VOLUME 1967 MAY NUMBER 2

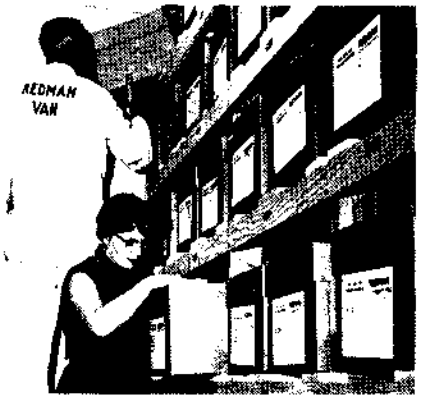
UTAH LAW REVIEW

UNIVERSITY OF UTAH COLLEGE OF LAW

Your Business Records

BEFORE

– and happy ever –



AFTER

With business becoming increasingly more complex, the retention of business records is one of today's most important business functions. REDMAN'S BUSINESS RECORDS CENTER was established with this in mind. To provide convenient and economical facilities where records of insurance companies, banks, statistical houses, sales organizations, manufacturer, medical offices, etc., may be maintained, consulted, even destroyed if required.

REDMAN

SALT LAKE • OGDEN

UTAH LAW REVIEW

VOL. 1967 MAY NO. 2

EDITORIAL OFFICES: The *Utah Law Review* is published at the University of Utah College of Law, Salt Lake City, Utah 84112 by the Utah Law Review Society. Second-class postage paid at Salt Lake City, Utah. All communications should be sent to the editorial offices.

SUBSCRIPTIONS: The *Utah Law Review* is published four times a year in March, May, July, and December. The subscription rate is $8 per year.

UNIVERSITY OF UTAH
COLLEGE OF LAW FACULTY

AARON, RICHARD I. (1966), Assistant Professor of Law. A.B., 1959, Harvard University; J.D., 1962, University of Wisconsin.

ANDERSEN, JERRY R. (1963), Associate Professor of Law. B.S.L., 1955, J.D., 1957, University of Utah.

BENNETT, WALLACE R. (1953), Associate Dean of the College of Law and Professor of Law. B.A., 1949, M.S., 1950, J.D., 1953, University of Utah; LL.M., 1957, Harvard University; LL.M. (Trade Regulations), 1963, New York University.

BOYCE, RONALD N. (1966), Clinical Associate Professor of Law. B.S.L., 1955, J.D., 1957, University of Utah.

EMERY, ALFRED C. (1947), Provost and Professor of Law. B.S., 1940, J.D., 1947, University of Utah.

FIRMAGE, EDWIN B. (1966), Assistant Professor of Law. B.S., 1960, M.S., 1962, Brigham Young University; J.D., 1963, LL.M., 1964, S.J.D., 1964, University of Chicago.

FLYNN, JOHN JOSEPH (1963), Assistant Professor of Law. B.S., 1958, Boston College, LL.B., 1961, Georgetown University.

FRANKEL, LIONEL H. (1966), Associate Professor of Law. B.A., 1953, Ursinus College; LL.B., 1956, Yale University.

JENSEN, A. LADRU (1926–1964), Professor Emeritus of Law. A.B., 1917, Brigham Young University; M.A., 1924, J.D., 1925, University of California.

LOCKHART, WILLIAM J. (1964), Assistant Professor of Law. B.A., 1955, J.D., 1961, University of Minnesota.

MAZOR, LESTER J. (1962), Associate Professor of Law. A.B., 1957, LL.B., 1960, Stanford University.

NIELSEN, ARTHUR H. (1950), Lecturer in Law, 510 Newhouse Bldg. J.D., 1937, University of Utah.

SCHMID, ROBERT L. (1954), Law Librarian with the rank of Associate Professor, J.D., 1954, University of Utah; M.L.L., 1956, University of Washington.

STEWART, I. DANIEL, JR. (1965), Assistant Professor of Law. B.A., 1959, J.D., 1962, University of Utah.

SWENSON, ROBERT W. (1953), Professor of Law. B.S.L., 1940, J.D., 1942, University of Minnesota.

THODE, E. WAYNE (1965), Professor of Law. B.S., 1943, University of Illinois; LL.B., 1950, University of Texas; S.J.D., 1964, Harvard University.

THURMAN, SAMUEL D. (1962), Dean of the College of Law and Professor of Law. A.B., 1935, University of Utah; LL.B., 1939, Stanford University.

VAN ALSTYNE, ARVO (1966), Professor of Law. B.A., 1943, LL.B., 1948, Yale University.

UTAH LAW REVIEW

VOL. 1967 MAY No. 2

TABLE OF CONTENTS

ARTICLES

NOTES

CASES NOTED

PRINTED IN THE UNITED STATES OF AMERICA

Published by the Utah Law Review Society, College of Law, University of Utah, Salt Lake City, Utah, and the University of Utah Press. Price: $2.00 per issue. If the subscriber wishes his subscription discontinued at its expiration, notice should be sent; otherwise, it is assumed that continuation is desired.

The *Wagon Mound No. 2* - Foreseeability Revised

*By Leon Green**

The judgments delivered by the Privy Council in the two *Wagon Mound* cases[1] have given new direction to the English common law of negligence and nuisance and, if approved by the House of Lords, will be of considerable importance to American courts. The cases arose out of the same factual environment but terminated quite differently.

While the ship was taking on fuel oil at the Caltex Wharf in Sydney Harbor, the engineers of the *Wagon Mound* allowed a great quantity of oil to be spilled on the water, and within a few hours it had drifted and accumulated around nearby Sheerlegs Wharf where the wharf owners, the Morts Dock Company, were engaged in oxy-acetylene welding and cutting in the course of repairing two vessels. During the welding operations pieces of hot metal frequently flew off and fell into the water. When the manager of the dock company saw the thick scum of oil around the wharf he stopped the work and consulted with the manager of Caltex about the danger of igniting the oil. He was assured that it was safe to proceed with the repair work, which was accordingly continued for two days until the oil became ignited and set fire to the wharf and the two vessels. How the oil was ignited was not definitely established, but it was accepted by the courts that some object which supported inflammable material was floating on the oil-covered water and that a hot piece of metal fell on the object and burned the material, which in turn ignited the oil.

In the first case the dock company instituted action in the Supreme Court of New South Wales against the ship *Wagon Mound* for the injury to the wharf, basing the action on both negligence and nuisance. Judgment for plaintiff on the negligence count was given in the trial court on the authority of *In re Polemis*.[2] Appeal to the full court was dismissed and further appeal was made to the Privy Council. The Privy Council rejected *Polemis* as bad law and dismissed the action of negligence,[3] but it did not consider the nuisance branch of the case other than to remand it to the Supreme Court of New South Wales where it has not been further pressed.

The plaintiffs in *Wagon Mound No. 2* were the owners of the vessels which were undergoing repair at the Sheerlegs Wharf. They based their claims on nuisance and negligence and were awarded substantial recoveries in the trial court, the Supreme Court of New South Wales (Walsh, J.), on

---

* Professor of Law, University of Texas, Austin, Texas.

[1] Overseas Tankship (U.K.) Ltd. v. Morts Dock & Eng'ring Co., [1961] A.C. 388 (P.C.) (Austl.) (The Wagon Mound No. 1); Overseas Tankship (U.K.) Ltd. v. Miller Steamship Co., [1966] 3 W.L.R. 498 (P.C.) (Austl.) (The Wagon Mound No. 2).

[2] [1921] 3 K.B. 560 (C.A.). *Polemis* and *Wagon Mound No. 1* are considered at some length in L. Green, *Foreseeability in Negligence Law*, 61 COLUM. L. REV. 1401 (1961), in THE LITIGATION PROCESS IN TORT LAW 283 (1965).

[3] Overseas Tankship (U.K.) Ltd. v. Morts Dock & Eng'ring Co., [1961] A.C. 388 (P.C.) (Austl.) (The Wagon Mound No. 1).

the nuisance count, but the count for negligence was dismissed, probably on the basis of the judgment of the Privy Council in *Wagon Mound No. 1.* The defendant appealed the decision based on nuisance, and plaintiffs appealed the decision based on negligence.

The findings of the trial judge are essential to the discussion of the judgment of the Privy Council (the Board[4]) delivered by Lord Reid reversing the judgment of the trial court on both counts but affirming for the plaintiffs the judgment for the damages assessed.[5] The findings of the trial judge were given in part as follows:

> (1) Reasonable people in the position of the officers of the *Wagon Mound* would regard the furnace oil as very difficult to ignite upon water. (2) Their personal experience would probably have been that this had very rarely happened. (3) If they had given attention to the risk of fire from the spillage, they would have regarded it is a possibility, but one which could become an actuality only in very exceptional circumstances. (4) They could have considered the chances of the required exceptional circumstances happening whilst the oil remained spread on the harbour waters as being remote. (5) I find that the occurrence of damages to the plaintiff's property as a result of the spillage was not reasonably foreseeable by those for whose acts the defendant would be responsible. . . . (8) having regard to those findings, and because of finding (5), I hold that the claim of each of the plaintiffs, framed in negligence, fails.[6]

Nuisance

The judgment of Walsh, J., on nuisance was based on the proposition that the spillage of the oil constituted a public nuisance, and the plaintiffs, by showing damages special or peculiar to them beyond injury to the public generally, were entitled to recover their losses. The judge's only problem was whether the losses for which damages could be recovered were required to be based on *foreseeability* or could be sustained on the basis of having been *direct.* He held that the losses were a direct result of defendant's having created a nuisance from which the fire originated and that foreseeability of the losses was not required. The Privy Council held that he was in error — that foreseeability was required in determining the extent of liability (which the council calls *measure of damages*) in nuisance as well as in negligence cases, but that under the evidence the defendant could have foreseen the damage to the vessels resulting from the spillage of the oil and was liable for negligence. The Council based its seeming rejection of its holding in

[4] Overseas Tankship (U.K.) Ltd. v. Miller Steamship Co., [1966] 3 W.L.R. 498, 502 (P.C.) (Austl.). Lord Reid speaks of the judgment of the Board. "Privy Council" is used here as a substitute for "Board."

[5] Overseas Tankship (U.K.) Ltd. v. Miller Steamship Co., [1966] 3 W.L.R. 498 (P.C.) (Austl.). This practice is sought to be explained by L. H. Hoffmann in his note in 83 L.Q. Rev. 13 (1967). Apparently under their Lordships' decision plaintiffs were entitled to recover damages on either nuisance or negligence, and the trial court had merely erred in stating the nuisance theory, and in rejecting the negligence theory as available under the facts of the case.

[6] Overseas Tankship (U.K.) Ltd. v. Miller Steamship Co., [1966] 3 W.L.R. 498, 503 (P.C.) (Austl.).

Wagon Mound No. 1 on the ground that the evidence of negligence was not fully developed in the earlier case as it was in *Wagon Mound No. 2*.[7]

Their Lordships' rationalization of the dual holdings on the law is quite significant. Their own examination of the nuisance decisions disclosed that the cases were not decisive of the validity of the conclusion reached by Walsh, J.; that there was a close kinship between nuisance and negligence; that the later cases, including *Wagon Mound No. 1*,[8] had rejected "direct" and accepted "foreseeability"of the losses as the *measure of damages* in negligence cases; that many nuisance cases were based on negligent conduct, and in such cases *foreseeability was essential to the measure of damages*; and finally their conclusion:

> It could not be right to discriminate between different cases of nuisance so as to make foreseeability a necessary element in determining damages in those cases where it is a necessary element in determining liability, but not in others. So the choice is between it being a necessary element in all cases of nuisance or in none. . . . It is not sufficient that the injury suffered by the respondents' vessels was the direct result of the nuisance if that injury was in the relevant sense unforeseeable.[9]

It is to be emphasized that the Privy Council made a distinction between the use of foreseeability as a test of *liability* and as an essential for the *measure of damages*. Only in determining the measure of damages were all nuisance cases, including those not based on negligent conduct, ruled by foreseeability.

NEGLIGENCE

In order to distinguish the basis of the judgment in *Wagon Mound No. 1*, the Privy Council examined the correctness of Walsh's finding that the "damage to the plaintiffs' property as a result of the spillage was not reasonably foreseeable by those for whose acts the defendant would be responsible." It was held that this was not a primary finding, but an inference or conclusion from his other findings.[10] The argument probably too severely discounts Walsh's findings.[11]

In *Wagon Mound No. 1* it was said that the Privy Council was not concerned with degrees of foreseeability because the finding was that the fire was

---

[7] *Id.* at 509–10.

[8] Cases cited note 1 *supra*. The Council also approved Hughes v. Lord Advocate, [1963] A.C. 837.

[9] Overseas Tankship (U.K.) Ltd. v. Miller Steamship Co., [1966] 3 W.L.R. 498, 509 (P.C.) (Austl.).

[10] *Id.* at 509–10.

[11] The Council stated:

> The vital parts of the findings of fact . . . are (1) that the officers of the *Wagon Mound* "would regard furnace oil as very difficult to ignite upon water" — not that they would regard this as impossible; (2) that their experience would probably have been "that this had very rarely happened" — not that they would never have heard of a case where it had happened, and (3) that they would have regarded it as a "possibility, but one which could become an actuality only in very exceptional circumstances" — not as in *The Wagon Mound (No. 1)*, that they could not reasonably be expected to have known that this oil was capable of being set afire when spread on water. The question which must now be determined is whether these differences between the findings in the two cases do or do not lead to different results in law.

Id. at 510.

not foreseeable at all, while in *Wagon Mound No. 2* the findings show that at least some risk of fire would have been realized by a reasonable man in the shoes of the vessels' engineers. So the question postulated is the precise meaning to be attached in this context to the words "foreseeable" and "reasonably foreseeable."[12] The Privy Council answered its own inquiry thusly:

> But it does not follow that, no matter what the circumstances may be, it is justifiable to neglect a risk of such a small magnitude. A reasonable man would only neglect such a risk if he had some valid reason for doing so, e.g., that it would involve considerable expense to eliminate the risk. . . .
>
> In the present case there was no justification whatever for discharging the oil into Sydney Harbour. Not only was it an offense to do so, but it involved considerable loss financially. If the ship's engineer had thought about the matter, there could have been no question of balancing the advantages and disadvantages. From every point of view it was both his duty and his interest to stop the discharge immediately.
>
> It follows that in their Lordships' view the only question is whether a reasonable man having the knowledge and experience to be expected of the chief engineer of the *Wagon Mound* would have known there was a real risk of the oil on the water catching fire in some way: if it did, serious damage to ships or other property was not only foreseeable but very likely.[13]

The Privy Council then rejected the proposition "*that if a real risk can properly be described as remote it must then be held to be not reasonably foreseeable.*"[14] Instead it postulated its *damage* formula in these terms:

> If a real risk is one which would occur to the mind of a reasonable man in the position of the defendant's servant and which he would not brush aside as far-fetched, and if the criterion is to be what that reasonable man would have done in the circumstances, then surely he would not neglect such a risk if action to eliminate it presented no difficulty, involved no disadvantage, and required no expense.[15]

What Was the Issue in *Wagon Mound No. 2*?

Causal relation between the spillage of the oil in Sydney Harbor and the fire damage to plaintiffs' vessels presented no issue. The *duty* to refrain from creating a public nuisance by spilling the oil in the harbor was not subject to question. The *negligence* of the *Wagon Mound* engineers in allowing the oil to spill in such quantities with respect to the peril created by fire for the plaintiffs' vessels was readily resolved by the Privy Council. Plaintiffs' losses were apparently not contested.

The issues left in doubt were: (1) Did *Wagon Mound's* duty to prevent the oil from spilling in the harbor include the risk of injury to plaintiffs' vessels by fire?; and (2) how should the plaintiffs' losses be evaluated? Inasmuch as the judgment rendered by the trial court was affrmed by the Privy Council, the evaluation of the losses raised no problem on appeal. Thus, under the findings only a single basic issue was presented for resolution in

---

[12] *Id.*

[13] *Id.* at 511.

[14] *Id.* at 512 (emphasis added).

[15] *Id.* at 512.

Wagon Mound No. 2. That issue was whether the duty owed by *Wagon Mound* to the plaintiffs with respect to the spillage of the oil included the risk of injury to their vessels by the burning oil. For a long period of time the English courts have considered such an issue as being one of remoteness.[16] However, the Privy Council rejected remoteness as the ultimate test of the extent of liability, which it calls the measure of damages, and held that although there be remoteness, if the risk is real though small, the measure of damages is to be determined on the basis of foreseeability.

HOW DETERMINE THE EXTENT OF LIABILITY?

The extent of liability, or limitation on liability, presents the same problem in tort as it does in contract or under statute. The ultimate question in each is against what risks does a common law tort rule, contract, or statute give the plaintiff protection and impose liability on the defendant for the losses which resulted from the violation of the defendant's duty? In the particular case "duty" has a highly significant meaning; namely, does the legal rule (tort, contract, or statute) on which the plaintiff bases his claim give the plaintiff protection against the risk of loss or losses he has suffered?[17] Once the factual data have been determined, whether by judge or by jury, the problem is for the judge (court) to determine which losses of those sustained fall within the scope or coverage of the defendant's duty, whether under the common law tort rule, or under the contract or statute which the defendant has violated. The "measure of damages" can only arise after the losses that fall within the scope or coverage of the defendant's duty have been determined, and in *measuring* and *evaluating* the losses for which the defendant will be held liable "foreseeability" is irrelevant. Whether certain items of loss fall within or without defendant's duty in a particular case usually requires the consideration of conflicting policies. Foreseeability may or may not be relevant at this point but if it is, its weight is usually slight as compared with the policy factors involved. There is no formula that automatically enables the court in the exercise of this function to include or exclude items of loss. Judgment may be guided by former judgments in analogous cases, but usually the factual data are so variable that a fresh judgment must be made in nearly all important cases.

Common law courts have never ceased in their efforts to develop a formula that would relieve them from the difficulties of determining the extent of liability in negligence cases. The terms "natural," "probable," "direct,"

[16] *See* J. FLEMING, THE LAW OF TORTS 178–213 (2d ed. 1961).

[17] In H. R. Moch Co. v. Rensselaer Water Co., 247 N.Y. 160, 159 N.E. 896 (1928), the plaintiff whose building had been destroyed by fire sought to recover damages against the water company for negligent failure to supply adequate water after it knew plaintiff's building was in danger of being destroyed. Plaintiff relied on three theories of liability: (1) defendant's contract with the city to supply water for fire protection, (2) its common law duty, having undertaken to supply water for such purpose, and (3) its duty under the New York statute. Chief Justice Cardozo held that "the law did not spread its protection so far" under any one of the theories. The foreseeability of harm, the contemplation of the parties under Hadley v. Baxendale 156 Eng. Rep. 145 (Ex. 1854), and the intent or purpose of the statute availed plaintiff nothing.

"proximate," "remote," "foreseeable," and many combinations of these and kindred terms have been formulated into tests for this purpose. None of them has saved the courts in difficult cases from the agony of using their cultivated good sense. The formulas seem to give aid when they are not needed but only intensify despair when judgment becomes difficult. In *Wagon Mound No. 2*, for example, the liability for the loss incurred by the plaintiffs due to the burning of their vessels was so clearly within the scope of defendant's duty to refrain from spilling a great quantity of oil in Sydney Harbor that the Privy Council required no formula to reach its judgment. Lord Reid implied as much: "From every point of view it was both his [the ship's engineer's] duty and his interest to stop the discharge immediately."[18] And in so holding it may be suggested that what the Privy Council determined in *Wagon Mound No. 1* was not a *measure of damages* or the extent of liability, but was instead the vital issue of negligence[19] which was resolved against the plaintiff in *Wagon Mound No. 1*. Once the issue of negligence was determined, the battle was over; no foreseeability was required to determine the damages. Lord Reid's formula may be nothing more than the general formula employed in determining liability in negligence cases, revised to meet the peculiar facts of *Wagon Mound No. 2*.

In order to suggest the irrelevance of "foreseeability" as a determinant of the extent of liability when the judgment to be reached is not so obvious, the following hypotheticals are imposed on *Wagon Mound No. 2*: Suppose one of the plaintiffs owned one of the vessels and was also its captain and owned part of the cargo. In the captain's quarters, destroyed by fire, were his very extravagant wardrobe, a diamond-studded pistol, a valuable stamp collection, a master's painting he had picked up in a foreign port, and a precious Stradivarius which afforded him many enjoyable evenings. He is given recovery for the loss of his vessel. For what items of those destroyed by the fire, including his part of the cargo, may he recover damages? How would Lord Reid's formula operate in extending or limiting the defendant's liability for the loss of these items, and what would be the chances of the shippers and consignees of the other part of the cargo of recovering their losses?

---

[18] Overseas Tankship (U.K.) Ltd. v. Miller Steamship Co., [1966] 3 W.L.R. 498, 511 (P.C.) (Austl.). And he added: "It follows that in their Lordships' view the only question is whether a reasonable man having the knowledge and experience to be expected of the chief engineer of the *Wagon Mound* would have known that there was a real risk of the oil on the water catching fire in some way: if it did, serious damage to ships or other property was not only foreseeable but very likely." *Id.* This would seem to be the very heart of the negligence formula.

[19] Inasmuch as the English courts have dispensed with juries in negligence cases, the judges in exercising this function make use of the foreseeability formula as something different from the use of foreseeability as a measure of damages, though the formulas are so similar that it is frequently difficult to guess which formula is being used and for what purpose. Denning, L.J., in King v. Phillips, [1953] 1 Q.B. 429 (C.A.), although a case different from that here under discussion, notes the ambiguities in foreseeability. The Privy Council recognizes in its approval of Hughes v. Lord Advocate, [1963] A.C. 837, "that in such cases damages can only be recovered if the injury complained of was not only caused by the alleged negligence but also was an injury of a class or character foreseeable *as a possible result of it*." Overseas Tankship (U.K.) Ltd. v. Miller Steamship Co., [1966] 3 W.L.R. 498, 506 (P.C.) (Austl.) (emphasis added).

FORESEEABILITY FORMULA REVISED

The judgment of the Privy Council in *Wagon Mound No. 2* is highly significant in that it revises and broadens the foreseeability formula heretofore utilized by the English courts whether used as a basis of duty, the extent of duty, or its violation. It accomplishes this revision by the addition of certain "policy" terms such as "a real risk," "balancing the advantages and disadvantages," and "no expense." Inasmuch as the Council viewed the case from "hindsight" (as must all courts in other cases), it could read into "foreseeability" whatever good policy demanded in order to place the risk of burning the plaintiffs' vessels upon the defendant. In fact it could not have avoided doing so because of the impossibility of putting itself in the attitude of a "reasonable man," considering what he should have foreseen before anything had actually happened, and at the same time forgetting what it knew had already happened. Viewing what defendant did and the losses plaintiffs suffered, the judges could not escape considering what *ought to be* a just adjustment as between the parties. English judges have considered "policy" a "wild horse" which they have been hesitant to mount and have remained pedestrian in their adherence to the well worn paths of legal terminology in the exercise of their lawmaking function. More recently, however, there has been demonstrated a noticeable tendency to expand this function by revising doctrinal formulas as was done here.[20]

By way of contrast, American judges have in this century openly accepted the responsibility of removing many of the limitations on liability in negligence cases imposed by their predecessors during the nineteenth century.[21] Some American courts, however, are quite satisfied to bring policy considerations to bear on modern problems through the expansion of old formulas as was done by the Privy Council in *Wagon Mound No. 2*. Other courts, not understanding this technique of camouflage, continue to ignore policy considerations and have consequently reached weird results in numerous cases. No better example can be found than the wide use of a mass of unintelligible causation doctrines tied to foreseeability as a prerequisite.[22] This double screening through the bankrupt terminology of negligence law

[20] Hedley Byrne & Co. v. Heller, [1965] 2 All E.R. 575 (H.L. 1963). See also the modification of the doctrine of precedent by Practice Statement of the House of Lords. 110 SOL. J. 584 (1966); Friedmann, *Limits of Judicial Law Making and Prospective Overruling*, 29 MOD. L. REV. 593 (1966); Leach, *Revisionism in the House of Lords*, 80 HARV. L. REV. 797 (1967). Not all the English judges have been adverse to the exercise of the judicial law making function. Brett, M.R. (later Lord Esher), anticipated M'Alister v. Stevenson [1932] A.C. 562, by almost half a century in Heaven v. Pender, [1883] 11 Q.B.D. 503, and Denning, L.J. (now Lord Denning) has in the middle 1900's been vigorously engaged in bringing English negligence law into the 20th century. Moreover, many distinguished English judges have through the Law Reform Committee successfully prevailed on parliament to enact significant reforms of tort law.

