Regulatory Act of 1975, ch. 721, [1975] Tex. Laws 2327, which will not effectively begin to regulate utilities rates until September 1, 1976, but did not consider this a legislative recognition of lack of jurisdiction in the courts. 526 S.W.2d at 528 n.1.

48. See Shepperd, *supra* note 17; Taylor, *supra* note 18.

49. 526 S.W.2d at 531, citing *Southwestern Tel. & Tel. Co. v. State*, 109 Tex. 337, 207 S.W. 308 (1918). In *Southwestern Tel. & Tel.* the court simply referred to the rates charged by plaintiff as "tolls" without discussing the importance of their terminology. Consequently, for constitutional construction at least, telephone rates fall within the ambit of TEX. CONST. art. IV, § 22.

50. TEX. CONST. art. IV, § 22.

51. TEX. REV. CIV. STAT. ANN. art. 4409 (1966). General statutes dealing with the office of the attorney general are TEX. REV. CIV. STAT. ANN. arts. 4394-4413a (1966).

52. 81 Tex. 530, 17 S.W. 60 (1891); see notes 37-40 *supra* and accompanying text.

53. 526 S.W.2d at 531.

54. *Id.*, distinguishing *Garcia v. Laughlin*, 155 Tex. 261, 285 S.W.2d 191 (1955); *State v. Reagan County Purchasing Co.*, 186 S.W.2d 128 (Tex. Civ. App.—El Paso

Upon consideration of the broad use of *Farmers'*, an apropos conclusion might be that the restrictive cases will be limited factually or will be reconciled with the general American rule upholding inherent attorney general common law authority.<sup>55</sup>

The many questions concerning the authority of the attorney general in areas where a regulatory body exists remain unresolved.<sup>56</sup> *Southwestern Bell* appears to resolve doubts as to the ability of the attorney general to act as a consumer advocate in the district courts where no regulatory scheme exists. It thus seems clear that there is no constitutional restraint on the attorney general's powers in terms of the public interest suit, at least in the absence of legislative regulation.<sup>57</sup> *Southwestern Bell* sheds no light, however, on the extent of those powers unless the decision is broadly interpreted beyond its apparent precedential value. Moreover, an excellent argument can be made urging that the case be limited to its facts since there was *no* administrative regulation exercised over an essentially monopolistic enterprise.<sup>58</sup>

Additional arguments may be advanced supporting a limited reading of the decision. The court emphasized that *Southwestern Bell* was a monopoly and a business affected with a public interest.<sup>59</sup> Thus, the precise scope of attorney general powers in the regulation of private corporations in the public interest may differ between corporations "affected with a public interest" and businesses in which the public is but incidentally interested.<sup>60</sup> This will require examination of the nature of the public interest sought to be vindicated and a defining of a public interest, or of a business affected therewith.<sup>61</sup> Further, had *Southwestern Bell* not been charging a toll for its services, it may be

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1944, writ ref'd w.o.m.); *State ex rel. Downs v. Harney*, 164 S.W.2d 55 (Tex. Civ. App.—San Antonio 1942, writ ref'd w.o.m.).

55. See Shepperd, *supra* note 17, at 1-2 n.3 and accompanying text, citing cases indicating the 35 jurisdictions recognize common law powers in their attorneys general.

56. Legislation establishing a regulatory body may curtail or pre-empt the inherent power of the office, and may even infringe upon the furtherance of constitutionally imposed duties. See note 31 *supra* and accompanying text (example of exceptions which may result from construction of legislation establishing the administrative body). See also Public Utilities Regulatory Act of 1975, ch. 721, [1975] Tex. Laws 2327; note 58 *infra*.

57. See note 47 *supra*.

58. *Southwestern Bell* argued essentially that between FCC regulation and municipal regulation authorized by the state legislature, the gap of intrastate rates was created by inadequate legislation and *Southwestern Bell* was basically unregulated. The court of civil appeals suggested that it could not fashion the appropriate remedy solely because the legislature had failed to provide the proper regulation. 523 S.W.2d at 71. Additionally, the legislature remains free to preclude the common law powers of the attorney general as has been done in environmental litigation. See note 30 *supra*. Ordinarily some procedure is established in regulatory legislation providing for proper appeals. See Public Utilities Regulatory Act of 1975, ch. 721, [1975] Tex. Laws 2327 (effective over rates September 1, 1976).

59. 526 S.W.2d at 529.

60. Enforcement powers over a corporation would not necessarily include an attack against an entire industry. However, it has been indicated that most corporations affected with a public interest are utility monopolies wherein an attack against the corporation is effectively an attack against the industry. See *City of Texarkana v. Wiggins*, 151 Tex. 100, 246 S.W.2d 622 (1952). See also *Queen Ins. Co. v. State*, 22 S.W. 1048 (Tex. Civ. App.), *rev'd on other grounds*, 86 Tex. 250, 24 S.W. 397 (1893) (unlawful attempted corporate combination).