[21] Among the most notable are the deep inroads made on governmental and charitable immunities, protection given unborn infants, actions by members of a family against other members for tortious injuries; the far reaching extensions of products liabilities, liabilities of contractors, and of landowners to young trespassing children hurt on dangerous premises; and the great extension of strict liabilities against ultra-hazardous enterprises.

[22] *E.g.*, Burleson v. Canada, 297 F.2d 588 (4th Cir. 1961); McLaughlin v. Mine Safety Appliances Co., 11 N.Y.2d 62, 181 N.E.2d 430, 226 N.Y.S.2d 407 (1926);

serves to protect these courts from any risk of professional backlash, inasmuch as the gibberish is so massively profound that it has gained a high degree of sanctity.

Foreseeability in Nuisance Cases

The Privy Council's judgment bringing the extent of a defendant's duty in nuisance cases under the foreseeability formula for the measure of damages, parallels a somewhat similar development in some American jurisdictions which make use of the foreseeability formula in nuisance cases to determine liability.[23] Perhaps it is more accurate to say that nuisance cases arising out of a landowner's negligence in the use of his premises are dealt with in some jurisdictions as negligence cases.[24] This is especially true with respect to risks created for highway travelers. The landowner's duty with respect to perils created for highway travelers has come to be exacting[25] and the duty problem in such cases is usually solved by means of negligence terminology.

Whether the foreseeability formula should be utilized to determine the extent of a defendant's duty for nuisance not arising out of negligence, as in cases where the utmost care has been employed or stricter liability is desirable, would seem questionable.[26] The risks that a neighbor suffers may be quite different and more severe than were to be expected by either the plaintiff or the defendant. Hindsight in nuisance cases is the prevailing basis for determining liability for the losses as well as their evaluation in terms of money. Foreseeability seems to be of primary importance only as a basis for the determination of the negligence issue in cases of negligent nuisance, and for seeking an injunction in clear cases of threatened injury.[27] If the injury is in process but the defendant's activity is a lawful and useful one, the prob-

---

Genell, Inc. v. Flynn, 163 Tex. 632, 358 S.W.2d 543 (1962); Restatement (Second) of Torts §§ 430–62 (1965); L. Green, *Duties, Risks, Causation Doctrines*, 41 Tex. L. Rev. 42 (1962), in The Litigation Process in Tort Law 215 (1965).

[23] *See* Ruocco v. United Advertising Corp., 98 Conn. 241, 119 A. 48 (1922); McFarlane v. City of Niagara Falls, 247 N.Y. 340, 160 N.E. 391 (1928); Comment, *Contributory Negligence as a Defense to Nuisance*, 29 Ill. L. Rev. 372 (1934); Comment, *Nuisance or Negligence: A Study in the Tyranny of Labels*, 24 Ind. L.J. 402 (1949).

[24] Reynolds Metals Co. v. Yturbide, 258 F.2d 321 (9th Cir.), *cert. denied*, 358 U.S. 840 (1958); Mitchell's Adm'r v. Brady, 124 Ky. 411, 99 S.W. 266 (1907); Rohlfs v. Weil, 271 N.Y. 444, 3 N.E.2d 588 (1936); Moretti v. C. S. Realty Co., 78 R.I. 341, 82 A.2d 608 (1951); Rose v. Socony-Vacuum Corp., 54 R.I. 411, 173 A. 627 (1934). Martin v. Reynolds Metals Co., 221 Ore. 86, 342 P.2d 790, *cert. denied*, 362 U.S. 918 (1959), a companion case in the state court, based liability upon trespass. The brilliant opinion by Justice O'Connell marks the case as one of the most advanced outposts of 20th century tort law. In fact, the lines between nuisance, negligence, trespass, and ultrahazardous theories of liability are becoming so dim that advocates and courts have a wide choice of law in dealing with the infinite variety of cases arising out of the operations of industrial enterprises. *Cf.* Foley v. H. F. Farnham Co., 135 Me. 29, 188 A. 708 (1936), for 19th century orthodoxy.

[25] *See* Hagy v. Allied Chemical & Dye Corp., 122 Cal. App. 2d 361, 265 P.2d 86 (1953); Hynes v. New York Cent. R.R., 231 N.Y. 229, 131 N.E. 898 (1921). For a thorough study, see Prosser, *Private Action for Public Nuisance*, 52 Va. L. Rev. 997 (1966).

[26] Green v. General Petroleum Corp., 205 Cal. 328, 270 P. 952 (1928); Kall v. Carruthers, 59 Cal. App. 555, 211 P. 43 (1943); Green, *Hazardous Oil and Gas Operations: Tort Liability*, 33 Tex. L. Rev. 574 (1955) in The Litigation Process in Tort Law 341 (1965).

[27] Krocker v. Westmoreland Planing Mill Co., 274 Pa. 143, 117 A. 669 (1922).

lem is usually to find some practical adjustment that will permit the continuance of the activity under restrictions that will not hurt either the plaintiff or the defendant too much.[28] There is no other area of tort law where formulas are so useless, where policies are so obvious, and where the remedies are so flexible and are so consistently arrived at on the spot so as to give the parties a livable adjustment.[29]

The Privy Council in substituting "foreseeability" for "direct" in both nuisance and negligence cases levels another hard blow at that historic term. It is true that in most cases the term "direct" is inadequate for measuring either liability or damages, but it served the common law for several centuries for various purposes and is ambiguous enough to permit wide variations in judgment.[30] When its elasticity is appreciated, "direct" permits acceptable judgments to be rendered. It does not have the wide flexibility of foreseeability, but in many cases it may serve the same purpose with less doctrinal confusion. *Polemis*[31] was its downfall, perhaps because it was too simple a term to satisfy professional rationalization.[32] It would seem, however, that under the formula of *Wagon Mound No. 2*, judgment for Polemis would have been inevitable: no reasonable man, if he had thought for a second, would have ignored the great danger that an explosion and destructive fire would result if a heavy timber were permitted to fall into a hold filled with petrol fumes. The risk was of far greater dimension than that posed by the floating oil in Sydney Harbor. The finding that a spark was not foreseeable was not a primary issue, but only one of several possibilities of triggering an explosion in the fume-filled hold. The issue was whether a reasonable man should have exercised care to avoid knocking the heavy timber into the hold, for however small the risk of setting off an explosion might have been, it was a "real" risk. "To eliminate it required no difficulty, involved no disadvantage, and required no expense."[33] However inadequate the term "direct," the decision in *Polemis* would seem to be given strong support by the *Wagon Mound* formula.

OVERLOADING FORESEEABILITY

The chief criticism that can be leveled at Lord Reid's formula is his overloading of the foreseeability concept.[34] Foreseeability is a delightful and

---

[28] Vowinckel v. N. Clark & Sons, 216 Cal. 156, 13 P.2d 733 (1932); Hannum v. Gruber, 346 Pa. 417, 31 A.2d 99 (1943); Burke v. Hollinger, 296 Pa. 510, 146 A. 115 (1929).

[29] Storey v. Central Hide & Rendering Co., 148 Tex. 509, 226 S.W.2d 615 (1950). *See also* cases cited note 28 *supra*.

[30] *See, e.g.*, Brackett v. Bellows Falls Hydro-Elec. Corp., 87 N.H. 173, 175 A. 822 (1934); Scott v. Shepherd, 96 Eng. Rep. 525 (K.B. 1773).

[31] *In re* Polemis, [1921] 3 K.B. 560 (C.A.).

[32] Sir Arthur Goodhart, the distinguished former editor of the *Law Quarterly Review*, who campaigned for many years to have the term jettisoned, is happy that the Privy Council has laid it to rest, and hopeful that the House of Lords will leave it lie. See his note, *Farewell to the Direct Consequence Doctrine*, 82 L.Q. REV. 444 (1966).

[33] Overseas Tankship (U.K.) Ltd. v. Miller Steamship Co., [1966] 3 W.L.R. 498, 512 (P.C.) (Austl.).

[34] "Foreseeability" is so bewitching in its appeal as a solvent of all the difficulties of negligence cases that first-year law students quickly become as enamored with it as some of the most highly respected jurists.

useful fiction with no restrictions in itself, and when linked with the fictitious reasonable man as a jury formula to determine whether a defendant failed to exercise reasonable care to avoid the risk of injury to his victim, it serves in every case to call forth a fresh judgment. As a judge's formula it is perhaps too glaringly fictitious unless given substantive additives so as to convert it into a meaningful concept for the assessment of policy factors. That a court, exercising the function of a jury in the determination of the issue of negligence, should take into account the risks a defendant should have taken into account when engaged in conduct hurtful to the plaintiff is sensible, but it is hardly an adequate formula for determining the "measure of damages" or extent of duty after the victim has suffered injury. Many foreseeable risks do not fall within the scope of any duty owed a plaintiff[35] while many unforeseeable risks do fall within the duty owed him.[36] After the event hindsight takes over and becomes the basis of judgment in measuring the adjustment that should be made; foreseeability becomes what should have been foreseen, not what was foreseen; what should have been foreseen becomes what the defendant should be liable for, and this brings into consideration the policy factors[37] that give rationality to the law. This progression in meaning can scarcely be labeled foreseeability. There must be some more serviceable term available for describing the process of judgment in the practical affairs of everyday life.

---

[35] Estes v. Gibson, 257 S.W.2d 604 (Ky. 1953) (gift of automobile to irresponsible son); State *ex rel.* Joyce v. Hatfield, 197 Md. 249, 78 A.2d 754 (1951) (tavern keeper served excessive alcoholic drinks to youngster whose inability to drive his car resulted in collision killing plaintiff's husband); Osterlind v. Hill, 263 Mass. 73, 160 N.E. 301 (1928) (failure to go to the aid of drowning drunk to whom defendant had rented boat); Emery v. Rochester Tel. Corp., 271 N.Y. 306, 3 N.E.2d 434 (1936) (failure of operator to give telephone connection to parent seeking to call doctor for his ill child); H.R. Moch Co. v. Rensselaer Water Co., 247 N.Y. 160, 159 N.E. 896 (1928) (failure to provide water service to save plaintiff's house from destruction by fire). *But see* Rappaport v. Nichols, 31 N.J. 188, 156 A.2d 1 (1959). Would serving a guest too many drinks render host liable to pedestrian injured by guest driving home while intoxicated? Is a father of an illegitimate child liable under tort law to child for the injuries suffered by virtue of his illegitimacy? Would it be of any significance whether father used every precaution to prevent the pregnancy of the child's mother or took no precautions at all? *See* Zepeda v. Zepeda, 41 Ill. App. 2d 240, 190 N.E.2d 849 (1963), cert. denied, 379 U.S. 945 (1964); William v. State, 18 N.Y.2d 481, 276 N.Y.S.2d 885 (1967).

[36] Bremer v. Lake Erie & W.R. Co., 318 Ill. 11, 148 N.E. 862 (1925); Tri-State Transit Co. v. Martin, 181 Miss. 388, 179 So. 349 (1938); Rasmussen v. Benson, 135 Neb. 232, 280 N.W. 890 (1938); Santos v. Unity Hospital 301 N.Y. 153, 93 N.E.2d 574 (1950); Ehret v. Village of Scarsdale, 269 N.Y. 198, 199 N.E. 56 (1935); Hines v. Morrow, 236 S.W. 183 (Tex. Civ. App. 1921); Dodge v. McArthur, 223 A.2d 453 (Vt. 1966); Sundquist v. Madison Ry., 197 Wis. 83, 221 N.W. 392 (1928).

[37] The writer, in an earlier article entitled *The Duty Problem in Negligence Cases*, 28 COLUM. L. REV. 1014 (1928), attempted to indicate the policy factors that influence courts to limit the duties of defendants in negligence cases. The factors there indicated were administrative, including former decisions, economic, moral, preventive, and justice as between the parties. These factors are clearly identifiable in the leading English and American cases of the 1800's when the courts were with great consistency imposing restrictions on liability. Over the last forty years in the relaxation, and in some instances the removal, of these restrictions altogether by court decisions, the same factors are also clearly identifiable. As radical changes in environments have occurred the litigation process has responded with increasing protection to their victims. It may be added that the social group has found that by giving greater protection to the individual greater protection is also given the group.

Civil Liability Under Rule 10b–5†

*By Daniel J. Dykstra**

The topic under consideration is one of vital significance. As one commentator has observed: "No issues in the realm of securities law are more afire today than those which pertain to Rule 10b–5 . . . ."[1] In the same vein another writer stated: "Of the vast amounts of statutory and quasi-statutory material governing the securities business, the Securities and Exchange Commission's rule 10b–5 has potentially the greatest direct importance to the largest number of people."[2]

These observations are not overstatements. Rule 10b–5 is a rule which has given and is giving rise to many issues, to much discussion, and to much litigation. While some of the issues raised may be considered settled, many are unresolved. Others are either in the process of formulation or are issues seen from afar — issues potentially observed and feared. In fact it is this state of nebulosity, this condition of flux, which makes rule 10b–5 a difficult one to discuss. Many cases are in conflict; many assertion are tenuously held.

Be that as it may, the issues and problems cannot be ignored. If rule 10b–5 currently defies many answers, we can, nonetheless, find light in observing its background, in noting its position in the general field of securities law, and in identifying points of conflict.

Rule 10b–5 was promulgated by the Securities Exchange Commission pursuant to authority conveyed by Congress in section 10(b) of the Securities Exchange Act of 1934. Section 10(b), the authorizing statute, provides the following:

> 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.[3]

On its surface at least, the statute quoted above seems reasonably precise in reference to certain items. One, it is a section concerned with manipulation and deception in connection with the purchase or sale of a security. Two, its jurisdiction rests from a federal point of view on the use of any instrumentality of interstate commerce or of the mails or of any national securities exchange. Three, the section relates to any security, not only those

---

† A speech presented at an institute on corporate securities held at the College of Law, University of Utah, on January 13, 1967.

* Professor of Law, University of California, Davis.

[1] Sommer, *Rule 10b–5: Notes for Legislation*, 17 W. Res. L. Rev. 1029 (1966).

[2] Note, *Proof of Scienter Necessary in a Private Suit Under SEC Anti-Fraud Rule 10b–5*, 63 Mich. L. Rev. 1070 (1965).

[3] Securities Exchange Act of 1934, 15 U.S.C. § 78j (1964).

registered on a national exchange. Four, its wording refers to "any person" and thus by implication it includes more than the individuals who may be classified as corporate insiders. Finally, it is evident that the statute is not self-operating, for the impropriety of the purchase or sale must be in contravention of such rules and regulations as the Commission may prescribe. Incidentally, section 10(b) also adds that such rules must be "in the public interest" or for "the protection of investors."

Having observed the statutory proviso which authorizes 10b–5, we now turn to the rule itself. As promulgated, it repeats many of the phrases contained in section 10(b). It refers to "any person," it invokes the same jurisdictional ground, and it encompasses the purchase or sale of any security. What is added by the rule is an elaboration of that which is illegal in connection with the purchase or sale of a security, for it specifies that it shall be unlawful:

(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, or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit on any person . . . .[4]

These are the provisions of the rule. Their meaning and their impact must now be examined.

The most immediate result of the rule was that its promulgation gave the Commission an effective instrument to utilize in its administrative activities. For example, under section 21(a) of the Securities Exchange Act the Commission has authority to make investigations to determine whether any person has violated any requirement of the act or any rule promulgated pursuant to it.[5] Quite obviously, therefore, rule 10b–5 enhanced the Commission's investigatory authority over the purchase and sale of securities. Effectiveness is added to this authority by the fact that section 21(a) gives the Commission discretion to publish the results of its investigations.[6]

Rule 10b–5 also increased the instances under which the Commission could impose penalties. Under the Exchange Act, section 15(b)(5), for example, the Commission is authorized to "deny registration to, suspend . . . or revoke the registration of, any broker or dealer . . . ." if it finds he has willfully violated any of the provisions of the acts relating to securities "or of any rule or regulation" promulgated thereunder.[7] Finally, rule 10b–5 provided the Commission with a device it could use under section 21(e) of the Exchange Act, for that section gives the Commission authority to bring injunction proceedings in the proper federal district court when it shall appear that "any person is engaged or about to engage in any acts or prac-

[4] SEC Rule 10b–5, 17 C.F.R. § 240.10b–5 (1964).
[5] Securities Exchange Act of 1934, 15 U.S.C. § 78u(a) (1964).
[6] *Id.*
[7] Securities Exchange Act of 1934, 15 U.S.C. § 78o(b)(5)(D).

tices which constitute or will contitute a violation of the provisions of this chapter, or any rule or regulation thereunder . . . ."[8]

It did not take the Commission long to utilize the leverage afforded by the rule. Rule 10b–5 was passed in 1942. In 1943 the Commission decided to conduct an investigation into the affairs of the Ward La France Trade Corporation,[9] particularly in reference to the purchase by certain insiders of publicly held shares of the corporation. The Commission concluded that these purchases had been made without revealing the company's significantly improved financial condition. Upon reaching this conclusion it decided to publish the results in order, as it said in its opinion, "to call attention to rule X-10b–5" (now known as rule 10b–5).[10]

A more striking example of the impact of rule 10b–5 as far as Commission activities are concerned was revealed in the now famous Cady-Roberts investigation.[11] As a result of that investigation, the Commission, utilizing its disciplinary powers, temporarily suspended a broker for selling shares on behalf of his customers without disclosing to purchasers the fact that the company whose shares he was selling had decided to reduce its dividend rate, a fact not yet publicly known.

While rule 10b–5 would be significant simply because of the enhanced power and flexibility it gives the Commission, that fact by itself would not provide the rule with its current importance. The added ingredient was provided in 1946 when the district court for the Eastern District of Pennsylvania ruled in the case of *Kardon v. The National Gypsum Co.*,[12] that section 10(b) and rule 10b–5 constituted the basis of a civil action by a seller against a buyer of securities.

Judge Kirkpatrick, in ruling that a civil action was maintainable, reached this conclusion despite significant counterarguments. Without pursuing these counterarguments at length, it may be noted that they revolved around the fact that neither section 10 nor rule 10b–5 specifically provides for civil liability. The absence of such a provision assumes added significance when it is observed that in the 1933 and 1934 acts Congress expressly provided for civil liability when it deemed such liability appropriate. Thus, in sections 11(a), 12(1), 12(2) and 15 of the 1933 act provisions are made for civil liability in reference to the matters covered by each section. In the Securities Exchange Act of 1934, sections 9, 16, 18, and 20 contain civil liability authorization for violations of matters contained therein. It should be noted that the 1933 act contains a section very comparable to section 10(b) of the 1934 act, namely section 17, and that that section had not been utilized prior to the *Kardon* case for purposes of imposing civil liability.

Although he was cognizant of these arguments, Judge Kirkpatrick was not convinced by them. He rested his conclusion that civil actions were maintainable under 10b–5 on two propositions. The first was the tort principle

[8] Securities Exchange Act of 1934, 15 U.S.C. § 78u(e).
[9] *In re* Ward La France Truck Corp., 13 S.E.C. 373 (1943).
[10] *Id.*
[11] *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).
[12] 69 F. Supp. 512 (E.D. Pa. 1946).

enunciated in the *Restatement of Torts*, section 286, to the effect that a legislative enactment or administrative regulation may be adopted as a standard of conduct on behalf of every person it was designed to protect from the particular harm to which the enactment or regulation pertained. In the instant case, of course, that would include an action by a seller of securities who alleged he made the sale because of the buyer's fraud and deceit. The second proposition upon which Judge Kirkpatrick based his conclusion was drawn from section 29(b) of the Securities Exchange Act, for that section provides in part that "[e]very contract made in violation of any provision of this title or of any rule or regulation thereunder . . . shall be void . . . ." If a contract in violation of a rule is to be void, the court reasoned, Congress "almost necessarily implies a [civil] remedy in respect of it."[13]

Much has been written pro and con concerning the validity of the judge's conclusion.[14] Such discussions are now, however, largely academic, for courts in ten circuits have permitted civil action under 10b–5. Furthermore, the United States Supreme Court has by implication given such actions its blessing.[15] It thus seems highly unlikely that a contrary position will gain much ground.

In order to appreciate the significance of this development, it is merely necessary to enumerate some of the legal questions it has raised. In asking such questions it should again be recalled that 10(b) and 10b–5 are directed at the employment of manipulative and deceptive devices in connection with the purchase or sale of any security. While this objective is relatively clear, its implementation and its boundaries are by no means clear. For example, is 10b–5 to be viewed as incorporating common law fraud into a federal setting? If so, must plaintiff show (a) misrepresentation, (b) in reference to a material fact, (c) made with knowledge of falsity, (d) with intent to deceive, (e) reliance by plaintiff, and (f) damages — the elements of common law fraud? If these requirements are not present, is 10b–5 to be viewed as a strict liability rule? If it is neither a common law fraud nor a strict liability rule, what are the elements of an action premised on its violation? Is nondisclosure as well as affirmative misrepresentation a basis for liability? Who may be subjected to liability under 10b–5? May buyers be sued? May sellers be sued? May a corporation sue? May a corporation be deceived into selling or buying securities by its own management? May noninsiders be sued? Does 10b–5 cover transactions which occur both on and off a registered securities exchange? Is liability limited to parties who are in privity with one another, or is it simply enough for plaintiff to show he parted with or acquired securities because of defendant's actions even if he did not sell or purchase them from the defendant?

---

[13] *Id.* at 514.

[14] *See* Ruder, *Civil Liability Under Rule 10b–5: Judicial Revision of Legislative Intent?*, 57 Nw. U.L. Rev. 627 (1963). For a response to this article see Joseph, *Civil Liability Under Rule 10b–5 — A Reply*, 59 Nw. U.L. Rev. 171 (1964).

[15] *See* Surowitz v. Hilton Hotels Corp., 383 U.S. 363 (1966); J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

These are but a few of the problems raised. In respect to many of them, it is fair to note that neither section 10 nor rule 10b–5 gives much guidance. This fact is in marked contrast to several of the sections which provide for civil liability, for they contain many stipulations relating to causation, good faith, reliance, plaintiff's knowledge or lack of knowledge, burden of proof, and measure of damage.

In embarking on a discussion of some of the aforementioned questions, it should be repeated that it is currently impossible to provide answers to many of them. The primary aim of the discussion is, therefore, a limited one; it is simply that of giving some assistance in clarifying the issues to which the questions relate.

The first item to be raised is that concerning the parties subject to liability under 10b–5. Specifically, may both buyers and sellers of securities be sued under that rule? The answer of the courts is "yes." A look at section 10b and rule 10b–5 might suggest this is an obvious answer, for these provisions refer to fraud and deceit in connection with the *sale* or *purchase* of a security. This simplicity is deceptive, however, for the Securities Act expressly provides for an action against *sellers* of securities who employ an "untrue statement of a material fact or omit to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading."[16] The section which contains this provision is 12(2). Since it explicitly provides for civil liability against sellers, is it not logical to assume that Congress intended that that section should be the sole avenue through which civil liability could be imposed on those who sold securities? One may react by asking, if this is the case, what difference does it make? After all, the section quoted sounds very much like 10b–5. The difference rests on what follows, for after providing for civil liability, the section goes on to state the elements of the action. It provides, for example, that purchasers must not have known of the untruth or omission. Furthermore, it provides that if a seller sustains the burden of proof of showing "he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission . . . ." he shall not be liable. Finally, section 13 of the Securities Act goes on to impose a very short statute of limitation, one year.

The dilemma is obvious. Section 12(2) of the Securities Act of 1933 is designed to permit actions against sellers of securities under specific and circumscribed conditions. Section 10(b) and rule 10b–5 are general, refer to sales and purchases, contain no reference to civil liability, but have been held, nonetheless, to be a basis for civil liability. It is one thing, however, to conclude that they permit the imposition of civil liability against a buyer, but another, in view of the specific provisions of section 12(2), to hold that they may be the basis of an action against a seller.

In 1961, the Ninth Circuit met this dilemma head-on in the case of *Ellis v. Carter*.[17] After posing the problem, it observed that there were four possible solutions. One, permit no civil liability under 10b–5. This would, how-

[16] 15 U.S.C. § 77m (1964).
[17] 291 F.2d 270 (9th Cir. 1961).

ever, result in an incongruity, for civil actions which exist against sellers because 12(2) of the Securities Act would remain, but would give no relief against buyers. Two, permit buyers to be sued under 10b–5 but require suits against sellers to be brought under section 12(2) of the Securities Act. This would also be incongruous because it would give one group a restrictive action while providing another group with a very broad and unrestricted remedy. Besides, such a result would fly in the face of the express wording of 10b–5 referring as it does to "purchase or sale." Three, permit buyers to sue under 10b–5, but as to them, incorporate the restrictions of the 1933 Act. This would result in the same inequality, especially if, as the court assumed, these restrictions would not be imposed upon sellers. Four, permit buyers and sellers to sue under 10b–5 without any distinction. This in effect would ignore section 12(2) of the Securities Act. Although it recognized that this result meant a nullification of procedural restrictions carefully imposed by Congress, the Ninth Circuit nonetheless found this solution the most logical and most acceptable of those enumerated. As previously observed, other decisions have reached similar conclusions.[18]

While observing that both buyers and sellers may be subject to liability under 10(b) and rule 10b–5, it is logical to ask if both face-to-face and market transactions are subject to their provisions. As already noted, the statute expressly states that it applies to "the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . ." Despite this broad pronouncement, defendants in 10b–5 actions have argued both ways. Some have maintained that the Securities Exchange Act was designed to regulate security exchanges and over-the-counter markets and thus 10(b) and rule 10b–5 may only be interpreted to apply to exchange market transactions.[19] In other actions, defendants have asserted that 10b–5 was only intended to fill in a gap, the gap existing in relation to face-to-face transactions.[20] Only in such transactions would buyers and sellers be in privity to one another and thus in an immediate position to engage in misrepresentation, nondislosure, or half-truths.

Courts bought neither argument. In other words, they applied 10b–5 to both exchange and direct transactions. In *Fratt v. Robinson*,[21] for example, the Ninth Circuit expressly reversed a district court ruling that 10b–5 did not extend to nonexchange buying and selling. In doing so, the court took the position that to state that the Exchange Act was designed solely to regulate

[18] *See, e.g.*, Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962); Matheson v. Armbrust, 284 F.2d 670 (9th Cir. 1960), *cert. denied*, 365 U.S. 870 (1961); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951). In Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964), Judge Doyle allowed purchasers to maintain an action under section 10(b) and rule 10b–5, but in an effort to place them in a logical statutory scheme he placed upon plaintiffs burdens of proof greater than those which exist under section 12(2) of the Securities Act.

[19] *See* Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951), *aff'd*, 235 F.2d 369 (3d Cir. 1956); Robinson v. Difford, 92 F. Supp. 145 (E.D. Pa. 1950).

[20] *See* List v. Fashion Park, Inc., 340 F.2d 457, 461–62 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 279 (S.D.N.Y. 1966).

[21] 203 F.2d 627 (9th Cir. 1953).

exchanges was too narrow a view. Its purpose was rather to regulate all transactions involving the interstate sale or purchase of securities.

As to transactions on the various exchanges, courts have in effect adopted the position of the Commission itself when it said in the *Cady-Roberts* affair,[22] "it would be anomalous indeed if the protection afforded by the anti-fraud provisions (rule 10b-5) were withdrawn from transactions effected on exchanges, the primary markets for security transactions."

Having noted generally that 10b-5 encompasses buyers and sellers and also applies to exchange and nonexchange transactions, it is appropriate to inquire whether such buyers, sellers, and transactions extend beyond corporate insiders. As already observed, 10b-5 refers to sales and purchases by "any person." Literally, then, it is not limited in application to "corporate insiders." As a practical matter, however, 10b-5 cases have usually dealt with the misuse of inside information and thus most actions thereunder have been against corporate insiders. It is appropriate to observe, however, that courts and the Commission take an expanded view of the corporate insider. While they have not classified as an insider every individual who happens to gain some special nonpublic information about a corporation, they have encompassed in this view persons possessing such knowledge if they occupy a special relationship to the corporation or to the securities in question. Three illustrations will prove the point.

1. In *In re Cady, Roberts & Co.*,[23] the Commission suspended a broker who sold Curtis-Wright corporation stock for his clients at a time when the broker had knowledge that Curtis-Wright was going to reduce its dividend. He obtained this knowledge from an office associate who was also a Curtis-Wright director. The broker could not be considered an insider in the usual sense of the word, but he knew he had inside information. Furthermore, he represented a figure of key responsibility in the securities market.

2. In *Pettit v. American Stock Exchange*,[24] Judge Palmieri of the Southern District of New York held plaintiff stated a good cause of action under 10b-5 against the American Stock Exchange because its officers had permitted the notorious Lowell Birrell to utilize the Exchange in connection with the sale of Swan-Finch stock even though the Exchange knew he was acting illegally. Obviously the Exchange was not an insider, but the district court said in effect that it was a responsible securities institution aiding and abetting an insider.

3. More recently the District Court for the Northern District of Indiana took this general fiduciary concept one step further when in a case involving the Midwestern United Life Insurance Co.[25] it held that a cause of action was stated against the company by a plaintiff who alleged that the company failed to report the improper activities of a brokerage firm which was dealing in the company's stock. The complaint did not charge the life insurance firm with participation in the transactions; it only asserted that the company knew

[22] *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

[23] *Id.*

[24] 217 F. Supp. 21 (S.D.N.Y. 1963).

[25] Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966).

about them.[26] Despite the lack of participation it was held that a cause of action was stated. The court reasoned that the company had special knowledge of what was happening in terms of its own stock, and it could not, therefore, sit back in disinterest. The very purpose of section 10(b) was to impose "a duty upon persons or corporations who are in a superior position to know crucial and material facts not to take advantage of those who are not in such a position."[27]

It has been argued that these cases add up to the fact that anyone who casually happens to overhear a bit of inside gossip about a corporation acts on it at his peril. This is an overstatement. The three cases deal with special persons as far as their relations to the securities industry are concerned. One defendant was a broker, another a securities exchange, and the third was the very company whose securities were being traded. None of these was a casual participant.[28]

Part and parcel of the question of insider activity is whether a corporation itself has a cause of action when it has been deceived by its directors and officers into issuing or purchasing its own shares. This question opens up a significant development, for it is now clear that corporations are finding an increased measure of protection under 10(b) and rule 10b–5.

In 1960, the Fifth Circuit in the case of *Hooper v. Mountain State Securities Corp.*[29] expressly held that a corporation is a "person" within the terms

---

[26] Plaintiff implied that the company was motivated in its do-nothing policy by the fact the transactions upped the price of shares and therefore enhanced the possibility of a merger then under discussion.

[27] Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 681 (N.D. Ind. 1966).

[28] At approximately the time this paper was being readied for submission to the *Utah Law Review* the following account appeared in the Wall Street Journal, Feb. 27, 1967, at 28, cols. 4–6.

> NEW YORK — A Federal judge ruled that disclosure regulations governing "insider" stock dealings apply to persons with privileged information about a company's plans, even if they aren't officers, directors or major stockholders of the company.
>
> The ruling, by Judge Inzer B. Wyatt in Federal district court here, involved 1961 dealings in the stock of National Hospital Supply Co., New York.
>
> . . . .
>
> Damages totaling $11,250 were awarded to Lawrence H. Frank and his sister, Bernice Frank Ross, from eight defendants: Charles S. Licht, president of National Hospital Supply; Samuel Bernstein, secretary-treasurer of the company; William V. Licht, vice president; Michael J. Coviello, director of sales; Seymour M. Friedman, general manager, and Sidney E. Licht, Edward Grapel and Leonard Bluestone, three dentists.
>
> Sidney E. Licht is the brother of Charles and William Licht. The Licht family held a controlling interest in the company. Drs. Grapel and Bluestone had been "close friends" of Charles and Sidney Licht for 30 years and "must have known a great deal" about the company's affairs, Judge Wyatt said.
>
> The judge said that Mr. Frank and Mrs. Ross sold 62.5 shares in National Hospital Supply to the eight defendants at $120 a share, without being told that the company planned a public offering of the stock at the equivalent of $600 a share and a separate private offering at the equivalent of $300 a share.
>
> The amount of damages was set at the difference of the selling price and the $300 a share for which the stock was to be offered privately.
>
> National Hospital Supply filed for bankruptcy in September 1966 and currently is being reorganized. Charles Licht said the defendants haven't decided whether to appeal.

[29] 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

of the rule and that the issuance of its shares is a sale. Furthermore, it ruled that because 10b–5 was intended to protect all persons who part with stock owned by them as the result of fraudulent practices, the very matter alleged, the corporation had a cause of action.[30] In 1964 the Second Circuit in *Ruckle v. Roto American Corp.*[31] held a cause of action was stated in a derivative suit alleging that a majority of directors prompted the corporation to sell them treasury shares at a price which was arbitrarily low. The complaint also alleged that the majority was aided in its actions by withholding information from other directors. In ruling as it did, the court obviously took the position that a corporation could be deceived by its own management, *i.e.*, by a majority of its directors.

The result is somewhat difficult to fathom in view of the fact that in the same year, the same court (the Second Circuit) in *O'Neill v. Maytag*[32] held that a derivative 10b–5 action on behalf of National Airlines was nonsustainable even though the directors of National Airlines induced the company to part with stock which they held in Pan American Airline at a value substantially less than its true worth. Although convinced that the plaintiff stated an action under state law for a breach of a fiduciary duty, the Second Circuit concluded that no action was stated under 10b–5 because there was no *deception* in connection with the sale. A breach of fiduciary duty, yes, but no deception. The conclusion that there was no deception apparently rested on the fact that all directors were acquainted with all of the circumstances related to the transaction.

The distinction the court was trying to draw between deception in connection with the sale of security (which would in the court's opinion be a 10b–5 action) and no deception, but, nonetheless, a breach of a fiduciary duty in relation to a sale of security (a non-10b–5 action) is tenuous at best. Not only is it a difficult distinction to draw, but it also seems to do violence to the notion that the corporation as an entity may be deceived even by all of its directors.[33]

Two recent cases throw further light on the right of a corporation to sue for the purchase of securities. In *Pappas v. Moss*[34] the United States District Court for New Jersey sustained a derivative action under 10b–5 which alleged that the corporation was induced to sell its stock at a figure under the prevailing price. Since the evidence suggests that *all* the directors knew the facts when they approved the sale, the purport of the holding is that a corporation, nonetheless, has a 10b–5 action.[35] In *Simon v. New Haven Board &*

[30] For a holding that a corporation induced by its own "insiders" to part with property for shares in another company which shares went to the "insiders" for "no consideration or a purely fictitious consideration" has a cause of action, see New Park Mining Co. v. Cranmer, 225 F. Supp. 261, 264 (S.D.N.Y. 1963).

[31] 339 F.2d 24 (2d Cir. 1964).

[32] 339 F.2d 764 (2d Cir. 1964).

[33] For further discussion of *O'Neill* and related cases see Fleischer, *"Federal Corporation Law": An Assessment*, 78 HARV. L. REV. 1146 (1965).

[34] 257 F. Supp. 345 (D.N.J. 1966).

[35] In Heilbrunn v. Hanover Equities Corp., 259 F. Supp. 936, 938 (S.D.N.Y. 1966), a memorandum opinion, Judge Frankel observed: "[I]t is clear that the corporation, as 'seller' of stock . . . may be defrauded by all its directors, and is not barred from relief by the notion of imputed knowledge."

Carton Co.[36] the district court for Connecticut held that a derivative action under 10b–5 is sustainable if it is alleged that shareholder approval of a resolution to issue stock at an unrealistic price was obtained because shareholders had not been informed as to certain facts by the board of directors.

Having looked generally at the parties and transactions which may be subjected to the requirements of 10(b) and rule 10b–5, there remains the very important issue concerning the basis for liability. What types of activity are prohibited by these provisions?

A casual perusal of rule 10b–5 might suggest that the answer is a simple one. Subsection (1) and subsection (3) employ the terms fraud and deceit. Subsection (2) seems obviously designed to cover the half-truth, the misleading partial disclosure. It may thus be concluded that the rule is aimed at fraud, deceit, and the half-truth. This conclusion, however, is but the beginning of analysis. The basic question remains: What within the context of section 10(b) and rule 10b–5 constitutes the ingredient of fraud and deceit?

In this connection, an issue frequently raised is whether nondisclosure as such will give rise to an action under 10b–5. In considering this question, it may be noted that none of the subsections gives a specific answer. This statement is valid despite the fact there are pronouncements which suggest that subsection (2) of 10b–5 prescribes that nondisclosure is unlawful. Literally speaking, however, this is not correct. Subsection (2) does not say that it is unlawful per se to refrain from disclosure. Rather the subsection states it is unlawful to "omit to state a material fact necessary in order to make the statements made . . . not misleading." This is pointed at the half-truth — not at nondisclosure as such. The distinction is a significant one. Further in considering the impact of nondisclosure it may be observed that most of the judicial comments related to the issue involve fact situations in which nondisclosure was combined with affirmative deceptive acts or misstatements. These utterances are, therefore, for the most part, in the realm of dicta. Despite this caveat, however, it is safe to conclude that under many circumstances nondisclosure of a material fact will by itself constitute the basis of a 10b–5 action. Certainly the Commission has taken this position. In *Cady-Roberts*,[37] the Commission disciplined a broker solely because he failed to reveal that the corporation whose securities he was selling had decided to lower its quarterly dividend. Furthermore, courts have rather consistently observed during the past few years that nondisclosure as such will be the basis of a 10b–5 action. While most, but not all, such pronouncements have been dicta, their frequency and consistency will make it difficult for the judiciary to take a contrary position. Typical of such pronouncements has been Judge Dawson's observation in the case of *Cochran v. Channing Corp.*:[38] "Fraud," he stated, "may be accomplished by false statements, a failure to correct a misleading impression left by statements already made or . . . by not stating anything at all when there is a duty to come forward and speak." Another

[36] 250 F. Supp. 297 (D. Conn. 1966).
[37] *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).
[38] 211 F. Supp. 239, 243 (S.D.N.Y. 1962).

example of judicial comment on nondisclosure is that of Judge Leahy in *Speed v. Transamerica Corp.*:[39]

> The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers. The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholders.

Two observations should be made concerning these and comparable judicial pronouncements. Courts are cognizant of the fact that rule 10b–5 does not specifically outlaw nondisclosure as such. They base their conclusion, however, on their belief that the general purport of section 10(b) and rule 10b–5 is to outlaw any activity, including nondisclosure, which acts as fraud or deceit upon a purchaser or seller. Taking this approach various judges have undoubtedly found comfort in a statement by the United States Supreme Court in the case of the *SEC v. Capital Gains Research Bureau*,[40] for therein the Court observed: "Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but flexibly to effectuate its remedial purposes."

As an example of the concept that the rule must be observed as a whole and "not technically and restrictively," attention is called to the Second Circuit's opinion in *List v. Fashion Park, Inc.*[41] In that opinion, it was said:

> It may well be that suits under Rule 10b–5 involving total nondisclosure cannot be brought pursuant to clause (2) of the rule. . . . Perhaps . . . they cannot be brought pursuant to clause (1) either. . . . But we fail to see that it makes any difference which clause of Rule 10b–5 is relied on by plaintiff, and no reason for requiring a choice has been pointed out to us.

The second observation which is warranted is that rulings to the effect that nondisclosure may be the basis of a 10b–5 action have been tied to the concept that an insider buyer or seller has a fiduciary duty to the shareholders in his corporation. This concept is an expansion of the common law, at least in most states, for the common law position was that the fiduciary duty of an insider ran only to his corporation and not to its individual shareholders. While it is thus an expansion, it is nonetheless conceivable that the concept of a fiduciary duty to corporate shareholders may serve as a limiting factor in terms of 10b–5 suits. Will the courts, for example, impose the same disclosure requirements on insiders in respect to transactions with those who, at least until the date of purchase, were strangers to the corporation?[42]

---

[39] 99 F. Supp. 808, 828–29 (D. Del. 1951), *aff'd*, 235 F.2d 369 (3d Cir. 1956).

[40] 375 U.S. 180, 195 (1963).

[41] 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

[42] Although the *Cady-Roberts* opinion suggests the question posed must be answered affirmatively, that is, that no distinction will be made between present shareholders and those who become shareholders by the transaction in question, it is too early to conclude that this will be the rule.

This question really raises the broader issue as to the specific limits on the defenses involved in a 10b–5 action. We have already noted that 10b–5 is, generally speaking, a rule designed to deal with fraud and deceit in conjunction with the purchase or sale af securities. Does this mean that the Commission has simply incorporated into a federal context the common law actions of fraud and deceit? There are cases which have so held. The Second Circuit, for example, so ruled in 1951 in the case of *Fischman v. Raytheon Manufacturing Co.*[43] More recent cases, however, have rather consistently taken a contrary position. For example, Judge Bonsal in the lengthy opinion which he recently handed down in the *Texas Gulf Sulphur* case said:

> The defendants assert that the Commission [plaintiff in the action] must establish the elements of common law fraud — misrepresentation or nondisclosure, materiality, scienter, intent to deceive, reliance, and causation — citing decisions in private actions brought under Section 10(b) requiring proof of one or more of these traditional elements as a condition precedent to relief. . . .
>
> However, recent decisions, even in private suits, do not require proof of these elements in actions charging violations of Rule 10b–5.[44]

Judge Bonsal proceeded to comment on a few of these decisions and then concluded his observations on the point by remarking that the word "fraud" in rule 10b–5 "cannot be interpreted in its narrow common law sense."[45]

Since Judge Bonsal's conclusions seem correct, it makes even more pressing the question of the elements of an action under 10b–5. Are section 10(b) and rule 10b–5 intended to serve as strict liability provisions? Is it only necessary for plaintiff to prove, for example, a misstatement or a nondisclosure accompanied by a purchase or sale of a security, or must scienter also be proved?

Certain courts appear to have taken the position that scienter is not an element of such an action. Judge Swinford of the Western District of Kentucky said, for example, in the case of *Texas Continental Life Insurance Co. v. Bankers Bond Co.*:[46]

> I am of the opinion that it was the intention of the Congress by this legislation [referring to section 10(b)] to give the purchaser of invalid bonds a right to recover without the necessity of offering proof of deceit and intentional fraud. The statute contemplates a new right of action for the good-faith purchaser to recover from the seller for constructive fraud which grows out of the failure to make a full and complete disclosure.
>
> . . . .
>
> A plaintiff purchaser need only prove that a statement in a prospectus or oral communication is in fact false or is a misleading omission and that he did not know of such untruth or omission.

In a similar vein, the Tenth Circuit in *Stevens v. Vowell*[47] said: "It is not necessary to allege or prove common law fraud to make out a case under the

---

[43] 188 F.2d 783 (2d Cir. 1951).

[44] SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 277 (S.D.N.Y. 1966).

[45] *Id.* at 278.

[46] 187 F. Supp. 14, 23 (W.D. Ky. 1960), *rev'd on other grounds*, 307 F.2d 242 (6th Cir. 1962).

[47] 343 F.2d 374, 379 (10th Cir. 1965).

statute and rule. It is only necessary to prove one of the prohibited actions such as the material misstatement of fact or the omission to state a material fact.[48]

While these pronouncements exist and may represent the wave of the future, it is nonetheless a fact that most 10b-5 cases have involved either deliberate omission, knowledge of the falsity of a statement (i.e., intent), or circumstances which at the very least suggest that the defendant should have known of the misrepresentation or omission in reference to their transactions. Despite this, however, it may be that lack of scienter will be a weak reed upon which to rest as far as defendants are concerned.[49]

Even though scienter is an uncertain element in a 10b-5 action, there are limiting factors which should not be overlooked. The rule itself stipulates, for example, that the untrue statement or omission must be in relation to a material fact. This requirement is of some significance. In fact, Judge Bonsal's decision in the *Texas Gulf Sulphur*[50] case turned on whether the information allegedly withheld was material. In analyzing this question, Judge Bonsal noted that one court defined material information as information which in reasonable and objective contemplation might affect the value of corporate stock or securities.[51] He also observed that the Commission defined it as information which if known "would clearly affect 'investment judgment.'"[52] After these observations, the Judge went on to state his own conclusions. While he did not think the test should be limited solely to information translatable into earnings, he did opine that: "[T]he test of materiality must necessarily be a conservative one, particularly since many actions under Section 10(b) are brought on the basis of hindsight."[53] He then went on to note that this means that shrewd or even educated guesses cannot be said to be material information.[54]

The Second Circuit in 1965 in *List v. Fashion Park, Inc.*[55] took a similar view of materiality. It said "[t]he basic test of 'materiality' . . . is whether 'a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question.'"[56] While

[48] For a contrary holding see Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964).

[49] For good discussions of the entire problem of scienter see Note, *Proof of Scienter Necessary in a Private Suit Under SEC Anti-Fraud Rule 10b-5*, 63 MICH. L. REV. 1070 (1965); Note, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824 (1965); Note, *Civil Liability Under Section 10B and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658 (1965).

[50] SEC v. Texas Gulf Sulfur Co., 258 F. Supp. 262, 278-80 (S.D.N.Y. 1966).

[51] *Id.* at 280, citing List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

[52] *Id.* (citing In re Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961)).