61. See *City of Texarkana v. Wiggins*, 151 Tex. 100, 104, 246 S.W.2d 622, 624 (1952) (defining business affected with a public interest as "what has come to be known as a utility service"). See also *Munn v. Illinois*, 94 U.S. 113 (1876).

argued that different results would have obtained. In the absence of toll charges, the issue would have devolved upon an interpretation of the "power . . . not authorized by law" provision. This would have forced the court specifically to confront the question of common law powers which now remains an issue in doubt.<sup>62</sup>

### III. CONCLUSION

Recent legislative activity has dealt with the authority of the attorney general. The Sixty-Fourth Legislature adopted the Public Utilities Regulatory Act providing for administrative regulation of tolls and rates of public utilities,<sup>63</sup> and proposed a new state constitution, which stated that "[t]he attorney general has the powers of the office as at common law except as expressly provided by law to the contrary."<sup>64</sup>

Despite the rejection of the proposed constitution by the voters, it is predicted that the supreme court will find common law powers within the attorney general's office. The court could easily broaden the definition of the "power . . . not authorized by law" provision of the present constitution<sup>65</sup> and thereby avoid the inevitable difficulty of distinguishing between taxes, tolls, freights, and wharfages, and an ordinary charge or price. While *Southwestern Bell* plainly does not require this construction, the trend of decisions indicates such a result.<sup>66</sup> This extension should not require a constitutional amendment,<sup>67</sup> but merely judicial expansion of present constitutional provisions<sup>68</sup> limited by the requirement of a showing of injury to the public interest.<sup>69</sup> In sum, the court indicated its readiness to uphold common law attorney general powers when presented with a case clearly requiring direct confrontation of the issue.

*Brian D. Lafving*

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62. See notes 31-42 *supra* and accompanying text.

63. Public Utilities Regulatory Act of 1975, ch. 721, [1975] Tex. Laws 2327. The act provides that any party to the proceeding before the commission is entitled to judicial review. The attorney general is empowered to act on his own initiative where the violation of a portion of the Act has occurred; however, the attorney general must have the approval of the commission before an injunction may be sought. *Id.* §§ 69, 71, 72(c), at 2349.

64. TEX. CONST. art. IV, § 19 (proposed) (defeated by Texas voters Nov. 4, 1975). The proposed constitution, in the same section, also provided that the attorney general should take action as "necessary to prevent a private corporation from exercising a power not authorized by law" and omitted the taxes, tolls, freight, and wharfage section of the present constitution. TEX. CONST. art. IV, § 22. Thus, while dispensing with the precise provision upon which *Southwestern Bell* is based, the proposed constitution expressly provided for the exercise of common law powers.

Additionally, the proposed constitution limited the authority of district and county attorneys to criminal prosecutions in courts below the court of appeals. TEX. CONST. art. V, § 11 (proposed) (defeated by Texas voters Nov. 4, 1975). All other powers and duties of the county and district attorneys were to be derived from a specific legislative mandate. These provisions would have avoided the conflict presented between article IV, § 22 and article V, § 21 of the present constitution. See notes 6-29 *supra* and accompanying text.

65. TEX. CONST. art. IV, § 22.

66. See authorities throughout Shepperd, *supra* note 17.

67. This statement assumes *Southwestern Bell's* construction as a limitation on earlier cases with contrary implications. See note 54 *supra* and accompanying text.

68. TEX. CONST. art. IV, § 22.

69. See note 40 *supra* and accompanying text.

## United Housing Foundation v. Forman: Shares of Stock in Nonprofit Housing Cooperative Are Not "Securities"

The United Housing Foundation (UHF), a nonprofit membership organization composed of labor unions, housing cooperatives, and civic groups, was established for the purpose of providing adequate housing accommodations for low and moderate income families. UHF in turn organized the Riverbay Corporation, a nonprofit organization to own and operate the land and buildings constituting Co-Op City,<sup>1</sup> the largest housing cooperative in New York City. As a prerequisite to living in Co-Op City, residents were required to purchase shares of stock in Riverbay.<sup>2</sup> Resident tenants of Co-op City brought a class action in federal court,<sup>3</sup> claiming they were defrauded in their purchase of the shares by certain misrepresentations in the cooperative's information bulletin.<sup>4</sup> The district court dismissed, finding that subject matter jurisdiction was lacking because the shares of stock in the cooperative housing project were not "securities" within the scope of the federal securities acts.<sup>5</sup> The Second Circuit reversed and remanded, holding that the shares were both "stock" and "investment contracts" and, therefore, were "securities."<sup>6</sup> The United States Supreme Court granted certiorari.

1. The project was organized pursuant to the New York State Private Housing Finance Law, commonly known as the Mitchell-Lama Act. In return for the developer's agreement to operate on a nonprofit basis and the state's power to review the development of the cooperative, New York provided the developer with large, long-term, low-interest mortgage loans and substantial tax exemptions. See N.Y. PRIV. HOUS. FIN. LAW §§ 11-37 (McKinney 1962), *as amended*, (McKinney Supp. 1975).