[53] *Id.*

[54] *Id.* at 284. Former S.E.C. Chairman Cary has written: "Where an insider has possession of facts that are known to him by virtue of his status and that, if known generally, would tend materially to affect the price of the security, the law requires that the insider disclose these facts to those with whom he deals or *forego the transaction.*" Cary, *Corporate Standards and Legal Rules*, 50 CALIF. L. REV. 408, 415 (1962) (emphasis in original).

[55] 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

[56] *Id.* at 462 (citing *Restatement of Torts* § 538(2)(a)).

this comment throws some light on materiality, it also opens a second possible limitation on a 10b–5 action for it clearly suggests that the material misrepresentation must be one on which the plaintiff relied. In the very case in which the comment was made, *List v. Fashion Park Inc.*, plaintiff lost because the court concluded that the plaintiff would not have acted differently had he known all the facts. In other words, the plaintiff was out because he could not show that he relied, or that he would have relied on the nondisclosure.

The United States District Court for the Eastern District of Wisconsin in *Kohler v. Kohler Co.*[57] decided for the defendant for a comparable reason. In this instance it is significant to observe that the court stressed the fact that the plaintiff was an experienced investor. This emphasis makes it clear that the reliance must (1) be reasonable and (2) that what is reasonable may very well depend upon the capacity, knowledge, and sophistication of the plaintiff.

While reliance by the plaintiff appears to be a reasonable limitation on 10b–5, and one rather uniformly adopted to date, it contains at least two inherent difficulties. One relates to the difficulty of proving reliance or the lack of it on an undisclosed fact. The other is concerned with the treatment of peripheral situations such as the following. Suppose, for example, directors deliberately understate earning reports in order to drive down the price of stock. The plaintiff does not hear or see these reports but sells his stock simply because the directors are successful in their efforts. Is plaintiff to be denied recovery because he did not see the reports and thus cannot prove reliance thereon? It would seem inequitable to so conclude. If, however, he can recover, what are the limits to a 10b–5 action?[58]

This question is directly related to the final issue I wish to discuss. That issue is whether or not plaintiff must be able to show privity in relation to the defendants. That is, must he be able to show that the stocks he bought or sold were purchased from or sold to the defendants? Or is it enough to show that he sold or purchased stock simply because of defendants' activities?

The first case to deal with this question was *Joseph v. Farnsworth Radio & Television Corp.*[59] In that action the court took note that the directors made false statements as to the corporation in order to boost the value of their shares. The plaintiffs did not, however, buy their stock until the defendants had finished selling theirs. Thus, it was evident that the plaintiffs did not buy from the directors. Because of this the court dismissed the action stating that in order for plaintiffs to have a case they must show a "semblance of privity between the vendor and purchaser."[60]

This result was immediately attacked by many commentators as being contrary to the intent and spirit of 10(b) and rule 10b–5. These critics argued that the section and the rule did not require privity, that they referred

[57] 208 F. Supp. 808 (E.D. Wis. 1962), *aff'd*, 319 F.2d 634 (7th Cir. 1963).

[58] For a penetrating look at the problem see Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b–5*, 65 COLUM. L. REV. 1361 (1965).

[59] 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd per curiam*, 198 F.2d 883 (2d Cir. 1952).

[60] *Id.* at 706.

to fraud and nondisclosure in "connection with the sale of a security," not necessarily a sale between plaintiff and defendant. Critics further asserted that if privity were required it is very unlikely that 10(b) and rule 10b–5 would apply to non-face-to-face transactions — that is, to transactions on the securities exchanges — for in such instances it would be difficult to relate sales and purchases.

While a few other decisions reached conclusions similar to the *Farnsworth* case, the drift was soon away from a strict privity concept. By 1962 the same court was saying in *Cochran v. Channing Corp.*[61] that the fact there is no privity of contract between plaintiff and defendant does not amount to a fatal defect of proof. It went on to observe that lack of privity will simply be one of the factors to be taken into account, not necessarily a controlling factor. As stated, other courts have taken a comparable position.[62] In fact, as a recent noted writer in the *Yale Law Journal* has said, "In recent years, the overwhelming number of courts that have considered the requirement of privity have discarded it as inappropriate."[63]

In truth, observations made earlier in this paper confirmed this conclusion, for we noted a case in which plaintiffs were able to maintain actions against the American Stock Exchange[64] and another case in which an action was allowed against an insurance company.[65] In neither of these cases was there privity between the parties to the action. It must be concluded, therefore, that lack of privity as such can no longer be considered an absolute limiting factor in a 10b–5 action. This is not to say, however, that privity has no significance whatsoever.

This brings me to my final observation, an observation already suggested, namely, that as of the present the limits of a 10b–5 action are impossible to ascertain. There are factors of significance, to be sure — for example, materiality, reliance, scienter, and privity — but no precise rules or limits.

The lack of precision should not be a cause for undue alarm, particularly for lawyers trained in a common law system, a system geared to a case to case development, a system in which the limits are hammered out over a period of time. Our real concern should be to see that the hammering out proceeds in an orderly fashion, evidencing a high sense of judicial statesmanship and an appropriate regard for all elements in our economy.

---

[61] 211 F. Supp. 239 (S.D.N.Y. 1962).

[62] Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964); Cooper v. North Jersey Trust Co., 226 F. Supp. 972 (S.D.N.Y. 1964); Texas Continental Life Ins. Co. v. Bankers Bond Co., 187 F. Supp. 14 (W.D. Ky. 1960), *rev'd on other grounds*, 307 F.2d 242 (6th Cir. 1962).

[63] Note, *Civil Liability Under Section 10B and Rule 10b–5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 663 (1965).

[64] Petit v. American Stock Exch., 217 F. Supp. 21 (S.D.N.Y. 1963).

[65] Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966).

UTAH LAW REVIEW

Member, National Conference of Law Reviews

VOL. 1967 MAY

NOTES

A Study of Labor Arbitration[1] — The Values and the Risks of the Rule of Law

Some of the best known authorities in labor law and arbitration are among those [2] who have criticized the 1960 labor arbitration decisions (the "*Trilogy*") of the Supreme Court.[3] In addition to disputing the accuracy of the Court's complimentary view of arbitration, some writers have criticized the labor arbitration process itself, saying that it is unworthy of the Court's praise and undeserving of the prominent role it has been given in federal labor relations law. A dearth of empirical studies and, perhaps, some political concern,[4] have hindered objective evaluation of both the decisions and the criticism. Thus, this note will examine labor arbitration in the light of experience gained since 1960 by two means — an empirical study of the use of precedent in arbitration opinions and a review of the post-1960 Supreme Court decisons that deal with labor arbitration.

I. Background

A. The 1960 "Trilogy"

The arbitration *Trilogy* was based upon the Court's duty, established in *Textile Workers Union v. Lincoln Mills*,[5] to develop a body of substantive

---

[1] "Arbitration" as used in labor law today refers to the arbitration of grievances arising under an existing collective bargaining contract. The procedure is one in which "a neutral third party or board, acting pursuant to authorization by both parties to a dispute, hears both sides of the controversy and issues an award, usually accompanied by a decision, which is final and binding on both parties." CCH Labor Law Course ¶ 3516 (16th ed. 1966). Voluntary arbitration of this kind is to be distinguished from "compulsory arbitration," in which a dispute settlement proceeds from a statutory directive to arbitrate. A distinction should also be drawn between arbitration and "conciliation" or "mediation," because the award of the arbitrator is binding whereas the suggestions of mediators are not. *Id.* Moreover, "mediation" usually refers to the resolving of disputes over new contract terms while arbitration is concerned with grievance disputes under an existing contract.

[2] *E.g.*, P. Hays, Labor Arbitration — A Dissenting View (1966); Davey, *The Supreme Court and Arbitration: The Musings of an Arbitrator*, 36 Notre Dame Law. 138 (1961); Gregory, *Enforcement of Collective Agreements by Arbitration*, 48 Va. L. Rev. 883 (1962); Meltzer, *The Supreme Court, Arbitrability and Collective Bargaining*, 28 U. Chi. L. Rev. 464 (1961); Rubenstein, *Some Thoughts on Labor Arbitration*, 49 Marq. L. Rev. 695 (1966); Wallen, *Recent Supreme Court Decisions on Arbitration: An Arbitrator's View*, 63 W. Va. L. Rev. 295 (1961). *See also* 13 Stan. L. Rev. 635 (1961).

[3] United Steelworkers v. Enterprise Wheel & Car Corp., 363 U.S. 593 (1960); United Steelworkers v. Warrior & Gulf Navigation Co., 363 U.S. 574 (1960); United Steelworkers v. American Mfg. Co., 363 U.S. 564 (1960). These three cases are hereinafter cited as *Trilogy*.

[4] It has seemed logical to some that the broadening of arbitral power on the matter of arbitrability, which was a primary result of the *Trilogy*, gives increased advantages to labor. Theoretically this advantage arises because the most a typical employer can expect to gain by arbitrating is the recognition of powers he would usually have in the absence of arbitration of the issue. The union, on the other hand, hopes to gain recognition of powers that it would never have in the absence of contract coverage, unless granted by federal law. *See* Burstein, *Labor Arbitration — A Management View*, in Proceedings of New York University Sixteenth Annual Conference on Labor 297, 311 (T. Christensen ed. 1963).

[5] 353 U.S. 448 (1957).

federal law governing the enforcement of collective bargaining agreements under section 301(a) of the Labor-Management Relations Act.[6] *Lincoln Mills* reversed the common law rule by holding that a court could grant specific performance of an agreement to arbitrate.[7] The 1960 cases established the additional principles that arbitrators rather than courts are to determine the arbitrability of disputes,[8] and that courts are to enforce arbitration awards subject to very limited powers of review.[9] The Court supported its position with a series of sweeping statements regarding the special competence of arbitrators and their role in the collective bargaining process. This language — most of it dicta — has been the target of the critics because it espouses concepts and theories of labor arbitration that are, allegedly, less clearly accepted in modern industrial relations than the unqualified words of the Court would indicate. In *United Steelworkers v. Warrior & Gulf Navigation Co.*,[10] which contains most of the asides on the arbitration process, Mr. Justice Douglas wrote that "arbitration of labor disputes under collective bargaining agreements is part and parcel of the collective bargaining process itself."[11] Proceeding from this premise, the opinion treated the collective bargaining contract as a "generalized code" covering "the whole employment relationship" and creating "a new common law — the common law of a particular industry or of a particular plant."[12] Because arbitration was seen as the "means of solving the unforeseeable by molding a system of private law for all the problems which may arise," the arbitrator's source of law "is not confined to the express provisions of the contract, as the industrial com-

[6] 29 U.S.C. § 185(a) (1964).

[7] At common law the agreement to arbitrate was not enforceable because the courts saw arbitration as an encroachment upon their own jurisdiction. The common law rule is explained, with apologies, by Justice Wolfe in Latter v. Holsum Bread Co., 108 Utah 364, 370, 160 P.2d 421, 423 (1945) (concurring opinion); *accord*, United States Asphalt Ref. Co. v. Trinidad Lake Petroleum Co., 222 F. 1006 (S.D.N.Y. 1915). *See also* Kadish, *Labor Arbitration and the Law in Utah*, 3 UTAH L. REV. 403 (1953).

[8] Prior to 1960, courts had been accustomed to ruling on the merits of disputes while clothing their decisions in the guise of deciding the arbitrability of the dispute. "Frivolous" claims were usually deemed nonarbitrable under the leading case, Machinists Local 402 v. Cutler-Hammer, Inc., 271 App. Div. 917, 67 N.Y.S.2d 317, *aff'd*, 297 N.Y. 519, 74 N.E.2d 464 (1947). However, in United Steelworkers v. American Mfg. Co., 363 U.S. 564 (1960), the Supreme Court compelled the arbitration of a grievance which the lower court had considered frivolous and patently not subject to arbitration under the collective agreement. The Court expressly disapproved of the *Cutler-Hammer* doctrine, stating that all grievances must be submitted to arbitration, "not merely those that a court may deem to be meritorious." *Id.* at 567. The function of a court in matters of arbitrability "is confined to ascertaining whether the party seeking arbitration is making a claim which on its face is governed by the contract." *Id.* at 568.

In the second case of the *Trilogy*, United Steelworkers v. Warrior & Gulf Navigation Co., 363 U.S. 574 (1960), the Court held that all disputes arising under a collective bargaining agreement that contains a no-strike clause are deemed to come within the arbitration clause of the agreement unless there is strong evidence of an intent to exclude the dispute. The arbitrator is to determine the scope of such exclusions, thereby determining arbitrability.

[9] In United Steelworkers v. Enterprise Wheel & Car Corp., 363 U.S. 593 (1960), the Court held that arbitration awards are to be upheld on review whenever the award "draws its essence from the collective bargaining agreement." *Id.* at 597. Thus, the "refusal of courts to review the merits of an arbitration award is the proper approach to arbitration under collective bargaining agreements." *Id.* at 596.

[10] 363 U.S. 574 (1960).

[11] *Id.* at 578.

[12] *Id.* at 578–79.

mon law — the practices of the industry and the shop — is equally a part of the collective bargaining agreement although not expressed in it." [13] The ability to draw upon such sources of law to the satisfaction of the parties is crucial; therefore, the arbitrator is chosen according to the parties' confidence in his ability to make decisions that will meet the unexpressed needs of the collective bargaining relationship.

This portrait of the arbitration process suffers from a number of deficiencies. Initially, the opinions reflect substantial reliance upon a famous article by Harry Shulman [14] that idealized a combination arbitration-mediation process which Shulman had elsewhere identified with the permanent umpire system,[15] although no attempt was made by the Court to distinguish between the permanent umpire and the ad hoc arbitrator. The failure to make this distinction undermines the validity of the Court's generalizations because ad hoc arbitrations are more common than arbitrations by permanent umpires.[16] A related problem is that arbitration has traditionally been under the exclusive control of the parties, which means that the number and variety of arbitration practices are infinite. As the role of the grievance arbitrator has come to be more sharply defined since World War II, there has been a tendency away from the negotiating or mediating type of arbitration. Until 1941, "arbitration" in labor relations had usually connoted what would now be called negotiation and was ordinarily concerned with the working out of contract terms.[17] The fostering of voluntary arbitration by the War Labor Board sharpened the distinction between the arbitration of contract terms and the arbitration of grievances. Thus, most of the arbitration clauses in contracts written after 1945 carried the intent that the commitment of the parties was to grievance arbitration, not to arbitration of new contract terms or to substantive issues beyond the scope of the contract.[18] Labor arbitration literature does reflect a continuing debate over the arbitrator's proper role in grievance arbitration, but the Court's position on the specific question

---

[13] *Id.* at 581–82.

[14] Shulman, *Reason, Contract, and Law in Labor Relations*, 68 HARV. L. REV. 999 (1955).

[15] Shulman, *The Role of Arbitration in the Collective Bargaining Process*, in LABOR LAW GROUP TRUST, LABOR RELATIONS AND THE LAW 711 (2d ed. D. Wollett & B. Aaron 1960). After observing that the distinction between the permanent umpire system and the ad hoc arbitration is "a differentiation of greatest moment," Shulman writes, "For the performance of the ultimate function of the grievance procedure including arbitration as I have described it, ad hoc arbitration is quite inadequate. . . . with respect to . . . the positive improvement of the parties' relation . . . ." *Id.* at 712.

[16] M. TROTTA, LABOR ARBITRATION 43 (1961). The ad hoc arbitration tribunal is a single arbitrator "selected by the parties after a dispute has arisen to hear one case or a group of cases. He may be selected frequently by the same parties but he has no prearranged relationship with them." *Id.* The permanent umpire, on the other hand, is appointed "for the life of the contract on a full-time or part-time (as needed) basis to deal continuously with such disputes as may arise requiring arbitral decision." *Id.* at 45. The permanent type of tribunal has grown steadily in recent years, particularly in larger industries.

[17] R. FLEMING, THE LABOR ARBITRATION PROCESS 1 (1965).

[18] *Id.* at 19.

whether arbitrators should be "mediators" or "judges" is not the most commonly held view.[19]

In addition to these conceptual weaknesses, the *Trilogy* description of arbitration contains a serious inconsistency. After describing the broad discretion of the arbitrator in *Warrior*, Mr. Justice Douglas retreated in *United Steelworkers v. Enterprise Wheel & Car Corp.*, by stating that

> [A]n arbitrator is confined to interpretation and application of the collective bargaining agreement; he does not sit to dispense his own brand of industrial justice. He may of course look for guidance from many sources, yet his award is legitimate only so long as it draws its essence from the collective bargaining agreement. When the arbitrator's words manifest an infidelity to this obligation, courts have no choice but to refuse enforcement of the award.[20]

When this rather restrictive statement is compared with the Court's earlier pronouncements, the Court's view of arbitral discretion becomes cloudy. It may be that broader discretion was intended to be exercised in determinations of arbitrability, the issue in *Warrior*, than in the rendering of arbitration awards or remedies, the issue in *Enterprise*. It may also be that the Court was giving advice to lower courts in *Warrior* and to arbitrators in *Enterprise*, suggesting that the two decisions are intended to give each group its own guidelines. This interpretation is particularly plausible in view of the underlying need in all three cases to somehow define the boundaries of the judicial and arbitral roles in the fashioning of industrial relations law. The Court was faced with no small difficulty in reconciling the legislative policy favoring private resolution of labor-management differences[21] with the direction given the judiciary by section 301 to become involved in those differences through the enforcing of collective bargaining agreements. Whether it was necessary for the Court to employ hyperbole or even to describe arbitration might well be considered a separate question, however, since much of the Court's language was unnecessary even in the establishment of relative spheres of jurisdiction. Whatever the reasons for the Court's position, its dicta as well as its holdings in the *Trilogy* have focused unprecedented attention on the labor arbitration process.

B. Historical Development of Labor Arbitration

By the time *Lincoln Mills* was decided in 1957, labor arbitration had developed into an isolated, private system of law. There are several reasons for this peculiar development. Historically, arbitration was used as a necessary means of settling disputes long before formal court systems were established.[22] As litigation in public forums developed, the arbitral tradition of lay judges was carried over even though private arbitration continued to have a

[19] *See* notes 61–63 *infra* and accompanying text.

[20] 363 U.S. at 597.

[21] "Final adjustment by a method agreed upon by the parties is declared to be the desirable method for settlement of grievance disputes arising over the application or interpretation of an existing collective-bargaining agreement." Labor-Management Relations Act § 203(d), 29 U.S.C. § 173(d) (1964).

[22] M. TROTTA, LABOR ARBITRATION 1–3 (1961); C. UPDEGRAFF & W. MCCOY, ARBITRATION OF LABOR DISPUTES 3–4 (2d ed. 1961).

place coexistent with the courts.[23] This concurrent development continued because of the utility of pragmatic dispute settlements short of litigation in many types of cases. Arbitration was especially useful for parties to a continuing relationship,[24] which largely explains its appropriateness in labor-management relations where the minimizing of friction and the expeditious resolution of differences are vital. The natural privacy of independent arbitration was reinforced by the hostility of the common law courts to arbitration as an encroachment upon their jurisdiction.[25] This haughty judicial attitude was even more marked in the labor area because of the historical animosity between American courts and the labor movement generally.[26] It was also an idea inherent in the legally established concept of modern collective bargaining that wages and other conditions of employment should be left to autonomous determination between labor and management.[27] Thus, labor arbitration grew out of the converging of two separate traditions — arbitration and labor — both of which had evolved into systems uniquely isolated from the normal forces of law. This isolation had become so much a part of the American tradition of labor arbitration that in 1955, perhaps in anticipation of *Lincoln Mills*, the "law" was asked to "stay out" of arbitration[28] because autonomy was believed necessary to the continued existence of arbitration's reason for being.

Some of those who took this anti-judiciary position believed not only that courts should not get involved, but that the arbitration process should remain free from any kind of "legalism." The leading statement of this view was an editorial published by the American Arbitration Association which observed with much concern the emergence of "a frustrating kind of legalism" in labor arbitration since World War II.[29] The editorial reflected what had been a

---

[23] J. DAWSON, A HISTORY OF LAY JUDGES 13 (1960).

[24] Peace has always been at a premium in such cases.

> [O]ne general theme . . . constantly recurred — the desirability of settlement by consent as a means of avoiding strife and promoting peace. The recitals in a decree of 1596 are characteristic:
>
> > It was moved and thought meete by this cowrt that some indifferent gentlemen who are of understanding and dwell in the county where the controversy groweth and may thereby knowe the partyes and credytt of the wytnesses. . . .
>
> should be asked to call the parties and bring them to a "friendly and quyett end." The color provided by . . . "friendly and quyett" is a significant clue to main attitudes.

Id. at 168.

[25] Note 7 *supra*. Former Justice Goldberg has observed that the courts were also reluctant to hold parties to rights and duties adjudicated without the protections of a court of law. Goldberg, *A Supreme Court Justice Looks at Arbitration*, 20 ARB. J. (n.s.) 13, 14 (1965).

[26] *See generally* C. GREGORY, LABOR AND THE LAW (2d rev. ed. 1958).

[27] Shulman, *Reason, Contract, and Law in Labor Relations*, 68 HARV. L. REV. 999 (1955).

[28] *Id.* at 1024. Dean Shulman's article is the classic statement of the autonomous position of arbitration in relationship to the courts.

[29] *Creeping Legalism in Labor Arbitration: An Editorial*, 13 ARB. J. (n.s.) 129 (1958). The editorial evoked alarmed responses in defense of such legal practices as reliance on precedent, procedural rules, and the use of counsel. *See, e.g.*, Aaron, *Labor Arbitration and its Critics*, 10 LAB. L.J. 605 (1959); Garrett, *Are Lawyers Necessarily an Evil in Grievance Arbitration?*, 8 U.C.L.A.L. REV. 535 (1961); Tobias, *In Defense of Creeping Legalism in Arbitration*, 13 IND. & LAB. REL. REV. 596 (1960).

continuing debate over the publishing of arbitration awards, reliance on precedent, the use of legal notions in matters of evidence and procedure, and the role of the arbitrator. The extreme isolationist view was influenced by its conception of labor arbitration as an extension of the collective bargaining process, which gave an even greater emphasis to the privacy and informality of arbitration.[30] There were many arbitrators and students in the late 1940's and early 1950's, however, who saw labor arbitration more as a decisional or judgment-oriented process [31] than as a compromising or mediating process. The distinction between these two positions seemed significant not only because it affected one's opinion regarding the nature of arbitration, but because the decisional viewpoint made arbitration more akin to the judicial process [32] and, therefore, more receptive to the use of "legalism."

In the midst of this debate *Lincoln Mills* and the *Trilogy* decisions were rendered, focusing the attention of students of the arbitration process upon the problems associated with judicial involvement. The arbitration opinions of the Supreme Court did little to resolve the specific questions about legalism, but they did put an end to much of the isolation enjoyed by arbitration. They also interjected a new factor — the close relationship between arbitration and the courts — into the discussion about the proper nature of the arbitration process and the role of the arbitrator. Moreover, the dicta in the *Trilogy* cases seemed to express an opinion about some of the issues in that discussion by supporting the "mediator" view of the arbitral role.

The purpose of the next section of this note is to examine one legalistic aspect of arbitration as it was used both before and after the Supreme Court's decisions in an effort to add some objective evidence to the discussion and to provide source material to be compared with the opinions of the Court in an evaluation of the present nature of arbitration.