2. The shares of stock could not be transferred to a non-tenant; they could not be pledged or encumbered; they would descend, along with the apartment, only to a surviving spouse; and, they carried no voting rights. If a tenant wished to terminate his occupancy and was forced to vacate, he was required to offer the stock back to Riverbay at its original selling price per share, or if Riverbay declined to repurchase, the tenant had to sell the stock for not more than the initial purchase price plus a fraction of the portion of the corporation's mortgage that the stock had paid off. See *id.* § 31(a), *as amended*, (McKinney Supp. 1975). Less than 10% of the total estimated cost of the project was to be raised by the sale of stock to tenants. The bulk of the cost was to be financed by a long-term low-interest mortgage loan from the New York Private Housing Finance Agency.

3. Named as defendants were UHF, Riverbay, Community Services, Inc. (CSI), the general contractor and sales agent for the project, as well as individual directors of UHF, Riverbay, and CSI, the State of New York, and the State Private Housing Finance Agency.

4. The crux of the claim was that the information bulletin represented that CSI, the contractor of the project, would bear all subsequent cost increases resulting from such factors as inflation, when, in fact, the cost of a four-room apartment had risen from \$92.08 in 1965 to \$158.72 in 1975. Plaintiffs claimed that these misrepresentations were in violation of Securities Act of 1933, § 17(a), 15 U.S.C. § 77q(a) (1970), and SEC rule 10b-5, 17 C.F.R. § 240.10b-5 (1974), promulgated under Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1970).

5. *Forman v. Community Services, Inc.*, 366 F. Supp. 1117 (S.D.N.Y. 1973). "The term 'security' means any note, stock . . . certificate of interest or participation in any profit-sharing agreement . . . investment contract . . . or, in general, any interest or instrument commonly known as a 'security' . . ." Securities Act of 1933, § 2(1), 15 U.S.C. § 77(b)(1) (1970). A "virtually identical" definition of a security is provided in Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1970). *Tcherepnin v. Knight*, 389 U.S. 332, 335-36 (1967). See SENATE COMM. ON BANKING AND CURRENCY, FEDERAL SECURITIES EXCHANGE ACT OF 1934, S. REP. NO. 792, 73d Cong., 2d Sess. 14 (1934).

6. *Forman v. Community Services, Inc.*, 500 F.2d 1246 (2d Cir. 1974), *noted in* 53 TEXAS L. REV. 623 (1975).

*Held, reversed:* Shares of stock entitling a purchaser to lease an apartment in a state subsidized and supervised nonprofit housing corporation are not "securities" within the purview of the Securities Act of 1933 and the Securities Exchange Act of 1934. *United Housing Foundation, Inc. v. Forman*, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975).

## I. DEFINITION OF SECURITIES

The definition of "security"<sup>7</sup> has undergone extensive evolution and growth since federal regulation began under the Securities Act of 1933.<sup>8</sup> The initial desire of Congress for an expansive rather than a restrictive concept,<sup>9</sup> coupled with the recent increase in potential liability under the securities acts,<sup>10</sup> has made litigation over the definition of "security" vital to all segments of the business community.<sup>11</sup> The Supreme Court first dealt with this issue in *SEC v. C.M. Joiner Leasing Corp.*,<sup>12</sup> when it ruled that an oil leasehold arrangement being sold by the defendant was not merely an interest in land, but was a type of security "in which the purchaser was paying both for a lease and a development project."<sup>13</sup> Shortly thereafter, the Court in *SEC v. W.J. Howey Co.* determined that the defendant's contracts for the sale and cultivation of citrus groves were securities, again holding that form should be disregarded for substance and the emphasis placed upon economic reality.<sup>14</sup> Twenty years later, in *Tcherepnin v. Knight*, the Court for a third time emphasized the "substance over form" analysis in finding that withdrawable capital shares in a savings and loan association were securities.<sup>15</sup> These cases clearly demonstrate the Court's commitment to looking to the economic substance of a transaction in reaching "[n]ovel, uncommon, irregular devices,"<sup>16</sup> which Congress sought to subject to the provisions of the federal securities laws.<sup>17</sup>

Another problem has arisen where a transaction is labeled a security but fails to meet the substantive tests.<sup>18</sup> Certain dictum in *Joiner* tends to support a so-called "literal approach" to finding a security. There, the Court remarked: "Instruments may be included within any of these definitions, as

7. See note 5 *supra*.

8. See generally 1 L. LOSS, SECURITIES REGULATION 455-512 (2d ed. 1961, Supp. 1962); 4 *id.* at 2485-557 (2d ed. 1969); Pasquesi, *The Expanding "Securities" Concept*, 49 ILL. B.J. 728 (1961).