II. Stare Decisis and Labor Arbitration

Arbitration is a more informal proceeding than the courtroom trial or the administrative hearing. The pleadings consist of a simple statement regarding the nature of the dispute followed by a possible answer, but otherwise there is no pretrial procedure. The hearing is conducted before a panel or an individual selected by the parties who is usually a professional arbitrator, a

[30] *See* Taylor, *The Voluntary Arbitration of Labor Disputes*, 49 Mich. L. Rev. 787 (1951).

> By this view the arbitrator has a roving commission to straighten things out, the immediate controversy marking the occasion for, but not the limits of, his intervention. If the formal submission leaves fringes of dispute unsettled, he will gladly undertake to tidy them up. . . .
>
> The critics of this view . . . [say] [i]t is a Messianic conception, a patent abuse of power, a substitution of one-man rule for the rule of law. . . . I suggest that we describe this view as one that sees the arbitrator, not as a judge, but as a labor-relations physician.

Fuller, *Collective Bargaining and the Arbitrator*, in Collective Bargaining and the Arbitrator's Role 8, 9 (M. Kahn ed. 1962).

[31] *E.g.*, Hepburn & Loiseaux, *The Nature of the Arbitration Process*, 10 Vand. L. Rev. 657, 662 (1957); Mentschikoff, *The Significance of Arbitration — A Preliminary Inquiry*, 17 Law & Contemp. Prob. 698, 699–700 (1952).

[32] Mentschikoff, *supra* note 31, at 699–700. A general discussion of the literature on both sides of this controversy may be found in Garrett, *supra* note 29, at 545–49.

lawyer, or an educator with experience in industrial relations. Although the procedure may be established by the parties and influenced by the preference of the arbitrator, basic rules have been established by custom, statute,[33] and by recommendations of organized groups of arbitrators.[34] The limited availability of judicial review and arbitration's isolation from most rules of law,[35] however, make any standards beyond the most elementary difficult to enforce. The concept of burden of proof is recognized and generally followed even though it may not always be characterized in legal nomenclature.[36] The arbitrator judges relevancy and materiality of evidence, but because the emphasis has traditionally been upon maximizing the amount of information made available to the arbitrator, evidentiary rules are not strict. Thus, hearsay is not ordinarily excluded, and the arbitrator may obtain permission to undertake limited investigations; but the reasons for the most basic rules of evidence seem to be generally accepted and implemented.[37] Studies of due process in arbitration indicate that fundamental standards of fairness are usually observed, although some concern is expressed regarding the risks to the rights of individual employees arising from the flexibility and informality of the arbitration process.[38]

---

[33] For a discussion of the federal and state arbitration statutes see *Report of the Committee on Labor Arbitration and the Law of Collective Bargaining Agreements*, in ABA SECTION OF LABOR RELATIONS LAW, 1966 COMMITTEE REPORTS 91, 92 (1966). The federal arbitration act, 9 U.S.C. §§ 1–14 (1964), was once thought to be inapplicable to labor arbitration disputes, Pennsylvania Greyhound Lines, Inc. v. Amalgamated Ass'n of Street Employees, 193 F.2d 327 (3d Cir. 1952), but it has been more recently interpreted to be applicable. Local 1645, Metal Prods. Workers v. Torrington Co., 242 F. Supp. 813 (D.C. Conn. 1965), *aff'd*, 358 F.2d 103 (2d Cir. 1966). Because the federal statute had not been considered applicable, a federal labor arbitration act was at one time proposed by the National Academy of Arbitrators. The specificity of this proposal would probably make it more useful in labor arbitration than the more general federal act now in existence. The proposal is set forth at M. TROTTA, *supra* note 16, at 400–14.

[34] See, for example, the list of 46 rules in AMERICAN ARBITRATION ASS'N VOLUNTARY LABOR ARBITRATION RULES (1965). Canons of ethics have also been adopted jointly by the National Academy of Arbitrators and the American Arbitration Association with the approval of the Federal Mediation and Conciliation Service. M. TROTTA, *supra* note 16, at 28. These canons are set forth in *id.*, at 381–89.

[35] It is not yet certain to what external sources of law arbitrators are or should be legally responsible under the limited review powers given the courts in the *Trilogy*. It appears that no rules of law are clearly binding upon them — except, perhaps, the most basic constitutional protections. *See* Fleming, *Some Problems of Evidence Before the Labor Arbitrator*, 60 MICH. L. REV. 133, 167 (1961). Even the Supreme Court's decisions on arbitration are not considered binding in any detailed sense by many arbitrators. *See* Smith & Jones, *The Impact of the Emerging Federal Law of Grievance Arbitration on Judges, Arbitrators, and Parties*, 52 VA. L. REV. 831, 866–73 (1966). An arbitration award will not be enforced by a court, however, if basic standards of fairness were not observed by the arbitrator. Moreover, awards may not require parties to violate existing law, Comment, *Judicial Enforcement of Labor Arbitrators' Awards*, 114 U. PA. L. REV. 1050, 1062 (1966), and specific statutory provisions may be binding upon arbitrators. *See* Jones, *Evidentiary Concepts in Labor Arbitration: Some Modern Variations on Ancient Legal Themes*, 13 U.C.L.A.L. REV. 1241, 1247–55 (1966). Professor Fleming has also observed that arbitrators rely heavily upon the courts in deciding how to handle certain kinds of evidence. Fleming, *Some Observations on Contract Grievances Before Courts and Arbitrators*, 15 STAN. L. REV. 595, 612 (1963).

[36] *See* Gorske, *Burden of Proof in Grievance Arbitration*, 43 MARQ. L. REV. 135, 179 (1959).

[37] *See generally* Jones, *supra* note 35.

[38] *See* Fleming, *Some Problems of Due Process and Fair Procedure in Labor Arbitration*, 13 STAN. L. REV. 235 (1961); Wirtz, *Due Process of Arbitration*, in THE ARBITRATOR AND THE PARTIES 1 (J. McKelvey ed. 1958).

The legal premises from which arbitration decisions are derived depend upon the clarity of the collective bargaining agreement with regard to the issue at hand. Since the arbitrator's power is based upon the contract, an effort is made to draw upon its terms; however, many arbitration cases involve pure factual determination, and many more reach the arbitration stage of the grievance procedure precisely because the contract is ambiguous. In cases of ambiguity, arbitrators must look to the circumstances under which the contract terms were written, the past practices between the parties, the handling of similar problems in other arbitration cases, or an intuitive judgment based upon the needs of the parties or the opinion of the arbitrator. It is at this point that serious questions arise regarding the role and discretion of the arbitrator.

On the matter of precedent, it is commonly observed that the doctrine of stare decisis has no application in labor arbitration.[39] However, as early as 1948 it was noted that the participation of lawyers and the publication of arbitration awards, which began in 1946, were resulting in the citation and analysis of precedents in arbitration opinions.[40] Furthermore, the compilation of arbitration awards has led to various categorizations and analyses designed to reflect the "common law" of arbitration.[41] A number of arbitrators and students have also argued affirmatively that reliance upon precedent would be beneficial to the arbitration process.[42] Disagreement with this position has been based primarily upon the fear that increased use of precedent would undermine the pragmatic flexibility that has been characteristic of arbitration.

A. A Study of Precedent in Arbitration Awards

What follows is the report of an attempt to analyze the use of precedent in three hundred arbitration decisions. It is hoped that this study will provide some empirical evidence for more general observations about stare decisis, legalism, and the nature of arbitral decision-making. This study, like any

---

[39] *E.g.*, M. BEATTY, LABOR-MANAGEMENT ARBITRATION MANUAL 121 (1960); M. TROTTA, *supra* note 16, at 76; 1 B. WERNE, ADMINISTRATION OF THE LABOR CONTRACT vi (1963).

[40] Note, *Case Law or "Free Decision" in Grievance Arbitration*, 62 HARV. L. REV. 118 (1948). *See also* Note, *Predictability of Result in Commercial Arbitration*, 61 HARV. L. REV. 1022 (1948). A plea is made in the latter source for more legalistic arbitration awards in order to increase the understanding and confidence of attorneys, although it is observed that substantive rules of law are not ignored in arbitration.

[41] *E.g.*, M. STONE, LABOR-MANAGEMENT CONTRACTS AT WORK (1961); 1–3 B. WERNE, ADMINISTRATION OF THE LABOR CONTRACT (1963). The latter is a three volume treatise based upon hundreds of arbitration decisions. It sets forth general rules and guidelines used in labor contract administration. *See also* Note, *Factors Relied on by Arbitrators in Determining Wage Rates*, 47 COLUM. L. REV. 1026 (1947); Note, *The Arbitration of Subcontracting Disputes*, 19 ME. L. REV. 55 (1967); Note, *Discharge in the "Law" of Arbitration*, 20 VAND. L. REV. 81 (1966).

The tendency to seek for conceptualization is further illustrated by a recent discussion of the use of past practice in arbitration decisions. It was there concluded that the combining of facts, contract language, past practice, and various intangibles to give the arbitrator his "intuition" is "no longer a satisfactory basis for decisions." Thus the adoption of a "general theory" on the adoption of past practice was advocated for the sake of certainty, predictability, and the acceptability of decisions. Comment, *The Doctrine of Past Practice in Labor Arbitration*, 38 U. COLO. L. REV. 229, 247 (1966).

[42] *E.g.*, Elkouri, *The Precedential Force of Labor Arbitration Awards*, 3 OKLA. L. REV. 255–59 (1950); Tobias, *supra* note 29.

study of decision-making processes, is fraught with difficulties inherent in observing selected examples of human behavior for the purpose of drawing generalizations applicable to an entire class of persons. Moreover, the use of written opinions as a reflection of the true bases for decisions is always subject to qualification, and written arbitration decisions must be even further qualified. Only four percent of the arbitration awards made in this country are written, reported, and published.[43] The arbitrators and the parties themselves decide whether to submit an opinion for publication, and the reasons for requesting publication are not very clear.[44] Also, the reasons for writing arbitration opinions differ from the reasons for writing judicial decisions. The latter are written with a definite intent to provide rationale for the future application of the decision as precedent; the former are often said to be written only to give the facts of and reasons for a particular case as a service to the immediate parties.[45] It appears obvious, however, that the *publication* of written arbitration awards by national services is primarily for the benefit of other arbitrators and other contracting parties who seek to understand common problems in labor relations. In addition to these qualifications, the accuracy of this study is limited by the fact that the weights and sources of given precedents are not always clear from written opinions; that prior cases may be followed or rejected without any indication to that effect in the written award; that arbitration decisions are not necessarily attempting to conform to the procedural or substantive standards of a body of common law; and that a study of only one factor provides but a limited amount of information about the arbitral process.

Nevertheless, citations of precedent are likely to be more tangible factors in deciding arbitration cases than are many other factors such as policy, intuition, or weighing of the equities, which, because usually unexpressed, are not readily subject to objective examination. As a hallmark of legalism, the precedent factor is also useful in determing whether arbitrators feel obliged to justify their decisions rationally or legally as opposed to merely giving a visceral response to the case at hand. Evidence of this kind should at least further understanding of what is happening in arbitration, which in turn should promote a more realistic discussion of what ought to be happening.

This study is based upon one hundred decisions written between March, 1948 and October, 1948; one hundred decisions written between March, 1956, and October, 1956; and one hundred written between May, 1965, and April, 1966. The first two periods represent the first year after the Taft-Hartley amendments to the NLRA were enacted and the first year before *Lincoln Mills*. The last period reflects the decisions written five years after the *Trilogy*. The periods were chosen to allow a determination of the effect of *Lincoln Mills* and the *Trilogy*, which should be reflected in the last hundred decisions.

[43] P. HAYS, LABOR ARBITRATION — A DISSENTING VIEW 53 (1966).

[44] One logical reason for having awards published is the arbitrator's desire to let his name and opinions appear in print as a means of advertising his availability and competence to decide other cases. Thus BNA's *Labor Arbitration Reports* provides biographical information on the arbitrators who decided the published cases "[t]o assist parties in their choice of an arbitrator." 46 Lab. Arb. iv (1966).

[45] M. STONE, LABOR-MANAGEMENT CONTRACTS AT WORK 289 (1961).

It is assumed that changes in the use of precedent that result from mere passage of time or accumulation of decisions will be shown by comparing the first two periods because no significant legislation or Supreme Court cases affecting arbitration occurred during that period. Trends appearing in the last period that did not begin in the second period are probably the result of the post-1957 cases. The decisions were selected on a random basis, the author reading the first hundred opinions in volumes 11, 27, and 46 of BNA's *Labor Arbitration Reports*.[46] As the cases were read, a record was made of the type of dispute (subcontracting, discharge, etc.); whether the arbitrator was permanent or ad hoc; whether counsel was present for neither party, both parties, the union only, or management only; the name and profession of the arbitrator; and whether there was any reliance on precedent.[47] If some reliance was indicated, it was evaluated as being mildly persuasive,[48] persuasive,[49] strongly persuasive,[50] authoritative,[51] or binding.[52] The source of the precedent was also recorded as coming from a judicial opinion, an NLRB opinion, a treatise on arbitration, or an arbitration opinion. Arbitration opinions were further categorized into cases dealing with the

[46] The cases were thus read in the order they appeared in the bound reports, although opinions under one page in length were omitted as well as opinions involving more than three grievances in the same opinion. The court opinions reprinted in earlier volumes were also omitted as were arbitration opinions dealing with the mediation of new contract terms or with veterans' problems only. These omissions were designed to preserve a consistency of the kinds of cases read in each period. The consistency that did appear by omitting what is indicated may be illustrated as follows: of the 100 opinions read in each period, there were 21 discharge cases in 1948, 24 in 1956, and 23 in 1965; there were 10 discipline cases in 1948, 7 in 1956, and 11 in 1965; there were 8 holiday-vacation cases in 1948, 6 in 1956, and 5 in 1965. More variety appeared in other types of cases, however. For example, there were 7 layoff cases in 1948, 4 in 1956, and 1 in 1965; there was 1 subcontracting case in 1948, 6 in 1956, and 3 in 1965.

[47] Of course, the precise detail necessary for categorizing each case in each area of comparison was not always present in the written opinions. For example, most of the more recent decisions do not indicate whether the arbitrator is ad hoc or permanent, although the earlier opinions usually state this fact. The presence of counsel is indicated in approximately two-thirds of the cases. Also, precedent is often mentioned without any citation of authority. *E.g.*, Harshaw Chem. Co., 46 Lab. Arb. 248, 251–52 (1965) (long list of factors to be applied in determining "just cause"); Todd Shipyards Corp., 27 Lab. Arb. 153, 156 (1956) ("It is a well established principle in arbitration that . . ."); Consolidated Vultee Aircraft Corp., 11 Lab. Arb. 152, 153 (1948) (reference made to the "well-established right of reasonable self defense" in employee fighting cases).

[48] *E.g.*, Central Soya Co., 46 Lab. Arb. 65, 69 (1966) ("It is not unusual" for certain terms to be left undefined; citation follows); F. L. Jacobs Co., 27 Lab. Arb. 339, 343 (1956) ("I agree in principle with the observations of" the arbitrator cited in the company's brief).

[49] *E.g.*, R. & K. Plastic Indus. Co., 46 Lab. Arb. 11, 15 (1966) (decision "supported by a number of published decisions"); Monsanto Chem. Co., 27 Lab. Arb. 400, 403 (1956) (prominent arbitrators cited, but only to give "comfort" to present arbitrator).

[50] *E.g.*, Square D Co., 46 Lab. Arb. 39, 42 (1966) (several generally recognized propositions followed by citations); Fruehauf Corp., 46 Lab. Arb. 15, 20–21 (1966) (the general rule established by other authorities applied to facts of case for decision).

[51] *E.g.*, Equitable Gas Co., 46 Lab. Arb. 81, 89–90 (1965) (numerous arbitration decisions taken to establish general rule; stare decisis expressly recognized); Morris P. Kirk & Son Inc., 27 Lab. Arb. 6, 10 (1956) ("[N]o more authoritative source" can be found than NLRB policy on recognition clauses).

[52] *E.g.*, Mobil Oil Co., 46 Lab. Arb. 140, 147–48 (1966); RKO Radio Pictures, Inc., 11 Lab. Arb. 268, 273 (1948) (other awards establish principles taken to be "sound and controlling" in instant case).

plant involved, the industry involved, or arbitrations in other industries. If no reliance on precedent was indicated, the primary sources of the arbitrator's legal premises were recorded — the plain meaning of the collective bargaining contract, past practice, a priori reasoning, or combinations of these. Many of the cases decided questions of fact so that no legal premises were involved. This categorization among cases where no precedent was cited provides a secondary study of the degree of discretion exercised in arbitration decisions.

1. Substantial increase in the use of persuasive precedent since 1957. Although the total number of cases in which there was some reliance upon cited authority remained nearly constant between 1948 and 1956, there was a 50 percent increase between 1956 and 1965.[53] A comparison of the three periods indicates that the natural accumulation of published arbitration awards or other relevant decisions is probably not a primary cause of the recent increase because there is not the gradual increase between each period which would be the logical result of the accumulation factor. More likely reasons for the increase are revealed by elements of the study dealing with the professions of arbitrators and the presence of counsel for the parties involved. In 1948, 53 percent of the arbitrators who wrote opinions considered by this study had received legal training.[54] Not all of these were attorneys by profession at the time the opinions were written, but they had obtained law degrees. Between 1948 and 1956 the number of law-trained arbitrators whose opinions were published dropped to 46.4 percent, but between 1956 and 1965 the number rose to 66.3 percent.[55] This recent increase parallels the increase between 1956 and 1965 in the use of precedent. In addition to showing a greater number of law-trained arbitrators since *Lincoln Mills* and the *Trilogy*, the study indicates that the law-trained arbitrators relied on precedent in a gradually increasing manner during all three periods.[56] A marked increase in the use of precedent among *nonlawyer* arbitrators between 1956 and 1965 shows that one definite factor in the general

[53] In 1948 there was some reliance on cited authority in 35% of the cases. In 1956 this figure was 33% but in 1965 it rose to 49%. Thus at the present time it may be said that about half of the published arbitration opinions contain at least some reference to prior authorities.

[54] Biographical sketches of nearly all the arbitrators whose opinions are published by BNA may be found in the index volumes to BNA's *Labor Arbitration Reports.*

[55] In tabular form, the percentages of attorneys and non-attorneys (by training) for the three periods are:

	legal training	*no legal training*
1948	53%	47%
1956	46.4%	53.6%
1965	66.3%	33.7%

[56] Comparison of reliance and nonreliance on precedent between arbitrators with and without legal training:

	% of attys who relied	*% of non-attyns who relied*
1948	39.2	24.4
1956	46.7	21.2
1965	52.4	37.5

increase is more frequent citation of authority by arbitrators who would not be expected to use precedent from sheer force of habit or training.[57]

With regard to the employment of legal counsel, the study shows that although the use of counsel by unions alone (when management had no counsel) has not increased since 1948, the number of cases in which counsel was present either for management alone or for both parties has clearly increased.[58] It is to be expected that the employment of counsel by the parties will result in legalistic briefs that contain citations of authority designed to persuade the arbitrator. However, citations of authority by the parties does not seem to have been a major cause of increased citations by arbitrators, judging by the relative constancy of the number of cases in which the arbitrator has referred to the parties' citations for the purpose of distinguishing them.[59] The general increase in the participation of lawyers in the arbitration process statistically parallels the increase in citations of precedent.

A further reason for the increase since 1956 is the awareness of arbitrators that the judiciary has become much more involved in the arbitration process. This kind of awareness would naturally make arbitrators more conscious of the need to explain the premises used in deciding a case. One aspect of the study showed that although vague references to precedents without citations of authority increased 50 percent between 1948 and 1956, references of this kind then decreased 25 percent between 1956 and 1965. In other words, arbitrators have become less inclined to state "general rules" of arbitration law without substantiating their statements by express citations of authority.

2. *No increase in the use of authoritative precedent.* One significant qualification must be added to the observation that precedent is being increasingly relied upon in arbitration cases; namely, that there has been no substantial increase in the use of *authoritative* precedents. Rather, the large increase has been in the use of *persuasive* precedents from arbitration decisions written in cases outside the plant in which the precedent is being applied. This suggests that although arbitrators are more concerned with justifying their decisions by the "weight of authority" derived from general arbitration opinions, they have not yet begun to treat that authority as binding. The authoritative precedents that are used come primarily from the same plant, but there are few such prior decisions available in most arbitrations. A few court cases and NLRB opinions are also treated as authoritative.

---

[57] The increase within this period was 76.9% in the percentage of arbitrators without legal training who relied on precedent. Compare the figures in note 56 *supra*.

[58] Percentage of cases in which counsel present for one, both, or neither party:

	neither	*union only*	*company only*	*both*
1948	50.0	7.5	25.0	17.5
1956	35.7	5.4	26.8	32.1
1965	21.1	7.9	35.5	35.5

It should be pointed out that not all published opinions gave an indication of which parties had counsel present. The number of opinions that contain this information has steadily increased, however, so that at present about three-fourths of the published awards list the names and titles of persons appearing at the arbitration.

[59] In 1948, 17% of the cases contained references to cases cited by one of the parties which were distinguished by the arbitrator from the case at hand. Some 15% contained references of this kind in 1956, and in 1965 the percentage moved back to 17%.

3. Decrease in the unsubstantiated exercise of arbitral discretion. The third major finding of this study was that the percentage of cases in which arbitrators premise their decisions upon intuitive reasoning has significantly decreased, suggesting again that the arbitrators are seeking to be rational if not legalistic in finding their decisional premises. This aspect of the study is based primarily upon an analysis of the sources of premises used in non-precedent cases.[60] This analysis revealed that the percentage of cases based upon plain meaning interpretations of contract language has steadily increased, while the percentage of decisions proceeding from the arbitrator's unarticulated or unsubstantiated reasoning have decreased.[61] The tendency of arbitrators to restrict themselves to the contract or to other observable limitations is further exhibited not only by the increased citation of authorities but also by several express statements in 1965–1966 cases to the effect that the arbitrator would not go beyond the contract to principles of "equity." [62] Far more often than not, there is a recognition that arbitrators are not to dispense their "own brand of industrial justice." [63] As a general observation, it appears from the cases studied that arbitrators are rather cautious about exercising discretion beyond the legitimate use of contract interpretation, persuasive or authoritative precedents, or past practice.

B. An Evaluation of Stare Decisis [64] *in Labor Arbitration*

While many writers would disclaim the existence of any stare decisis principle in labor arbitration,[65] the study reveals that the principle is an increasingly recognized factor in arbitral decision-making. Of course, if the entire country were treated as one common law arbitration jurisdiction, then general recognition of persuasive precedents would be insufficient to establish true stare decisis. However, the more logical jurisdictional lines should

---

[60] For purposes of comparison and analysis, the cases were categorized according to the source of the premises from which the arbitration opinion proceeded. These categories were: (1) the plain meaning of the contract, (2) reason or intuition of the arbitrator, (3) past practice, (4) cases of fact determination. In addition, cases involving mixtures of these various factors were categorized.

[61] In cases in which no precedent was relied upon, the following factors were the bases or premises of the decision. There were 65 such cases in 1948, 67 in 1956, and 52 in 1965. The figures given are in percentages of the total cases for the year involved. Abbreviations: F, fact; K, plain meaning of contract; R, reason or intuition of arbitrator; PP, past practice; Mixed, more than two factors used.

	F	*K*	*R*	*PP*	*F&K*	*F&R*	*F&PP*	*K&R*	*K&PP*	*R&PP*	*Mixed*
1948	18.5	9.2	7.7	0.0	12.3	27.7	4.6	7.7	6.2	3.1	3.0
1956	16.4	11.9	7.5	3.0	13.4	17.9	3.0	10.4	7.5	1.5	7.5
1965	17.3	15.4	1.9	1.9	17.3	17.3	1.9	9.6	7.7	1.9	7.8

[62] *E.g.*, Fibreboard Paper Prods. Corp., 46 Lab. Arb. 59, 61 (1966); R. & K. Plastic Indus. Co., 46 Lab. Arb. 11, 15 (1966).

[63] United Steelworkers v. Enterprise Wheel & Car Corp., 363 U.S. 593, 597 (1960).

[64] It should be noted that use of the term "stare decisis" as a blanket term referring to the use of both authoritative and persuasive precedents is subject to some possible qualification in the labor arbitration context. Prior decisions within the same plant may be followed for reasons other than stare decisis and citations of the prior cases will not be explained. One reason for following a prior decision is that it evidences the establishment of a type of past practice between the parties. Another is that the meaning of a contract term in issue might have been established in the prior arbitration so it would be followed for reasons akin to the res judicata policy.

[65] Note 39 *supra*.

probably be drawn around each plant or industry in which a collective bargaining agreement is in force. Assuming the existence of these narrower boundaries, it is quite consistent with stare decisis for one jurisdiction to treat the decisions of other jurisdictions as persuasive rather than authoritative. Thus, one reason why stare decisis has not seemed applicable to arbitration may be because of the innumerable independent arbitration jurisdictions, not because the rationale of the stare decisis principle is not relevant to the arbitration process. The study seems to substantiate this interpretation by showing that, particularly in the 1965–1966 cases, prior decisions from within the plant are quite consistently treated as authoritative rather than as persuasive.[66]

Aside from what may in fact exist, a more important question is whether stare decisis *ought* to be recognized by labor arbitrators and, if so, to what degree and with what qualifications arising from the peculiar nature of arbitration. It will be assumed in the following discussion that "stare decisis" refers to the use of persuasive authority from sources outside the plant in addition to the use of precedent cases from within the plant.

In its most basic sense, stare decisis is a natural response to the human need for reasonably certain expectations based upon past experience.[67] Thus, past experience is a significant reason for adhering to precedent just as new experience is a reason for departing from it. In both senses experience is, as Holmes said, the life of the law. When any development of law is so rapid and far-reaching as labor arbitration has become in the last two decades, accumulated experience in that development becomes an important source of knowledge if not a source of law.[68] There may not be the assurance that the experience contained in accumulated labor arbitration reports is the same kind of refined product that is produced by the appellate judicial process, but there is at least a collection of "expert testimony" sufficient to establish minimal generalizations.[69]

Beyond this foundational level, being able to rely upon prior decisions seems to further the private ordering of business, to promote fair and efficient

---

[66] For other expressions of the authoritative force of prior awards involving the same parties see Mobil Oil Co., 46 Lab. Arb. 140, 147 (1966); O & S Bearing Co., 12 Lab. Arb. 132, 135 (1949) (dictum). Both of these cases involved ad hoc arbitrators. Prior awards have had even more consistent authority in arbitration by permanent umpires. Elkouri, *supra* note 42, at 262–63.

[67] *See* Mentschikoff, *supra* note 31, at 701.

[68] *See* Elkouri, *Development of "Plant Law,"* in COLLECTIVE BARGAINING AND THE LAW 245 (1959); Larkin, *Comments*, in SYMPOSIUM ON LABOR RELATIONS LAW 422 (R. Slovenko ed. 1961).

[69] As stated by one authority:

> Outside the area controlled by statute there is no more important treasury of experience than the record of grievance arbitrations. Surely arbitrators have not labored at the administration of collective agreements for almost two decades without arriving at some generalizations upon which the unbiased can agree, even though partisan interests preclude unanimity. Perhaps only a few rules have developed, but there are attitudes, approaches, and even a number of flexible principles.

A. COX, LAW AND THE NATIONAL LABOR POLICY 72 (UCLA Institute of Industrial Relations Monograph No. 5, 1960).

adjudication, and to engender public confidence in decisional processes.[70] The private ordering of labor-management business is furthered by the parties' reliance upon prior arbitration decisions in drafting collective agreements and in interpreting existing provisions to permit or bar certain types of conduct. It can be argued that the parties to labor contracts should not be held to know all the "common law" of grievance arbitration because of the infinite variety of practices, the uncertain legal status of interpretations in other industries, and the policy favoring private determination of the terms of a collective bargaining relationship. On the other hand, many typical contract provisions are and should be treated as terms of art because of the convenience of expressing in shorthand form the understanding of the contracting parties. Such terms as "wages" and "discharge" fall into this category.[71] A related aspect of the private ordering permitted by reliance upon precedent is the confidence that may underlie the advice of counsel when predictability is possible. The past practice between the parties makes an additional contribution toward predictability,[72] but often there has been no past practice on a point of controversy between the particular parties involved. One reason for not encouraging attorneys' opinions in labor-management questions is that unions seem less able (or less willing) than management to afford legal advice.[73] The issue behind this objection — whether attorneys should be used in every phase of labor relations — is beyond the scope of the present discussion, but research of arbitration opinions by parties as well as by counsel can be useful in determining the wisdom of proceeding to the arbitration stage of the grievance process. If the incentive to arbitrate is minimized by greater predictability, settlements will be more likely and the policy favoring resolution of labor differences by the parties will be promoted. There may still be instances in which the parties would prefer to seek resolution of a dispute by arbitration rather than by resort to a "consensus" among other arbitrators, but this would be possible even if stare decisis were otherwise recognized since the parties to an arbitration could always stipulate that decisions from other plants or industries are not to be considered or they could seek to persuade an arbitrator that a

[70] For a good brief discussion of the role of stare decisis see H. HART & A. SACKS, THE LEGAL PROCESS: BASIC PROBLEMS IN THE MAKING AND APPLICATION OF LAW 587 (1958).

[71] *See* Gray, *Some Thoughts on the Use of Precedents in Labor Arbitration*, 6 ARB. J. (n.s.) 135 (1951).

[72] One writer thinks that past practice almost exclusively serves this function in labor relations, where there is said to be no stare decisis principle. M. STONE, LABOR-MANAGEMENT CONTRACTS AT WORK 277–78 (1961). The study discussed in this note indicated that precedents are used more frequently than is past practice in interpreting contract language.

Another important factor in the predictability of ad hoc arbitration decisions is whether the arbitrator is known to the parties. R. FLEMING, THE LABOR ARBITRATION PROCESS 79 (1965). This factor is not very relevant at an early stage of the grievance process because the arbitrator may not be chosen until the parties have decided that arbitration is necessary.

[73] As indicated earlier, note 58 *supra*, the use of legal counsel by management in arbitration proceedings has increased more rapidly than has the use of counsel by labor, even though unions seem to be employing counsel approximately 50% more now than in 1948.

minority approach is better. Whether reliance upon the "common law of arbitration" undermines the traditional purpose of arbitration, also at issue here, is considered later.

With regard to the role of precedent in furthering fair and efficient disposition of differences, many of the "ordering" considerations are applicable because, to the extent that predictability and settlement are possible, the economic and social costs of labor disputes are minimized. Fairness is generally promoted when the rule of law is followed and objective criteria for decision are available. This impersonalizing factor has further merit in labor arbitration because it tends to avoid the emphasis on shopping for an arbitrator who will decide in a given party's favor.[74] Reliance upon the rule of law, however, also poses a conflict with the traditional pragmatism that has characterized arbitration.

Another historical virtue of the stare decisis doctrine is that it furthers public confidence in the decisional process by making the decision subject to public and professional inspection according to discernible objective criteria and by using an impersonal, reasoned basis for the decision. Acceptability to the parties is also said to be promoted by these objective factors in a decision,[75] and the parties' willingness to voluntarily accept an arbitrator's award has traditionally been a key concept in successful arbitration.[76] Whether labor arbitration is in reality a voluntary process today may be disputed,[77] but because of the increased power of unions and the risks inherent to management through more arbitration,[78] acceptability of arbitration awards to management seems particularly important. The related question of acceptability to the public seems more relevant to judicial decisions than to arbitration, at least if one accepts the view that arbitration is essentially a private affair.[79] The preference given arbitration by the Supreme Court, however, seems to have cast it in the role of a creator of national labor law under the broad direction of section 301 and *Lincoln Mills*.[80] Given this unique cir-

[74] "Arbitrator shopping" has been recognized and criticized by a respected labor commentator. P. HAYS, LABOR ARBITRATION — A DISSENTING VIEW 39 (1966). *See also* Tobias, *supra* note 29, at 599–600.

[75] *See* Shulman, *Reason, Contract, and Law in Labor Relations*, 68 HARV. L. REV. 999, 1020 (1955).

[76] *See* Bernstein, *Nudging and Shoving All Parties to a Jurisdictional Dispute into Arbitration: The Dubious Procedure of National Steel*, 78 HARV. L. REV. 784 (1965).

[77] *See* Jones, *On Nudging and Shoving the National Steel Arbitration into a Dubious Procedure*, 79 HARV. L. REV. 327 (1965).

[78] Note 4 *supra*.

[79] For a statement of that view see Seitz, *The Arbitrator's Responsibility for Public Policy*, 19 ARB. J. (n.s.) 23 (1964). Furthermore, one long-standing argument against the publication of arbitration awards is that matters of private business concern should not be so widely revealed. *See* Cherne, *Should Arbitration Awards Be Published?*, 1 ARB. J. (n.s.) 75 (1946).

[80] As stated by ABA Committee Co-Chairman Paul Kuelthau,

> Because of the prevalence of provisions for arbitration in collective agreements, and because of the reluctance of the courts under the influence of the Supreme Court's 1960 trilogy decisions to interfere with arbitration and arbitration awards, the substantive law of the collective agreement is in fact being fashioned largely by arbitrators rather than by the courts.

Report of the Committee on Labor Arbitration and the Law of Collective Bargaining Agreements, in ABA SECTION OF LABOR RELATIONS LAW, 1966 COMMITTEE REPORTS 91, 114 (1966).

cumstance, it appears that arbitrators have a peculiar responsibility to the public to the extent that their role in affecting national labor policies affects the public interest. Moreover, one labor authority has characterized the arbitrator's interpreting of the collective agreement as the vehicle of due process in industry. This function gives those interpretations a responsibility to the public derived from the size and power of the economic interest groups involved.[81] In a narrower and yet in a more significant sense, labor arbitration now has a responsibility to communicate and interact with the judiciary in the shared role of developing the federal common law of labor relations. This responsibility, with all its limitations arising from the Supreme Court's desire to preserve arbitration's relative autonomy,[82] suggests that arbitrators should be accountable to the courts even if judicial review of their opinions remains discouraged. Before the 1960 cases, the courts were admonished by Professor Cox to recognize the peculiarities of administering collective agreements so that the law created under section 301 would be responsive to the needs and practices of labor-management relations.[83] The acceptance of this view in the *Trilogy* carries with it the implication that arbitration should reciprocate with an effort to understand and communicate with the judiciary. Thus, not only must there be a philosophy of grievance arbitration created "in terms which are familiar to the courts," [84] but "[i]f we are to develop a rationale of grievance arbitration, more work should be directed towards identifying the standards which shape arbitral opinions . . . ." [85] The use of reasoned opinions based on accepted objective criteria, including the doctrine of precedent, would seem to be one standard that is familiar to the courts and useful as a matter of labor policy.

Assuming that the recognition of prior decisions has general value in arbitration, one must still face the question whether the basic nature of arbitration is prohibitively undermined by adoption of the precedent principle. Even if it is only partially undermined, some accommodation of the conflicting policies is in order. There appear to be three fundamental objections to the use of precedent, persuasive or authoritative, that are based upon the pragmatic, private nature of arbitration. The first of these is that reliance upon precedent makes arbitration too inflexible because the facts of the particular case are not given sufficient weight.[86] This fear of excessive rigidity, which has long been a ground for criticizing the common law doctrine of stare decisis, was probably influential in the adoption of a somewhat more flexible approach to stare decisis in this country than had existed in England. More recently, the "socialization of the law" in the twentieth century has responded

[81] Jones, *Power and Prudence in the Arbitration of Labor Disputes: A Venture in Some Hypotheses*, 11 U.C.L.A.L. REV. 675, 789–90 (1964).

[82] *See* notes 134–37 *infra* and accompanying text.

[83] *E.g.*, A. COX, LAW AND THE NATIONAL LABOR POLICY (UCLA Institute of Industrial Relations Monograph No. 6, 1960); Cox, *Reflections upon Labor Arbitration*, 72 HARV. L. REV. 1482 (1959).

[84] Cox, *supra* note 83, at 1489.

[85] *Id.* at 1500.

[86] Cherne, *supra* note 79; Gitelman, *The Evolution of Labor Arbitration*, 9 DE PAUL L. REV. 181, 188–93 (1960).

to the need for a very liberal approach to precedent in order to keep the common law abreast of significant changes in the needs of society.[87] Some students of jurisprudence maintain that most judges decide cases on the basis of policy, if not emotion or intuition, and that the use of precedent merely provides a rationale for a decision already made.[88] Thus, the modern judicial approach to stare decisis is in fact quite flexible, particularly on the appellate level, although a few arbitrators and others continue to regard the doctrine as requiring undeviating adherence to past decisions.

It appears that some confusion has resulted from the semantic deception inherent in the popularly believed statements that courts accept the stare decisis principle and arbitrators do not. The fact is that "informal" arbitrators clearly use techniques employed by "formal" judges, such as looking to persuasive or authoritative precedents, and that judges use such informal techniques as intuition and weighing the facts and equities of a given case. A primary difference between the two processes, which may account for some of the confusion, is that in arbitration the policy or equity factors have traditionally been brought more "into the open" than has been the case in judicial opinions.[89] Thus, while observers of arbitration may plead for arbitrators to make more explicit the role of precedent or other objective criteria in their decisions, observers of the judicial process plead for judges to make more explicit the real weight of the equities or policy factors.[90] Another difference of some importance is that arbitrators seldom face a "line of authority" composed of decisions from within the plant. With either tribunal, reliance upon precedent is seldom the entire basis for a decision; therefore, the risk of inflexibility alone does not outweigh the beneficial uses of accepting prior decisions as influential in a subsequent case.

A second and more serious objection to the use of stare decisis in labor arbitration is that emphasis upon the rule of law is foreign to arbitration's functional justification for coexisting with the judicial process as a separate kind of proceeding.[91] One simple conceptualization of the functional distinction that has historically existed between courts and arbitrators seems to be that while courts have a legislative as well as an adjudicative role, arbitrators have had primarily an adjudicative role. Thus, courts are theoretically more concerned with stare decisis and the rule of law because of the relationship of their decision to past and future cases within their jurisdiction. Because

[87] Kocourek & Koven, *Renovation of the Common Law Through Stare Decisis*, 29 ILL. L. REV. 971, 976 (1935).

[88] *See, e.g.*, E. BODENHEIMER, JURISPRUDENCE 103–25 (1962) (general sketch of sociological jurisprudence and legal realism); Hutcheson, *The Judgment Intuitive: The Function of the "Hunch" in Judicial Decision*, 14 CORNELL L.Q. 274 (1929). Compare also Professor Cox's observation on the Warren Court, which, he says, is becoming very intuitive. Cox, *Constitutional Adjudication and the Promotion of Human Rights*, Foreword to Note, *The Supreme Court, 1965 Term*, 80 HARV. L. REV. 91, 94–99 (1966).

[89] *See* Mentschikoff, *supra* note 31, at 701–02.

[90] Address by Karl N. Llewellyn, in *Report of the Cincinnati Conference on the Status of the Rule of Stare Decisis*, 14 U. CIN. L. REV. 203, 216–17 (1940).

[91] For discussions of the traditional nature of arbitration, see Jones, *Power and Prudence in the Arbitration of Labor Disputes: A Venture in Some Hypotheses*, 11 U.C.L.A.L. REV. 675, 701–15 (1964); Morvant, *The Nature of Industrial Arbitration*, 12 LAB. L.J. 1042 (1961).

arbitrators are neither part of a state-run system nor part of a jurisdiction containing higher and lower tribunals, the emphasis in arbitration is upon the specific dispute, even though there may be some prospective or res judicata effect given the arbitrator's determination of the meaning of a given contract provision. By choosing the arbitrator themselves, the parties commit themselves to greater emphasis upon the subjective evaluation of the person selected than upon that person's ability to interpret "the law." The proceeding is conducted in private, it can be simple and efficient, and each arbitration is an independent event for which a subjective response that is fair enough to be acceptable is sufficient. However, if the rule of law is to be consistently applied in labor arbitration through increased reliance upon the authority of other arbitration opinions, it could be argued that arbitration should become part of the formal legal system — or at least take on formal legal trappings — in order to ensure fairness, objective consistency, and enforcement. Appeals on the merits would become more important, the participation of lawyers would become more necessary, and all arbitration awards would have to be published. The present status of arbitration is somewhere between these contrasting positions, but the movement is toward the rule of law.[92]

The third problem with using stare decisis is the assumption in applying that doctrine that there should be uniformity of decision at different times and places. This objection is closely connected with the problem just discussed because uniformity of treatment seems to require an ascendency of the rule of law applicable throughout the jurisdiction in which uniformity is sought. Stare decisis assures reasonable uniformity just as it assures relative certainty, predictability, and stability — by representing the law of the jurisdiction. There are probably instances in which national uniformity would be desirable in the administration of labor agreements.[93] The Supreme Court has expressed on at least two occasions a strong policy favoring uniformity between state and federal courts under section 301, particularly in questions involving "the formation of the collective agreement and the private settlement of disputes under it." [94] Whether arbitrators should establish or contribute toward that uniform law is another question, however, since there are several reasons, apart from the risks to arbitration's functional utility that are created by increased uniformity, why arbitration is not well suited to create uniform standards. Professor Mentschikoff has pointed out, for example, that many matters require uniformity not because one substantive view is necessarily best in all cases, but because "[m]ankind needs an irreducible minimum of certainty in order to operate efficiently." [95] In most instances of this kind, where it is better for the entire polity that there be a certain rule

[92] Notes 53–63 *supra* and accompanying text.

[93] *See* note 71 *supra* and accompanying text. There may also be merit to establishing uniform procedural standards. *See* Tobias, *supra* note 29, at 101.

[94] UAW v. Hoosier Cardinal Corp., 383 U.S. 696, 702 (1966); *see* note 112 *infra* and accompanying text.

[95] Mentschikoff, *The Significance of Arbitration — A Preliminary Inquiry*, 17 LAW & CONTEMP. PROB. 698, 709 (1952).

than no rule at all, that "irreducible minimum would seem to be better handled by the courts than by arbitration even though in the particular case the result would have been better decided in arbitration." [96] This is because the arbitrator, as one of the group for whom the rule is specifically established, treats the particular needs of the group as the dominant criteria for decision. "He may, indeed, be blind to the needs of the rest of us. That is inherently less likely to occur in our formal legal system." [97] Thus, it is argued, the highest courts should establish the basic uniform rules because the courts are better able to evaluate the needs of society generally,[98] even though arbitrators are better able to evaluate the needs of particular parties in particular cases. It appears that private collective bargaining, arbitration, the NLRB, the judiciary, and Congress all have functional roles to play in enabling workable labor-management relations. The more one is removed from the individual plant along this spectrum, the more responsible the given agency is to establish uniform national policy. If arbitrators attempt to assume general policy-making roles more properly assumed by agencies with broader functions, there is no small danger that the traditional utility of arbitration may be destroyed and that the greater institutional competence of other agencies along the spectrum will force the removal of arbitration from the picture.

Another limitation upon the ability of arbitrators to create uniform principles is that uniformity through a consensus of the published reports depends upon the assumption that words and phrases have the same meaning in all industries. Since the meaning of similar language varies significantly between industries according to the customs that have been independently established,[99] the development of uniform meanings risks the possible misapplication of "general rules." In addition, there are at present numerous problems associated with the use of published arbitration opinions for the determination of sound substantive principles of general application.[100] The need for the certainty provided by uniformity must also be weighed against the policy that favors the resolution of labor differences by the parties themselves.

A synthesis of the values and risks of a stare decisis principle in labor arbitration yields a concept that is short of true stare decisis. At the same time, it seems quite possible to make use of the experience, efficiency, and accountability enabled by recognizing and using prior arbitration awards as

---

[96] *Id.*

[97] *Id.* at 709–10.

[98] Another difference between courts and arbitrators that is relevant to a comparison of their respective abilities to fashion uniform labor laws arises from the more limited power sources available to the arbitrator. He is primarily a creature of the contract. The contract "is the charter, not only of the parties' rights but of his powers as well. The courts, on the other hand, have a commission broader than that of the enforcement of contracts. They have, accordingly, claimed the power to interpret contracts broadly in terms of their evident purpose . . . ." Fuller, *Collective Bargaining and the Arbitrator*, in COLLECTIVE BARGAINING AND THE ARBITRATOR'S ROLE 8, 14–15 (M. Kahn ed. 1962).

[99] See the comments of arbitrator Seward in *Panel Discussion: The Emerging "Industrial Jurisprudence"* in COLLECTIVE BARGAINING AND THE LAW 243, 262–63 (1959).

[100] *See* notes 43–45 *supra* and accompanying text.

factors in arbitral decision-making. Predictability and settlement cannot be based upon the same degree of reliance that may be possible in a normal stare decisis system, but broad kinds of predictions may be used. The use of reasoned opinions that explain to the parties and to the courts as accurately as possible why the arbitrator decided as he did should still be encouraged since this practice can make the arbitration process observable and acceptable. It should be realized that the desire for certainty and for uniformity, motivated by the obvious values of stability and efficiency, will tend to produce even greater citations of and reliance upon prior analogous awards by parties as well as by arbitrators. The growing participation of attorneys in all phases of the arbitration process will only hasten this tendency. However, if the rule of law becomes more important than the adjudicative function of arbitration, it may well be that arbitration will evolve into an arm of the formal legal system. If this were to happen, the roles of courts and arbitrators would become confused and the present value of private arbitration might become lost.[101]

III. POST-1960 SUPREME COURT DECISIONS ON ARBITRATION

Although the Supreme Court has given no indication since 1960 of any significant changes in its attitude toward labor arbitration,[102] several of the Court's decisions have explained the original pronouncements to the extent that role of arbitration is somewhat more clearly defined.

A. Arbitrability

Two cases have held arbitrability to be a question for courts rather than for arbitrators, although in both cases the only aspect of arbitrability determined by the Court was whether the arbitration clause applied at all to the employer.[103] These holdings give substance to the qualification expressed by

---

[101] As stated by one experienced student of labor arbitration:

> Perhaps the greatest hazard to the continued utility of arbitration is actually that it may become unduly conceptualized through its increasing contact with judicial administration and the influences legal reasoning exerts upon it. Paradoxically however, at least in the context of labor arbitration, the continued utility of arbitration to the parties having resort to it requires that there be some measure of predictability attributable so as to govern plant decisions by supervisors. The practical operation of this paradox has created the expectancy that arbitration will effectuate justice in the specific case, with careful but not controlling concern for past usages.