9. See HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, FEDERAL SUPERVISION OF TRAFFIC IN INVESTMENT SECURITIES IN INTERSTATE COMMERCE, H.R. REP. NO. 85, 73d Cong., 1st Sess. 11 (1933).

10. The greatest increase in liability has been under rule 10b-5, 17 C.F.R. § 240.10b-5 (1974). For a discussion of its scope see 1 A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5, § 2.2 (1974).

11. See Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367-68 & n.8 (1967).

12. 320 U.S. 344 (1943).

13. *Id.* at 349. The court looked to the "economic interest" in the well-drilling undertaking in determining that the leaseholds were securities. *Id.*; see text accompanying note 22 *infra*.

14. 328 U.S. 293, 298 (1946); see notes 23-24 *infra* and accompanying text.

15. 389 U.S. 332, 336 (1967).

16. 320 U.S. at 351.

17. See Comment, *What Is a Security? Howey, Turner Enterprises, and Franchise Agreements*, 22 KAN. L. REV. 55, 59 (1973).

18. See notes 21-22 *infra* and accompanying text.

matter of law, if on their face they answer to the name or description."<sup>19</sup> In exposing the fallacy of the literal approach, one commentator has noted that, "just as some things which look like real estate are securities, some things which look like securities are real estate."<sup>20</sup> Despite this dictum in *Joiner*, the literal approach has received little approval by the courts.<sup>21</sup>

Certainly the holding in *Joiner* was not based on a literal approach in determining that an oil leasehold was a security. Rather, the inquiry in *Joiner* was directed at the "character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."<sup>22</sup> More specific criteria for determining the existence of a security were provided by the Supreme Court in *SEC v. W. J. Howe Co.*<sup>23</sup> where the Court defined a security as "a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . ."<sup>24</sup> Although the *Howe* test has become the most frequently cited formulation of the investment contract,<sup>25</sup> it has not been uniformly interpreted. The first part of the test, an investment of money, is self-explanatory and has received little attention by the courts.<sup>26</sup> Although "common enterprise" has caused some litigation,<sup>27</sup> the most troublesome aspects have been the third, "expectation of profits," and fourth, "solely from the efforts of others," elements of the *Howe* test.<sup>28</sup>

It is significant that the third component of the *Howe* formula is the ex-

19. 320 U.S. at 351.

20. 1 L. LOSS, *supra* note 8, at 492-93. Although Professor Loss seemingly adheres to the "substance over form" analysis, he has also stated: "When the ownership of an individual apartment is evidenced by stock in the cooperative, as it usually is, the federal and state securities statutes would seem *literally* to apply." *Id.* (emphasis added). Similarly, Professor Marsh has remarked: "When a stock corporation is used, the Securities Acts literally apply, even though the profit motive is not dominant." R. JENNINGS & H. MARSH, *SECURITIES REGULATION* 300 (3d ed. 1972). *But see Coffey*, *supra* note 11, at 403-07. Indeed, the federal statute states that stock is *not* a security if "the context otherwise requires." 15 U.S.C. §§ 77b, 78c(a) (1970).

21. *See, e.g., C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354 (7th Cir. 1975); *McClure v. First Nat'l Bank*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); *Lino v. City Investing Co.*, 487 F.2d 689 (3d Cir. 1973). *But see* 1050 *Tenants Corp. v. Jakobson*, 503 F.2d 1375 (2d Cir. 1974).

22. 320 U.S. at 352-53.

23. 328 U.S. 293 (1946).

24. *Id.* at 298-99. The Court's test was adopted from the Supreme Court of Minnesota in *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 177 N.W. 937, 938 (1920).

25. The *Howe* Court noted that the term "investment contract" was undefined by the securities acts. 328 U.S. at 298. Left to judicial interpretation, the Court remarked that the term should embody "a flexible rather than a static principle." *Id.* at 299. Professor Loss describes the term "investment contract" as a "catchall." 1 L. LOSS, *supra* note 8, at 483. *See also* Note, *Securities Regulation—Securities Defined—Investor Participation as Limitation on Statutory Definition*, 48 TUL. L. REV. 738, 740 (1974).

26. *See* Long, *An Attempt To Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 143 (1971).

27. *See, e.g., SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974); *SEC v. Brigadoon Scotch Distrib.*, 388 F. Supp. 1288 (S.D.N.Y. 1975); *Rochkind v. Reynolds Sec., Inc.*, 388 F. Supp. 254 (D. Md. 1975). *See also* Long, *supra* note 26, at 143-44.