Jones, *supra* note 91, at 688.

[102] Most of the decisions that contain any reference to the *Trilogy* also contain some reaffirmation of the national labor policy favoring the private settlement of disputes with arbitration as a key factor in those settlements. *E.g.*, Carey v. Westinghouse Elec. Corp., 375 U.S. 261, 270–71 & n.7 (1964); Teamsters Local 174 v. Lucas Flour Co., 369 U.S. 95, 105 (1962). The major limitation of a general nature on this policy was the case of Sinclair Ref. Co. v. Atkinson, 370 U.S. 195 (1962), in which the Court denied an injunction sought by an employer against a strike that violated a no-strike clause. The Court stated that the Norris-LaGuardia Act, 29 U.S.C. § 101 (1964), limits the pro-arbitration policy when the right to strike is involved.

[103] John Wiley & Sons v. Livingston, 376 U.S. 543 (1964); Atkinson v. Sinclair Ref. Co., 370 U.S. 238 (1962). In *Atkinson*, the collective bargaining agreement excluded all disputes from arbitration except employee grievances. In determining whether the employer's § 301(a) damage suit for breach of contract should have been submitted to arbitration, the Court assumed the duty of deciding that the contract did not obligate the employer to arbitrate.

For an analysis of arbitrability decisions by arbitrators between 1960 and 1962 see Fleming, *Arbitrators and Arbitrability*, 1963 WASH. U.L.Q. 200.

the Court in 1960 upon the general rule that arbitrability is a matter for the arbitrator. In the 1964 case of *John Wiley & Sons v. Livingston*,[104] the Court explained that courts are to determine whether a party agreed initially to arbitrate disputes of a particular kind. Once the fact of this agreement is established, the arbitrability of a particular dispute is a decision for the arbitrator unless the matter is specifically excluded from the contract. The arbitrator is also to determine whether a dispute is ripe for arbitration under the grievance procedure of the contract.

The Court has also touched upon a question of arbitrability that troubled some observers of the *Warrior* case — whether all matters arising under the contract are arbitrable unless specifically excluded in the contract.[105] *Drake Bakeries, Inc. v. Local 50, American Bakery Workers*,[106] decided in 1962, seemed to support the arbitrable-unless-excluded position. However, some uncertainty may have been cast upon the Court's position in 1964 by its affirming, without opinion, a Seventh Circuit decision that held a close question of arbitrability to be a matter for the court even though the employer's general obligation to arbitrate was not in issue.[107] The Seventh Circuit used language to the effect that parties must consent to the arbitration of any matter before it is arbitrable, but in *Warrior* it was made clear that disputes are presumptively arbitrable unless excluded by "forceful evidence." [108]

B. The Sui Generis Nature of Federal Labor Arbitration Law

The Court has expressed several times its view of the collective bargaining agreement as being more than an ordinary contract. This means that normal principles of contract law are not necessarily applicable to disputes arising under labor-management agreements. In the *Wiley* case, for example, the Court held that a collective bargaining contract could survive a corporate merger while observing that "the principles of law governing ordinary contracts would not bind to a contract an unconsenting successor to a contracting party . . . ." [109] This general approach was qualified in 1966, however, by *UAW v. Hoosier Cardinal Corp.*,[110] which held that state statutes of limitations on contract actions apply to labor grievances arising under collective

---

[104] 376 U.S. 543 (1964).

[105] *See* note 8 *supra*. The Court stated that when "an absolute no-strike clause is included in the agreement, then in a very real sense everything that management does is subject to the agreement . . . ." 363 U.S. at 583. Therefore, "[i]n the absence of any express provision excluding a particular grievance from arbitration, we think only the most forceful evidence of a purpose to exclude the claim from arbitration can prevail. . . ." *Id.* at 584–85. The breadth of the Court's statement seems even broader since it was held in Teamsters Local 174 v. Lucas Flour Co., 369 U.S. 95 (1962), that a no-strike clause may be implied when a broad arbitration clause is present.

[106] 370 U.S. 254 (1962).

[107] Independent Petroleum Workers v. American Oil Co., 324 F.2d 903 (7th Cir. 1963), *aff'd by an equally divided Court*, 379 U.S. 130 (1964).

[108] Note 105 *supra*.

[109] 376 U.S. at 550 (1964). The same approach was taken in a recent case that required the Railway Adjustment Board to bring one union into a contract dispute between another union and an employer. Transportation-Communication Union v. Union Pac. R.R., 385 U.S. 157 (1966).

[110] 383 U.S. 696 (1966).

bargaining contracts. Some observers have interpreted this case to signal a possible return to the use of ordinary contract law,[111] but the Court explained in *Hoosier Cardinal* that "federal labor law" will continue to be applied in most cases concerning the administration of collective agreements.[112]

The *Wiley* case [113] articulated a related principle of the federal common law that is new to labor arbitration. The Court there explained that the duty to arbitrate "is not in any real sense the simple product of a consensual relationship." [114] Thus, the legal premises upon which the holding in *Wiley* was based came not from traditional arbitration or contract law,[115] but from "national labor policy" which contemplates elements of compulsion as well as consent in "voluntary" labor arbitration.

These illustrations suggest that the Court's attitude toward developing the law under section 301 has been highly pragmatic.[116] It therefore seems significant to identify and remain aware of the functional reasons that have motivated the Court to develop the principles thus far established. Further developments are likely to be more pragmatic than conceptual, depending more upon demonstrated values in labor-management relations than upon theoretical consistency.

C. The Discretion and Competence of Arbitrators

The Supreme Court has not said a great deal about arbitral discretion or competence since 1960, but one or two inferences may be drawn from the cases. There was some hint in the 1960 *Warrior* case that arbitration should be seen as an extension of the collective bargaining process.[117] If this view were correct, an arbitrator would have discretion to award remedies that require concessions of the parties beyond the explicit terms of the contract. However, *Humphrey v. Moore* [118] held that an employee can claim a contract violation under section 301 if the parties (labor and management) settle a grievance that goes beyond the strict terms of the contract. This holding appears to limit not only the discretion of the parties but also the discretion

---

[111] *Report of the Committee on Labor Arbitration and the Law of Collective Bargaining Agreements*, in ABA SECTION OF LABOR RELATIONS LAW, 1966 COMMITTEE REPORTS 91, 113 (1966).

[112] One reason for creating a new federal law of collective bargaining contracts is the need for uniformity, according to the Court. As stated in Teamsters Local 174 v. Lucas Flour Co., 369 U.S. 95 (1962), the "possibility that individual contract terms might have different meanings under . . . [two systems of law] would inevitably exert a disruptive influence upon both the negotiation and administration of collective agreements." *Id.* at 103–04. This position was reaffirmed in *Hoosier Cardinal*: "The need for uniformity . . . is greatest where its absence would threaten the smooth functioning of those consensual processes that federal labor law is chiefly designed to promote — the formation of the collective agreement and the private settlement of disputes under it." 383 U.S. at 702.

[113] John Wiley & Sons v. Livingston, 376 U.S. 543 (1964).

[114] *Id.* at 550.

[115] The consensual nature of the agreement to arbitrate has long been considered the very basis of arbitration as a private system of settling disputes. *See* Bernstein, *supra* note 76.

[116] *Compare id. with* Jones, *On Nudging and Shoving the National Steel Arbitration into a Dubious Procedure*, 79 HARV. L. REV. 327 (1965).

[117] United Steelworkers v. Warrior & Gulf Navigation Co., 363 U.S. 574, 578 (1960).

[118] 375 U.S. 335 (1964).

of the arbitrator, because if the parties cannot go beyond the contract by mutual consent, the arbitrator's discretion is a fortiori limited to the contract. Without this limitation arising from *Humphrey*, the parties could theoretically consent to giving the arbitrator discretion that exceeds the contract in the submission agreement or by their mutual consent as parties to the arbitration. Mr. Justice Goldberg's concurring opinion in *Humphrey*[119] argued on the broad theory of *Warrior* that the grievance procedure is part of a continuous collective bargaining process; therefore, the parties should be able to settle disputes beyond the scope of the contract even though the arbitrator could not. Thus, he would allow the parties wide discretion in making settlements while confining the arbitrator's discretion. The development of a theory designed to protect individual employees under the collective agreement was the Court's objective in *Humphrey*, but since individual rights are often involved in the grievance process the effect of the case will probably be to limit arbitral discretion by limiting the powers the parties may give the arbitrator.

Although most arbitration cases before the Supreme Court have dealt with the allocation of duties between courts and arbitrators, the involvement of the NLRB in administering collective agreements has received some treatment. In *Carey v. Westinghouse Electric Corp.*,[120] in which the Court ordered arbitration of a dispute that involved a representation conflict between two unions, the NLRB policy of honoring arbitration awards[121] was approved and encouraged.[122] The Court has stated in a recent case, however, that the policies enunciated in the *Trilogy* do not apply with the same vigor to the Board as they do to the courts. The arbitrator's "greater institutional competency" described in *Warrior*'s comparison of courts and arbitrators is not considered as great in relation to the NLRB; therefore, the Board need not await an arbitrator's determination of questions relating to the grievance process before enforcing a party's rights under the NLRA.[123] This opinion emphasizes what was evident in the *Trilogy* — that the Court's praise of arbitration and arbitrators in those cases was intended to be an explanation for the benefit of lower courts rather than a new statement on the nature of arbitration.

IV. Observations on Arbitration and the Federal Common Law

A comparison of the Supreme Court's decisions with the arbitration awards studied provides the basis for a few concluding observations.

---

[119] *Id.* at 351.

[120] 375 U.S. 261 (1964).

[121] International Harvester Co., 138 N.L.R.B. 923 (1962); Spielberg Mfg. Co., 112 N.L.R.B. 1080 (1955). The Board's position is that it will accept an arbitrator's award, even when the award requires a party to commit what would otherwise be an unfair labor practice, if "the award is not palpably wrong." International Harvester Co., *supra* at 929. The Board thus will not substitute its judgment for that of the arbitrator because that would defeat "the common goal of national labor policy of encouraging the final adjustment of disputes" by arbitration. *Id.* If, however, an arbitration proceeding does not measure up to the Board's standards of fairness, the award will not be honored. *See* Gateway Transp. Co., 137 N.L.R.B. 1763 (1962).

[122] 375 U.S. at 270–71 & n.7.

[123] NLRB v. Acme Indus. Co., 385 U.S. 432, 436 (1967).

A. The Nature of Labor Arbitration

The policy of the Court has been and remains based upon the assumption that arbitration should be a private enclave, isolated and insulated from excessive judicial intervention, even though the surrounding field of federal law being developed under section 301 purports to deal with collective bargaining agreements. This policy enables diversity according to the self-determination of the parties within such outer limits of uniform policy as the Court has established on the issues of arbitrability, enforcement of awards, and the basic contractual rights of individual employees. The Court has made no serious effort since 1960 to state as a matter of general policy whether the arbitrator is or should be a mediator or a judge, or whether arbitration should be an "extension" of collective bargaining. Arbitrators, however, have shown concern for confining their discretion to the terms of the contract, using increasingly whatever interpretive aids are available within the limits of accepted construction principles. Thus, it can generally be said that they conceive of themselves as judges rather than as mediators or "physicians," [124] which indicates that the restrictive view of the arbitrator's authority expressed in the *Enterprise* case has proven to be more accurate than the broader description given in *Warrior*. At the same time sufficient flexibility is permitted by the Court's attitude to enable the parties to grant the arbitrator broader authority in situations calling for more discretion.[125] That arbitrators do not generally attempt to mediate suggests that they conceive of their role as something distinct from collective bargaining. They should nonetheless realize their relationship to the bargaining process. Professor Fuller, in discussing the interdependence of various phases of industrial self-government, has expressed the desirability of arbitrators' maintaining a balanced obedience to the contract as apparently understood by the parties in order to provide a functional adjunct to collective bargaining:

> The mediating form-free arbitrator and his opposite number, the stiffly literal judge, are equally threats to effective collective bargaining. The first may dissipate the benefits of careful negotiation and draftsmanship by disregarding the contract in the resolution of disputes. The second may dissipate those benefits by projecting into the agreement incongruent meanings, foreign to the thinking of those who created it.[126]

B. The Discretion of the Arbitrator

Much of the criticism of the *Trilogy* cases was directed at Justice Douglas' view of the arbitrator as a "philosopher king" type of mediator endowed by the parties with wide discretion. This view of arbitration was probably

---

[124] *See* notes 30–32 *supra* and accompanying text.

[125] Typically, broader powers are granted the permanent umpire than are granted the ad hoc arbitrator. *See* notes 14–16 *supra* and accompanying text. Parties are also encouraged to let the breadth of the submission agreement be affected by the nature of the controversy. For a worthwhile discussion of the factors that should be considered in determining whether an adjudicative or mediative arbitration should be preferred according to given conditions see Fuller, *Collective Bargaining and the Arbitrator*, in COLLECTIVE BARGAINING AND THE ARBITRATOR'S ROLE 8, 24–54 (M. Kahn ed. 1962).

[126] Fuller, *supra* note 125, at 51.

factually inaccurate at the time it was stated [127] and it has since become less accurate. Thus, much of the writing that took issue with the Court's dicta was misdirected or irrelevant because the *Trilogy* holdings did not depend upon the factual accuracy of the dicta. In response to the need for a workable accommodation between arbitration and the newly established role of the judiciary,[128] the holdings of the *Trilogy* sought to preserve whatever functional value the arbitration system had in a field that placed a premium upon voluntary settlements. As subsequent cases have clarified their ratio decidendi, it appears that the 1960 cases did not create any new discretionary powers in arbitrators beyond the discretion needed to decide specific questions of arbitrability. Proceeding from the *Trilogy*, the Court has established the principle that courts are still to decide whether a party has any general duty to arbitrate under a collective agreement while arbitrators are to decide the arbitrability of particular disputes. In other situations arbitral discretion has been indirectly limited by the Court's growing concern over the protection of employees' rights,[129] and the NLRB has been assured that arbitrators' "institutional competency" does not impair the Board's jurisdiction. In retrospect it seems that the Court has been more concerned with preserving a successful existing function from judicial interference than with exalting arbitration to a position or giving it a license it never had or deserved.

Lincoln Mills and the *Trilogy* nonetheless seem to have generated a desire among arbitrators and parties to make arbitration more consistent with "legalism" and the rule of law,[130] which should serve, in some measure, to quiet the fears of those who saw arbitration as too irresponsible to deserve a significant position under section 301.[131] It is probably desirable to limit the scope of arbitral discretion in order to leave the parties with the primary responsibility for settling their broader differences. Increased reliance upon precedent as an aspect of the rule of law will also fill, within limits, the needs of efficiency and certainty. However, arbitration should still retain its pragmatic, subjective features if its role is to have meaning and if its insulation from judicial involvement is to be preserved and justified. Discretion, therefore, should not be stifled to the point that labor arbitration ceases to be true arbitration.[132]

C. Arbitration, the Courts, and the Law

Before the *Trilogy* and *Lincoln Mills*, the most serious policy issue concerning arbitration was whether there should be any judicial involvement in

---

[127] *See* notes 14–19 *supra* and accompanying text.

[128] *See* Dunau, *Comments*, in SYMPOSIUM ON LABOR RELATIONS LAW 257–60 (R. Slovenko ed. 1961).

[129] *See* Humphrey v. Moore, 375 U.S. 335 (1964).

[130] This inference may be drawn quite logically from the results of the study of arbitration decisions discussed *supra*, particularly from the marked increase in the use of precedent since 1960 and from the tendency exhibited to provide more orthodox legal reasons for arbitral decisions.

[131] *See, e.g.*, P. HAYS, LABOR ARBITRATION — A DISSENTING VIEW 37–75 (1966).

[132] For elaboration of this point see Jones, *Evidentiary Concepts in Labor Arbitration: Some Modern Variations on Ancient Legal Themes*, 13 U.C.L.A.L. REV. 1241, 1252 (1966).

labor arbitration.[133] Between these two landmarks, Professor Cox's primary concern was that the judiciary might not understand and accept arbitration because of the historical gap that had developed between the two areas.[134] Strongly influenced by Cox's arguments, the Supreme Court made the judiciary at once involved and yet uninvolved by its policy of enforcing arbitration awards while leaving the merits of grievance disputes solely to arbitrators. The Court introduced the necessary "coherent philosophy"[135] that would force lower courts to accept the large degree of isolation and privacy present in orthodox labor arbitration. The fear that the arbitration system would be "transplanted to the courts"[136] was temporarily allayed, although that fear has not disappeared.[137] Since 1960, the Court has attempted to preserve the policy of arbitral privacy while at the same time it has been building a wall of standards around arbitration through other breach-of-contract suits under section 301 and through decisions on arbitrability and the enforcement of awards. The Court has been providing that degree of uniform federal law necessary to limit reasonably the freedom of labor, management, and arbitrators as the broader needs of society demand. Thus, a functional division of authority has been accomplished that properly seems to be determined by the respective abilities and purposes of courts and arbitrators.[138]

Some observers have assumed that the courts would eventually involve themselves in the development of uniform principles of substantive law dealing with the merits of contract grievances. This view is supported by the argument that there should be uniformity in the law applied in grievance cases by courts and arbitrators.[139] If there is not uniform development of substantive principles between both tribunals, it has been contended, the result will be forum shopping and confusion, which will hinder smooth labor-management relations. This argument assumes, however, that the responsibilities of courts and arbitrators will overlap in the functional division of duties that has been developed by the Supreme Court. Thus far there has been little significant overlap when the contract contained an arbitration clause,[140] and there are few labor contracts that do not provide for arbitra-

---

[133] *See* notes 25–28 *supra* and accompanying text.

[134] A. COX, LAW AND THE NATIONAL LABOR POLICY 66 (UCLA Institute of Industrial Relations Monograph No. 5, 1960).

[135] *See* Cox, *The Legal Nature of Collective Bargaining Agreements*, in COLLECTIVE BARGAINING AND THE LAW 107, 142 (1959); Cox, *Current Problems in the Law of Grievance Arbitration*, 30 ROCKY MT. L. REV. 247, 258 (1958).

[136] Feinsinger, *Enforcement of Labor Agreements — A New Era in Collective Bargaining*, 43 VA. L. REV. 1261, 1274 (1957).

[137] *See, e.g.*, Crawford, *Comments*, in SYMPOSIUM ON LABOR RELATIONS LAW 359, 363 (R. Slovenko ed. 1961).

[138] *See* notes 95–99 *supra* and accompanying text.

[139] Jay, *Arbitration and the Federal Common Law of Collective Bargaining Agreements*, 37 N.Y.U.L. REV. 448, 452 (1962). Note also the Supreme Court's concern with uniformity expressed in two cases since 1960. *See* note 112 *supra*.

[140] Obviously the parties can choose to take contract disputes to court by omitting an arbitration clause from the contract. There is also the possibility that court relief may be sought in the form of a declaratory judgment, before there has been a violation of the contract containing an arbitration clause. Fleming, *Some Observations on Contract Grievances Before Courts and Arbitrators*, 15 STAN. L. REV. 595, 600–03 (1963).

tion.[141] As long as arbitration or other private final adjustment is encouraged as a foundation stone of national labor policy, as long as the courts do not involve themselves in the merits of grievances, and as long as arbitrators accept both the authority and the limitations placed upon them by the Court, there should continue to be no serious overlapping of responsibility between courts and arbitrators. Thus, there will be no need for broader judicial review to ensure uniformity because each tribunal will be dealing with its own kinds of problems. Whatever irreducible minimum of uniformity is necessary to preserve the present policy can be left to the courts while arbitrators decide the merits of particular disputes with the privacy and simplicity that make arbitration functionally different from courts.[142] Of course, whether the courts will continue to see the wisdom of avoiding the merits of grievances and whether arbitrators can maintain reasonable limits upon the rule of law in arbitration remain to be seen; but any substantial deviation from the present approach stands to injure the utility of arbitration.

Bruce C. Hafen

[141] Approximately 94% of all collective bargaining contracts contain arbitration clauses. Jay, *supra* note 139, at 452 n.18. The most significant exceptions are the Teamsters Union contracts.

[142] A similar conclusion is reached in Comment, *Judicial Enforcement of Labor Arbitrators' Awards*, 114 U. PA. L. REV. 1050 (1966).

"Like Grade and Quality" Under Section 2(a) of the Robinson-Patman Act

I. Introduction

A. Background

The Robinson-Patman Act[1] was passed in 1936 as an amendment to section 2 of the Clayton Act.[2] The legislative history clearly establishes that Congress was attempting to make it impossible for large volume buyers to gain competitive advantage over small volume buyers solely because of quantity purchasing ability.[3]

---

[1] Robinson-Patman Act § 2(a), (b), 15 U.S.C. § 13(a), (b) (1964), provides in part:

> (a) It shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality, where either or any of the purchases involved in such discrimination are in commerce, where such commodities are sold for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, and where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them: *Provided*, That nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered: *Provided, however*, That the Federal Trade Commission may, after due investigation and hearing to all interested parties, fix and establish quantity limits, and revise the same as it finds necessary, as to particular commodities or classes of commodities, where it finds that available purchasers in greater quantities are so few as to render differentials on account thereof unjustly discriminatory or promotive of monopoly in any line of commerce; and the foregoing shall then not be construed to permit differentials based on differences in quantities greater than those so fixed and established: *And provided further*, That nothing herein contained shall prevent persons engaged in selling goods, wares, or merchandise in commerce from selecting their own customers in bona fide transactions and not in restraint of trade: *And provided further*, That nothing herein contained shall prevent price changes from time to time wherein response to changing conditions affecting the market for or the marketability of the goods concerned, such as but not limited to actual or imminent deterioration of perishable goods, obsolescence of seasonal goods, distress sales under court process, or sales in good faith in discontinuance of business in the goods concerned.
>
> (b) Upon proof being made, at any hearing on a complaint under this section, that there has been discrimination in price or services or facilities furnished, the burden of rebutting the prima-facie case thus made by showing justification shall be upon the person charged with a violation of this section, and unless justification shall be affirmatively shown, the Commission is authorized to issue an order terminating the discrimination: *Provided, however*, That nothing herein contained shall prevent a seller rebutting the prima-facie case thus made by showing that his lower price or the furnishing of services or facilities to any purchaser or purchasers was made in good faith to meet an equally low price of a competitor, or the services or facilities furnished by a competitor.

[2] Clayton Act § 2, ch. 323, § 2, 38 Stat. 730 (1914).

[3] Section 2 of the original Clayton Act had contained a quantity discount proviso. The House Committee Report on the Robinson-Patman Act considered that the quantity discount allowed under the original Clayton Act made § 2 a nullity. *See* H.R. Rep. No. 2287, 74th Cong., 2d Sess. 7 (1936). The amendment was expected to "limit the use of quantity price differentials to the sphere of actual cost differences." *Id.* at 9. The same legislative purpose of the amendment was emphasized by the Senate Committee which reported it, S. Rep. No. 1502, 74th Cong., 2d Sess. 4–6 (1936), and by the congressman in charge of the conference report. 80 Cong. Rec. 9417–18 (1936).