28. *See generally* Berman & Stone, *Federal Securities Law and the Sale of Condominiums, Homes, and Homesites*, 30 BUS. LAW. 411 (1975); Long, *supra* note 27; Comment, *supra* note 17; Note, *Securities Law—Investment Contracts*, 6 CREIGHTON L. REV. 450 (1973); Note, *Securities Law—Co-Op Apartments—Shares of a Cooperative Housing Corporation Are Securities*, 62 GEO. L.J. 1515 (1974); Note, *supra* note 25.



pectation, not the realization, of profit. The expectation element has been criticized because attention is drawn away from the risk of immediate loss of initial investment by emphasizing the promise of future profits.<sup>29</sup> In addition, the word "profit" itself has created interpretative dilemmas. Although some courts have strictly construed the definition of profit,<sup>30</sup> other courts have avoided a narrow construction in either of two ways. The first method, the "risk capital" analysis, was formulated by the California Supreme Court in *Silver Hills Country Club v. Sobieski*.<sup>31</sup> In that case, a purchaser of a membership in a then-unfinished country club was deemed to have invested in a security, even though he received no interest in the profits of the club. Without a reference to *Howey*, the court emphasized the risk of the purchaser's capital investment rather than any profit he might receive.<sup>32</sup> Although *Silver Hills* was decided under state security laws,<sup>33</sup> it has affected federal<sup>34</sup> as well as other state court decisions.<sup>35</sup> The second approach to a less restrictive construction of the term "profit" involves expanding the term to include "benefit."<sup>36</sup> Thus, using this broader definition, there is

29. See note 32 *infra*.

30. Where investors were promised a fixed fee instead of a share of the profits, some jurisdictions have held there is no profit motivation and hence no security. *Emery v. So-Soft of Ohio, Inc.*, 199 N.E.2d 120 (Ohio Civ. App. 1964); *Pennsylvania Sec. Comm'r v. Consumers Research Consultants, Inc.*, 414 Pa. 253, 199 A.2d 428 (1964); cf. *People v. Syde*, 37 Cal. 2d 765, 768, 235 P.2d 601, 602-03 (1951). This reasoning has been criticized because it fails to view profits from the point of view of the offeree and instead only looks at the balance sheet of the offeror corporation. See *State v. Hawaii Market Center*, 52 Hawaii 642, 485 P.2d 105, 110 (1971). See also Long, *supra* note 26, at 144.

31. 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). However, Professor Long argues that the "risk capital" concept pre-dates *Silver Hills*. See Long, *supra* note 26, at 168-69.

*Silver Hills* has been profusely treated by many legal scholars. See generally Coffey, *supra* note 11; Long, *supra* note 26; Miller, *Cooperative Apartments: Real Estate or Securities?*, 45 B.U.L. REV. 465 (1965); Sobieski, *Securities Regulation in California: Recent Developments*, 11 U.C.L.A.L. REV. 1 (1963); Note, *Securities Regulation: "Beneficial Interest in Title to Property" as a Security*, 50 CALIF. L. REV. 156 (1962).

32. Expanding the *Silver Hills* concept, Professor Coffey contends that the risk to capital investment is the distinguishing feature of a security and that too much emphasis has been placed on the inducement of future profits. See Coffey, *supra* note 11, at 375. See also Note, *Securities—Shares in Cooperative Housing Corporations Subject to Federal Securities Regulations*, 8 SUFFOLK U.L. REV. 1289, 1300 n.45 (1974).

33. CAL. CORP. CODE § 25008 (West 1975).

34. One federal court has approved the risk capital analysis of *Silver Hills*. *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973). Other federal courts have alluded to *Silver Hills* on the risk capital issue, but have avoided adopting the concept as a basis for decision. See, e.g., *Bitter v. Hoby's Int'l, Inc.*, 498 F.2d 183, 185 (9th Cir. 1974); *Nash & Associates, Inc. v. Lum's, Inc.*, 484 F.2d 392, 395 (6th Cir. 1973); *Wieboldt v. Metz*, 355 F. Supp. 255, 258-61 (S.D.N.Y. 1973); *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640, 646-47 (D. Colo. 1970), *aff'd*, 460 F.2d 666 (10th Cir. 1972). At least one court has expressly rejected *Silver Hills*. *L.H.M., Inc. v. Lewis*, 371 F. Supp. 395, 397 (D.N.J. 1974).

35. The Supreme Court of Hawaii has accepted the *Silver Hills* analysis. *State v. Hawaii Market Center, Inc.*, 52 Hawaii 642, 485 P.2d 105, 109-10 (1971). At least two courts have held that the *Silver Hills* analysis is compatible with *Howey*. *Gibbs v. State*, 209 S.E.2d 691, 695-96 (Ga. Civ. App. 1974); *State v. Consumer Business System, Inc.*, 482 F.2d 549 (Ore. Civ. App. 1971).

36. From an economic standpoint, "profit" is anything that increases one's satisfaction or utility—the benefit does not need to be monetary in nature. See generally P. SAMUELSON, *ECONOMICS* 618-26 (9th ed. 1973). The expansion of the term "profit" occurs most often in the context of housing cooperatives. See, e.g., *State ex rel. Russel v. Sweeny*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961); *Pine Grove Manor, Inc. v. Director*, 68 N.J. Super. 135, 151, 171 A.2d 676, 685 (N.J. App. 1961); Com-

support for the position that stock in a housing cooperative is a "security" because the investor is benefited by the use of an apartment, and other advantages such as lower rental rates and certain tax deductions.<sup>37</sup>

The obscurity of definition of the "profit" element is apparent when considering whether stock in a housing cooperative is a "security." Not only is the tension heightened between the "substance over form" concept and the "literal approach," but *Howey's* requirement of an "expectation of profit" must be squarely confronted. The few state courts that faced this issue held that stock in a housing cooperative is not a "security."<sup>38</sup> The thrust of these decisions was that the purchase of stock in a housing cooperative is motivated by homeownership, similar to an ordinary real estate transaction rather than an investment with a view toward profit.<sup>39</sup>

The Securities Exchange Commission took an ambiguous position as to whether shares of stock in housing cooperatives are securities. SEC rule 235 exempts cooperative housing transactions from the registration requirement under certain conditions.<sup>40</sup> It has been argued that rule 235 negatively implies that cooperative housing stock is a security, since the SEC would not have exempted a particular transaction unless it was thought to be a security.<sup>41</sup> However, SEC Securities Act Release No. 5347 concerning residential real estate offerings casts considerable doubt on the negative implication argument.<sup>42</sup> The release sets forth guidelines to distinguish between those housing arrangements entered into for investment versus those simply for living purposes, the latter not being encompassed by the securities laws. Al-

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monwealth v. 2101 Cooperative, Inc., 183 A.2d 325 (Pa. 1962); State *ex rel.* Troy v. Lumberman's Clinic, 186 Wash. 384, 58 P.2d 812 (1936); *cf.* Davenport v. United States, 260 F.2d 591 (9th Cir. 1958); Ashton v. Thornley Realty Co., 346 F. Supp. 1294, 1301 (S.D.N.Y. 1972), *aff'd*, 471 F.2d 647 (2d Cir. 1973).

37. See Miller, *supra* note 31, at 481. At least one commentator has speculated that "a cooperative housing corporation share is a 'security' and is within the ambit of federal securities regulation." Note, *Cooperative Housing Corporation and the Federal Securities Laws*, 71 COLUM. L. REV. 118, 132 (1971). However, Professor Miller has indicated that, "so long as profit does not mean benefit (as it has not) and so long as profit is the often unspoken but essential element of motivation in securities sales and purchases, federal securities law should not apply." Miller, *supra* note 31, at 496. See also Note, *Securities Law—Co-Op Apartments—Shares of a Cooperative Housing Corporation Are Securities*, 62 GEO. L.J. 1515, 1529 (1974).

38. Only three state courts have dealt with this specific issue. Willmont v. Tellone, 137 So. 2d 610 (Fla. App. 1962); Brothers v. McMahon, 351 Ill. App. 321, 115 N.E.2d 116 (1953); State v. Silberberg, 166 Ohio St. 101, 139 N.E.2d 342 (1956). However, *McMahon* is of questionable validity within Illinois. See Note, *Cooperative Housing Corporations and the Federal Securities Laws*, 71 COLUM. L. REV. 118, 130 n.38 (1971). See generally Miller, *supra* note 31, at 474-86. At least one federal court has held that shares of stock in a housing cooperative constitute a security. 1050 Tenants Corp. v. Jakobson, 503 F.2d 1975 (2d Cir. 1974).

39. See generally Miller, *supra* note 31, at 474-86; Note, *supra* note 38, at 128-32. The "risk capital" and "benefit" analyses are not necessarily mutually exclusive. For example, if "profit" is viewed as synonymous with "benefit," then some "profit" can be ascertained in the *Silver Hills* transaction. See Coffey, *supra* note 11, at 403; Note, *Franchise Sales: Are They Sales of Securities?*, 34 ALBANY L. REV. 383, 390 (1970). However, Professor Miller argues that the "risk" analysis replaces the "profit" test. See Miller, *supra* note 32, at 478. See also Note, *supra* note 38, at 130.

40. 17 C.F.R. §§ 230, 235 (1973).

41. Note, *supra* note 38, at 127. But see 1 L. Loss, *supra* note 9, at 493-94.

42. Some commentators have argued that the exemption was devised by the SEC to avoid the cooperative housing issue. See Zammit, *Securities Law Aspects of Cooperative Housing*, 169 N.Y.L.J., Jan. 8, 1973, at 1; SEC Securities Act Release No. 5347 (Jan. 4, 1973).

though the release primarily pertained to condominiums, traditionally a distinct realty concept, some commentators contended that condominiums and cooperatives are virtually identical.<sup>43</sup> Thus, its effect on housing cooperatives was unclear.<sup>44</sup> Against this background of the enigmatic concept of "profit," and an ambiguous position by the SEC, the time was ripe for the Supreme Court to decide whether shares of stock in a nonprofit housing cooperative are securities within the scope of the federal securities laws.<sup>45</sup>

## II. UNITED HOUSING FOUNDATION, INC. v. FORMAN

The Supreme Court, in holding that shares of stock in a state subsidized and supervised nonprofit housing cooperative are not "securities," based its decision on two primary determinations. Initially, the Court revalidated the axiom that form should be disregarded for substance.<sup>46</sup> Holding for the first time that a certain transaction was *not* a security, the Supreme Court used the "substance over form" analysis to preclude, rather than evoke,<sup>47</sup> application of the securities acts. Writing for the majority, Justice Powell rejected the "literal approach" because of its incompatibility with the "substance over form" concept.<sup>48</sup> The Court recognized that the intent of Congress was to apply the securities laws to economic transactions, and that the application of the laws should "turn on the economic realities underlying a transaction," and not on the name.<sup>49</sup>

The second, and more significant determination by the Court was that shares of stock in a nonprofit housing cooperative do not constitute "invest-

43. See Berman & Stone, *supra* note 28, at n.49; Parness, *Stock in Cooperative Apartment Corporation as a Security Under Federal Securities Laws*, 9 REAL PROP., PROB. & TR. J. 259, 264-65 (1974). See generally Rohen, *The Securities Law Implications of Condominium Marketing Programs Which Feature a Rental Pool*, 2 CONN. L. REV. 1 (1969).

44. The release states, "Although this release speaks in terms of condominiums it applies to offerings of all types of units in real estate developments which have characteristics similar to those described herein." Release No. 5347, *supra* note 42. The Commissioner, at one point in the release, uses the phrase "cooperative unit." *Id.* See Berman & Stone, *supra* note 28, at 424-25; Note, *Securities Law—Co-Op Apartments—Shares of a Cooperative Housing Corporation Are Securities*, 62 GEO. L.J. 1515, 1528 n.65 (1974).

45. Congress also has begun to awaken to the securities problems surrounding condominiums and cooperatives as evidenced by its commissioning the Department of Housing and Urban Development to study the need and feasibility of federal regulation. See Housing and Community Development Act of 1974, Pub. L. No. 93-383, § 821 (Aug. 22, 1974). See also Note, *Securities Regulation—Shares of a State-Subsidized Nonprofit Cooperative Housing Corporation Are Securities Under Federal Securities Laws*, 53 TEXAS L. REV. 623, 634 n.56 (1975).

46. 95 S. Ct. at 2058, 44 L. Ed. 2d at 630.

47. See, e.g., *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943). However, some circuit courts have held certain instruments not to be securities. See, e.g., *McClure v. First Nat'l Bank*, 497 F.2d 490, 494-95 (5th Cir. 1974); *Bellah v. First Nat'l Bank*, 495 F.2d 1109, 1113-14 (5th Cir. 1974). *But cf.* *Continental Mktg. Corp. v. SEC*, 387 F.2d 466, 470-71 (10th Cir. 1967), *cert. denied*, 391 U.S. 905 (1968); *Penfield Co. v. SEC*, 143 F.2d 746, 750-51 (9th Cir.), *cert. denied*, 323 U.S. 768 (1944); *Lino v. City Investing Co.*, 487 F.2d 689, 694 (3d Cir. 1973).

48. 95 S. Ct. at 2058-59, 44 L. Ed. 2d at 630-31.

49. *Id.* at 2059, 44 L. Ed. 2d at 630. Writing for the dissent, Justice Brennan, joined by Justices Douglas and White, referred to the *Joiner* dictum in adhering to the "literal approach." 95 S. Ct. at 2067, 44 L. Ed. 2d at 639-40 (Brennan, J., dissenting). See notes 18-21 *supra* and accompanying text.

ment contracts" as defined by the *Howey* test.<sup>50</sup> Reaffirming the *Joiner* and *Tcherepnin* definitions of profit,<sup>51</sup> the Court placed greatest emphasis on the presence or absence of a profit motive in determining that this stock was not a security. The Court examined the aggregate characteristics of the cooperative's stock, determining that the motivation of purchasers was solely to acquire subsidized low-cost living spaces.<sup>52</sup>

By stressing the motivation of the purchaser in respect to profit expectation, the Court could have concluded its decision by holding that the *Howey* test of expectation of profit was not met because Riverbay stock was not an investment for profit.<sup>53</sup> Instead, the Court went on to refine the definition of profit as it applies to the investment contract concept. First, the Court found that the deductibility for tax purposes of the portion of the monthly rental charge applied to interest on the mortgage did not constitute "profit."<sup>54</sup> The Court held next that savings in rent could not properly be considered an appropriate "theory of 'profits'" because the benefit could not be liquidated into cash.<sup>55</sup> Third, the possibility of net income derived from leasing commercial facilities was considered. The Court hesitantly admitted that this may have been a form of "profit," but even if it had been, it was "far too speculative and insubstantial" to bring the transaction within the securities acts.<sup>56</sup>

These three findings have the potential of substantially affecting securities law. Profit undoubtedly means more than mere non-pecuniary benefit,<sup>57</sup> since even some forms of economic benefit, such as rental savings and tax deductions, do not satisfy *United Housing's* definition of "profit."<sup>58</sup> But the Court indicated that even income which is found to be profit, if it is "too speculative and insubstantial," does not come within the scope of the securities laws.<sup>59</sup> The "speculative and insubstantial" finding is especially significant in that it departs from the literal language of *Howey*. The Court under-

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50. *Id.* at 2060, 2062, 44 L. Ed. 2d at 632, 634; see note 24 *supra* and accompanying text.

51. "By profits, the Court has meant either capital appreciation resulting from the development of the initial investment [*Joiner*] . . . or a participation in earnings resulting from the use of investors' funds [*Tcherepnin*] . . ." 95 S. Ct. at 2060, 44 L. Ed. 2d at 632.

52. *Id.* at 2060, 44 L. Ed. 2d at 631-32. The ambiguous stance of the SEC as to whether "stock" of this nature is a "security," was further complicated by the SEC's amicus brief, urging the Court to find the federal securities laws applicable to this case. See notes 40-44 *supra* and accompanying text. Taking note of the SEC's inconsistent position, the Court refused to give any significance to the Commission's brief. 95 S. Ct. at 2063-64 n.24, 44 L. Ed. 2d at 635-36 n.24.

53. See note 24 *supra* and accompanying text.

54. 95 S. Ct. at 2062, 44 L. Ed. 2d at 634. This tax deduction is available through INT. REV. CODE OF 1954, § 216. Although the court of appeals held tax deductions were a form of "profit," 500 F.2d at 1254, the legislative history of the Code indicates that these deductions were incident to home ownership, not investment. See Note, *supra* note 44, at 1522-23.

55. 95 S. Ct. at 2062, 44 L. Ed. 2d at 634.

56. *Id.* The dissent centered on this issue, Justice Brennan contending that Riverbay, as a lessor of commercial and office space, was gathering substantial revenues, therefore enabling the corporation to curb spiraling rental rates. 95 S. Ct. at 2064-65, 44 L. Ed. 2d at 637. The dissent also argued that tax benefits are a form of "profit." *Id.* at 2064-65, 44 L. Ed. 2d at 637-38.

57. See notes 36, 37 *supra* and accompanying text.

58. See notes 36-39 *supra* and accompanying text.

59. 95 S. Ct. at 2062, 44 L. Ed. 2d at 634.

took to place quantitative limits on the profit requirement which are in no way suggested in *Howey*.

Finally, the Court took note of the risk capital concept,<sup>60</sup> but declined to discuss its validity. Justice Powell remarked that even if the Court were willing to adopt that test, it would be inapplicable because the purchasers of apartments in Co-Op City took no significant risk.<sup>61</sup> Although the Supreme Court disclaimed any position on the validity of the risk capital test, it is clear that the Court's focus was upon motivation of investment and the nature of profit, not upon the risk to initial investment, in determining that Riverbay stock was not a security.

### III. CONCLUSION

The extraordinary growth of the antifraud provisions of the securities acts<sup>62</sup> has accelerated the definitional expansion of a "security." The only reason the plaintiffs in *United Housing* desired to have Riverbay "stock" treated as a "security," was to obtain the protection of the federal securities laws. Both *United Housing* and its companion case, *Blue Chip Stamps v. Manor Drug Stores*,<sup>63</sup> indicate a developing conservative trend of the present Court in the field of securities law. Although fear of the expansion of the antifraud provisions was not treated, the Court is clearly limiting the number of persons who will be afforded the protection of the federal securities laws.

The holding of *United Housing* sets forth for the first time criteria for determining what is *not* a security. The Second Circuit had erroneously reasoned that the "substance" of the commercial transaction was being scrutinized when it found Riverbay stock to be a "security." The Supreme Court re-examined the "substance over form" analysis and concluded that the "economic reality" of Riverbay stock was something different from what the circuit court found it to be. Although the Court recognized that the term "security" is to be broadly interpreted, it nonetheless placed some limits on a concept which had at times seemed unbounded. The Court's willingness to delineate the profit requirement may extend to the other elements of *Howey* as well. The impact of *United Housing* will be minimized if courts, by limiting the case to its facts, stress the government supported and nonprofit foundation aspects of the decision. In any event, *United Housing* casts a new light on the continually developing body of law concerning the definitional complexities of a security, and may mark the beginning of a period in which the heretofore expanding concept of securities begins to stabilize.

*Robert Thompson Mowry*

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60. See notes 31-35 *supra* and accompanying text.

61. 95 S. Ct. at 2063 n.23, 44 L. Ed. 2d at 635 n.23.

62. See generally A. BROMBERG, *supra* note 10.

63. 95 S. Ct. 1917, 44 L. Ed. 2d 539 (1975); see Note, *Blue Chip Stamps v. Manor Drug Store: Affirmation of the Birnbaum Doctrine*, p. 951 *supra*.