The traditional system of distribution for American business in the early part of the twentieth century had been the manufacturer-wholesaler-retailer scheme. There were no shortcuts in this system and it seemed to yield a fair profit for all concerned.[4] However, the rapid growth of chain stores resulting in their increased size during the 1920's enabled them to perform the functions of both the wholesaler and the retailer.[5] Due to operating efficiency connected with size and because the chain stores were often able to purchase at rates which other retailers were unable to obtain, a significant number of independent retailers went out of business.[6] The decline of the independent retailer in turn contributed to the decline of the wholesaler.[7]

The independent wholesalers and retailers reacted to this threat to their business postition by forming cooperatives to obtain a better bargaining position,[8] by organizing trade associations to "force" manufacturers to refrain from granting discounts to the chains,[9] and by appealing to the federal and state legislatures.[10] Congress answered the appeal by directing the Federal Trade Commission to investigate the operations of the chain stores;[11] the result was a report that if the chain stores remained unchecked there would be a trend toward chain-store supremacy.[12] Thereafter, following the normal legislative processes,[13] the Robinson-Patman Act was passed in response to the report of the Commission.

There are certain anomalies connected with the wording of the bill. The statute is intended to restrict the activities of buyers, yet the majority of the restrictions seem to apply to sellers.[14] The act was engrafted onto the antitrust laws, which laws had fostered "hard" competition;[15] yet, Robinson-Patman has often been viewed as a measure designed to protect the distribution system of the day — particularly small businesses.[16] One noted authority has commented on the irony surrounding the paradoxical birth of the statute.

> In its broadest sense, Robinson-Patman in 1936 reincarnated the spirit of the deceased N.R.A. in the corpus of antitrust. Indeed, by an

---

[4] Rowe, *The Evolution of the Robinson-Patman Act: A Twenty-Year Perspective*, 57 COLUM. L. REV. 1059, 1061 (1957).

[5] *Id.* at 1061–62.

[6] *See* J. PALAMOUNTAIN, THE POLITICS OF DISTRIBUTION 12–13 (1955).

[7] *Id.* at 17–23.

[8] Fulda, *Food Distribution in the United States, The Struggle Between Independents and Chains*, 99 U. PA. L. REV. 1051, 1061–69 (1951).

[9] Rowe, *supra* note 4, at 1063. Those manufacturers who traded with chains were often blacklisted and boycotted by the wholesaler-retailer trade associations. *Id.* However, this particular method of combating the chains usually resulted in a finding that the wholesalers and retailers were engaged in illegal restraints of trade or unfair methods of competition. *See, e.g.*, United States v. Southern Cal. Wholesale Grocers' Ass'n, 7 F.2d 944, 948–49 (S.D. Cal. 1925); Wholesale Grocers' Ass'n, 11 F.T.C. 415 (1927).

[10] Rowe, *supra* note 4, at 1064.

[11] *See* FTC, FINAL REPORT ON THE CHAIN-STORE INVESTIGATION, S. Doc. No. 4, 74th Cong., 1st Sess. (1935).

[12] *Id.* at 86–87.

[13] 80 CONG. REC. 9422, 9903–04 (1936).

[14] E. KINTNER, AN ANTITRUST PRIMER 59–60 (1964).

[15] *See* Standard Oil Co. v. FTC, 340 U.S. 231, 248–49 (1951).

[16] *See generally* B. DIXON, PRICE DISCRIMINATION AND MARKETING MANAGEMENT 84 (1960); H.R. REP. No. 2287, 74th Cong., 2d Sess., pt. 2, at 5 (1936) (views of the minority).

> ironic twist of history, Congress thereby codified a catalogue of pricing restrictions virtually identical with the sugar industry's Code of Ethics which the Supreme Court in the same year condemned as an illegal restraint of trade under the Sherman Act.[17]

The alleged inconsistencies between Robinson-Patman and the other antitrust laws have clouded the interpretation of the Robinson-Patman Act and seem to have confused some courts as to what the policy of the antitrust laws should be.

B. The Purpose of the Note

The purpose of this note is to examine the meaning of the phrase "like grade and quality" in section 2(a) of the Robinson-Patman Act, which has recently undergone examination by the Supreme Court in the *Borden* cases. The interpretation of the phrase which has been given by the Federal Trade Commission and the courts will be discussed and analyzed. Like grade and quality interpretations will also be discussed concerning their relationship with the cost justification and meeting competition defenses. The implications of injury to competition as they relate to like grade and quality will be analyzed. It is hoped that through the above examinations some light will be cast on the problems confronted by the Commission and what it has tried to accomplish by the test for like grade and quality which is presently employed. Changes concerning the test which are more in harmony with the purposes of the Robinson-Patman Act are also outlined.

II. INTERPRETATIONS OF LIKE GRADE AND QUALITY

The inclusion of "like grade and quality" among the jurisdictional requirements of the Robinson-Patman Act was an attempt to prohibit price differences by sellers on products which were substantially similar when the differences could not be justified on the basis of cost.[18] To violate the Act, the price differences must injure competition on the secondary line (among buyers) or primary line (among sellers). It was felt that unfair price differences could be more easily determined if "the price discrimination statute" were confined to business transactions wherein similar products were being sold.[19] Hence, the requirement of like grade and quality was changed from a defense under the original section 2 of the Clayton Act to a jurisdictional criterion under the amended section 2(a).[20] Consequently, the effect of a ruling that the goods in question are not of like grade and quality is now complete inapplicability of section 2(a) of the Robinson-Patman Act.[21]

---

[17] Rowe, *supra* note 4, at 1074 (footnotes omitted).

[18] *See* C. EDWARDS, THE PRICE DISCRIMINATION LAW 29–31 (1959).

[19] ATTORNEY GENERAL'S NATIONAL COMMITTEE, REPORT ON THE ANTITRUST LAWS 157 (1955).

[20] *See* 15 U.S.C. § 13(a) (1964).

[21] The other jurisdictional criteria under § 2 of the Act are:
(1) a seller engaged in interstate commerce;
(2) discrimination in price;
(3) discrimination between different purchasers;
(4) one of the purchases must be in interstate commerce;
(5) the purchases must be of commodities;
(6) the commodities must be sold for use, consumption, or resale;

Sellers may not discriminate in price among their buyers of goods of like grade and quality. If the goods are not of like grade and quality, sellers may differentiate in price on the separate products to any degree they desire without violating section 2(a).

A. The Federal Trade Commission View of Like Grade and Quality

The Commission has always determined (with an exception noted below) that goods which are physically identical are of like grade and quality regardless of brand name. When the products in question have not been physically identical the Commission has found them to be of like grade and quality if they are reasonably interchangeable functionally unless there are significant physical differentiations and/or unless there are significant differences in the marketability of the products.[22]

In *Goodyear Tire & Rubber Co.*,[23] respondent sold tires to Sears, Roebuck and Company which were nearly identical to tires sold to its other buyers except for the All-State brand affixed to the tires sold to Sears. There was also a slight dissimilarity in tread design.[24] Sears paid less for the tires than did the other buyers. The tires were held to be of like grade and quality and Goodyear was, consequently, found to have discriminated in price among

(7) the sale must be within the United States or any Territory thereof or the District of Columbia, or any insular possession or other place under the jurisdiction of the United States;
(8) the effect of the discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce.

15 U.S.C. § 13(a) (1964); Seidman, *Price Discrimination Cases*, in 2 HOFFMANN'S ANTITRUST LAW AND TECHNIQUES 412–13 (1963).

There has been some question as to what should be considered a commodity. In Fleetway, Inc. v. Public Serv. Interstate Transp. Co., 72 F.2d 761 (3d Cir. 1934), *cert. denied*, 293 U.S. 626 (1935), it was held that transportation of passengers by bus was not a commodity. The *Fleetway* case was decided before the Clayton Act was amended, however. Since the Robinson-Patman amendment it has been indicated that a contract for the erection of a building was not for the sale of a commodity. *See* General Shale Prods. Corp. v. Struck Const. Co., 37 F. Supp. 598, 602–03 (W.D. Ky. 1941), *aff'd*, 132 F.2d 425 (6th Cir. 1942), *cert. denied*, 318 U.S. 780 (1943). The Commission has held that the sale of a "Christmas Club" system to banks comes within the reach of § 2(a). Christmas Club, 25 F.T.C. 1116 (1937). It has also been held that realty is not a "commodity" within the meaning of the Robinson-Patman Act, Gaylord Shops, Inc. v. Pittsburgh Miracle Mile Town & Country Shopping Center, Inc,. 219 F. Supp. 400 (W.D. Pa. 1963), and similarly as to television time. CBS v. Amana Refrigeration, Inc., 295 F.2d 375 (7th Cir. 1961), *cert. denied*, 369 U.S. 812 (1962).

[22] In two groups of cases decided informally by the Commission shortly after passage of the Act, it was decided that certain ladies' handbags and ladies' hats were not of like grade and quality. 81 CONG. REC. APP. 2337, 2339 (1937). The first group of handbags, it was said, appeared to be of unlike grade and quality "particularly with respect to market values." *Id.* at 2337. The market value differentiation seemed to be a factor to add to the apparent physical dissimilarities. The handbags in the second group were also found to be of unlike grade and quality. *Id.* at 2339. These bags bore the buyer's private label but were also physically different from the seller's regular bags due to a special design or style. A different style, if distinctive enough, certainly qualifies as a physical differentiation. The hats were also found not to be of like grade and quality because some were less marketable styles. *Id.* One aspect of the differentiation in the hat cases is that some styles sold more rapidly than others — a commercial variation; yet, it is obvious that the hats would have to have been physically distinct enough for customers to have been able to tell the difference. Consequently, the Federal Trade Commission in these early cases was using a test based on physical similarities and dissimilarities with the added factor of market appeal variations used as an aid.

[23] 22 F.T.C. 232 (1936), *rev'd on other grounds*, 101 F.2d 620 (6th Cir. 1939).

[24] *See id.* at 255.

its purchasers of like goods.[25] The Hansen Inoculator Company produced commercial inoculants which are used in the treatment of leguminous plants. They sold their own brand of inoculant to buyers at a different price than they sold private-label inoculant. The inoculants sold were identical. It was held that the goods were of like grade and quality and that Hansen had violated section 2(a).[26]

These cases demonstrate that goods which are physically identical, even though they carry a different brand, are viewed by the Commission as goods of like grade and quality.[27] The *Goodyear* case is the foundation for the doctrine that goods which are not exactly identical physically, but which are still functionally interchangeable, are also to be viewed as goods of like grade and quality.

A decision that seems out of harmony with this analysis is *Champion Spark Plug Co.*[28] In *Champion* the respondent sold a special brand spark plug cheaper than it sold its regular brand. There were slight physical variations in the plugs which were of unknown functional significance. It was ultimately determined that certain of the goods were not of like grade and quality. This seeming inconsistency in result can be explained in two ways. First, evidence introduced by the Commission was insufficient to show like grade and quality.[29] This is at most a change in procedure by the Commission and not an indication of a change in the test to measure like grade and quality. Before *Champion* the assumption was that in lieu of a contrary showing the products in question were presumed to be of like grade and quality.[30] In this case the presumption was reversed. Today, the presumption seems to be the same as it was in the pre-*Champion* era. Second, the FTC trial staff conceded, for reasons unknown, that the spark plugs were not of like grade and quality.[31]

Subsequent decisions demonstrate that the Commission has continued to follow the general test outlined above. In *General Foods Corp.*,[32] respondent sold coffee in a regular grocery pack to some buyers and in a special pack

[25] It is true that the respondent did not attempt to contest this issue. Goodyear, in effect, conceded that the tires were of like grade and quality. *Id.* at 290. However, there is certainly no indication that the issue would have been decided differently had Goodyear been adamant concerning the jurisdictional issue of "like grade and quality."

[26] Hansen Inoculator Co., 26 F.T.C. 303 (1938). In United States Rubber Co., 28 F.T.C. 1489 (1939), the respondent sold tires under its own brand and under special brands to some purchasers at different prices. It was held that all the tires were of like grade and quality. It has also been demonstrated that if the goods were significantly distinguishable physically by style or design the Commission was likely to determine that the Act did not apply to them. *See* note 22 *supra.*

[27] Page Dairy Co., 50 F.T.C. 395 (1953), also demonstrates that goods which are chemically and physically alike but labeled differently will be held to be of like grade and quality. Page sold vitamin D milk. They labeled some as vitamin D and sold it for one cent more per quart than unlabeled identical milk. It was held that the two types of milk were of like grade and quality and that § 2(a) had been violated.

[28] 50 F.T.C. 30 (1953).

[29] *See id.* at 47.

[30] *See* authorities cited notes 23–26 *supra.*

[31] *See* Rowe, *Price Differentials and Product Differentiation: The Issues Under the Robinson-Patman Act*, 66 YALE L.J. 1, 13 (1956).

[32] 52 F.T.C. 798 (1956).

to Institution Contract Wagon Distributors.[33] The coffees were sold at different prices, and it was alleged that General Foods was discriminating in prices between buyers of goods of like grade and quality.[34] The two types of coffee were held to be of like grade and quality even though there were some physical distinctions between them.[35] The coffee sold in the special pack was a blend of six different kinds of coffee beans and the regular grocery pack was a blend of five.[36] There were variances in the roasting processes and also indications that the color and taste of the two types of coffee were not identical.[37] However, the physical differences were not great and the evidentiary effect of the differences was tempered by the facts that, first, the coffees were functionally similar,[38] and second, they were competitive, or in other words, commercially similar to each other.[39] The Commission remained consistent with its prior holdings, measuring functional and commercial similarity to determine like grade and quality when the physical distinctions between the products were not great.[40]

A recent case demonstrates that the Commission is still using essentially the same test. In *Quaker Oats Co.*,[41] the respondent sold a special blend of oat flour to the Gerber Products Company at a cheaper price than it sold other flour to other customers. The types of flour were physically different; the flour sold to Gerber had a higher hull content than the flour sold to other customers.[42] The Commission looked, as it does in cases wherein the products

[33] *Id.* at 800.

[34] *Id.* at 807, 810.

[35] *Id.* at 817.

[36] *Id.* at 800.

[37] *Id.* at 800, 816–17.

[38] *Id.* at 817 ("same use").

[39] *Id.* at 816.

[40] An earlier case had focused on functional interchangeability. *See* E. Edelmann & Co., 51 F.T.C. 978 (1955), *aff'd*, 239 F.2d 152 (7th Cir. 1957), wherein it was held that certain automotive products were of like grade and quality. The parts had been sold to larger accounts at lower prices and respondent alleged that because of a different brand name or mark, and because the printed inserts were different, the parts were not of like grade and quality. The products were not physically identical but were enough alike for the Commission to hold that they were of like grade and quality because of functional interchangeability. *Id.* at 983.

Like grade and quality has been used in § 2(d) of the Robinson-Patman Act as well as in § 2(a). It has been observed that the decision in Atalanta Trading Corp., 53 F.T.C. 565 (1956), was a "truly aberrational decision." *See* Comment, *Like Grade and Quality: Emergence of the Commercial Standard*, 26 OHIO ST. L.J. 294, 299 (1965). Respondents were charged with a § 2(d) violation for granting promotional allowances on specially packaged ham and bacon sold to one customer, while at the same time, no promotional allowances had been granted to purchasers of other pork products from respondent. The products were held by the Commission to be of like grade and quality. It does indeed seem that this is stretching the old test. It is not really apparent if there were physical differences in the way the meat was cut or designed. It would seem that the physical differences were significant. Neither is it apparent what commercially or functionally significant differences there were between the products — what purposes customers would buy each product for and at what price. It could be argued that the products were functionally interchangeable in that they were both for eating. That would be a tremendously broad interpretation of the functional test, however. It does seem that the Commission was inconsistent with its prior decisions in *Atalanta*. However, *Atalanta* was a § 2(d) case and not a § 2(a) case and the sections do not necessarily require the same test.

[41] [1963–1965 Transfer Binder] TRADE REG. REP. ¶ 17,134 (FTC 1964).

[42] *Id.* at 22,215.

are not physically identical, to commercial and functional factors and determined that the two types of flour were not of like grade and quality and that section 2(a) did not apply. The Commission found that the higher hull content rendered the Gerber flour unacceptable to anyone except Gerber,[43] which indicated that the flours were not functionally interchangeable. Moreover, the physical differences obviously affected consumer preferences for the two types of flour.[44] In this case the differences in consumer preference for the two types of flour actually rendered the types functionally noninterchangeable. There could be cases, it seems, wherein the products would be physically different and functionally interchangeable, and yet consumer preference for the two might be *so* different that the goods would still not be of like grade and quality. In fact, *Quaker Oats* could be so viewed if one were to take the position that flour of a higher hull content could be reasonably interchangeable with lower hull content flour for most purposes. At any rate the Commission remained consistent with its old test of measuring the degree of commercial and functional similarity to determine like grade and quality in cases in which the goods are not physically identical.

A different type of case is presented if a producer sells his products in lines. A line is a group of similar products which is usually sold as a single unit. It may be a group of products necessary to fulfill a function broader than that which a single product could fulfill, such as a line of bathroom fixtures or tools. A line may also be a group of the same products differentiated only by size. Obviously each product within a line is somewhat physically and functionally different. A line of products is sold so a dealer can sell as a unit several different but related products that buyers find convenient or necessary to purchase together. The Commission adopted a common sense approach to these kinds of cases by reasoning that if a seller combines various products into a line, he cannot escape the jurisdiction of the Robinson-Patman Act by claiming that each product in a line is physically and functionally different so the goods are not of like grade and quality. Discrimination in prices between purchasers of the lines is prohibited because the lines are held to be of like grade and quality.[45] A consistent analytical approach to these "line" cases is to view each "line" as a product itself. The seller is selling it as such; he should be held to the same test for like grade and quality for lines of products as other sellers are for single unit products.[46]

The Commission has recently applied the same test to "lines" as it does to single products. In *Universal-Rundle Corp.*,[47] a respondent sold plumbing fixture lines. Universal was charged with a violation of section 2(a) because it allegedly discriminated in prices between goods of like grade and quality by selling a line to Sears at a lower price than it sold its regular line. There

---

[43] *Id.*

[44] *See id.*

[45] *See, e.g.*, P. & D. Mfg. Co., 52 F.T.C. 1155, 1166 (1956), *aff'd*, 245 F.2d 281 (7th Cir. 1957).

[46] *See* United States Rubber Co., 46 F.T.C. 998 (1950), for a case in which lines of products were held to be of like grade and quality. *Cf.* Thermoid Co., 55 F.T.C. 518 (1958) (dictum).

[47] [1963–1965 Transfer Binder] TRADE REG. REP. ¶ 16,948 (FTC 1964).

were physical differences in the two lines. The regular line sizes were different, the design was somewhat different, and the quantity of enameled surface was different.[48] The Commission determined that the lines were not of like grade and quality. It reasoned that the goods were physically different and that the differences significantly affected marketability of the two lines; the effect was enough to preclude a finding of like grade and quality.[49] The case is consistent with the older "line" cases and with all of the single-unit like grade and quality cases. First, the line was viewed as a single product. Second, the factor of commercial difference was significant enough to preclude a finding of like grade and quality even though, in this instance, the lines were functionally interchangeable.

Contrary to continuing criticism against the merits of the test of the Commission in like grade and quality cases,[50] the Commission, as has been demonstrated, has used a consistent, rational test. The test, admittedly, cannot be overly mechanical because of the varying fact situations presented. It has been charged that the Commission decisions concerning like grade and quality are confusing,[51] uncertain,[52] mechanical,[53] and inconsistent.[54] The uncertainty, confusion, and inconsistency charges seem to stem from an undue reliance on the *Champion Spark Plug* case which demonstrated nothing more than a change in procedure by the Commission.[55] The charge that the test is too simple is not accurate. It is true that the test is simple when the products are physically identical. The finding of physical identity is tantamount to a finding that the products are of like grade and quality. In light of the legislative history of the section the Commission could hardly do otherwise.[56] When the goods are not physically identical the Commission has considered other factors. If the goods have been so different that they could not be reasonably interchanged or are significantly different commercially, the Commission has determined that the goods are not of like grade and quality — a reasonable approach. It would be impossible to lay down a simple test to measure how great the functional variations or market variations or both together must be to make the goods in question of unlike grade and quality. As critics have pointed out, whether differences in size, style, color, wear-

[48] *Id.* at 22,004.

[49] *Id.* at 22,005.

[50] This type of criticism is to be distinguished from criticism directed against the actual test the Commission has used. Whether the Commission's test is a good one will be dealt with subsequently.

[51] Rowe, *Price Differentials and Product Differentiation: The Issues Under the Robinson-Patman Act*, 66 YALE L.J. 1, 15 (1956).

[52] Comment, *Like Grade and Quality: Emergence of the Commercial Standard*, 26 OHIO ST. L.J. 294, 296 (1965).

[53] *See* Cassaday & Grether, *The Proper Interpretation of "Like Grade and Quality" Within the Meaning of Section 2(a) of the Robinson-Patman Act*, 30 S. CAL. L. REV. 241, 251 (1957).

[54] *See* Hopfl, *What Goods Are "of Like Grade and Quality"?*, 52 A.B.A.J. 1133, 1135 (1966).

[55] *See* text accompanying notes 28–31 *supra*.

[56] *Hearings on H.R. 4995 Before the House Comm. on the Judiciary*, 74th Cong., 2d Sess. 355, 421 (1936); *see* H.R. REP. No. 2287, 74th Cong., 2d Sess. 4 (1936); 80 CONG. REC. 8115 (1936).

ability, flavor, etc., render the act inapplicable is a complex determination.[57] But the Commission has not been unaware of these problems and has formulated a reasonable test. If the products are substantially or significantly different physically or commercially, they will not be of like grade and quality. This test is admittedly somewhat vague, but it is perhaps as good as those enunciated for "monopoly" or "substantial lessening of competition." An answer to the complaint about the lack of certainty under like grade and quality is that "[t]he degree of change required . . . to create a difference in grade or quality is not capable of precise mathematical calculation."[58]

B. Courts' View of Like Grade and Quality

Although the Commission has not decided many cases dealing with like grade and quality, which is one reason the test has not become more definite and refined, the courts have addressed themselves to the problem even less frequently.

The first and perhaps the only significant decision in the courts construing like grade and quality subsequent to the Robinson-Patman amendment[59] is *Bruce's Juices, Inc. v. American Can Co.*[60] American Can sold cans of different sizes to its customers. The complainant charged competitive injury because American refused to sell to complainant a certain size of can which American sold to complainant's competitor at a low price. Bruce's was charged a higher price by American for a comparable but different sized can. It was held that all of the cans were of like grade and quality.[61] The rationale for the decision was that the cans were functionally interchangeable (gave substantially identical performance) and were commercially similar even though there were physical differences.[62] This determination of like grade and quality was affirmed on appeal.[63]

Although the authority is scanty, the courts seem to have endorsed the test of the Commission when the goods are not physically identical. The degree

---

[57] *See* Cassady & Grether, *supra* note 53, at 251–52.

[58] Seidman, *supra* note 21, at 426.

[59] One case decided under unamended section 2(a), Boss Mfg. Co. v. Payne Glove Co., 71 F.2d 768 (8th Cir.), *cert. denied*, 293 U.S. 590 (1934), held that certain mittens and gloves were not of like grade and quality. One line of the gloves sold for a cheaper price and a price discrimination violation of the act was alleged. The low-priced gloves were made of cheaper materials, by less expert workmen, and were less rigidly inspected. It was demonstrated that the low-price gloves were less durable although they were no different in appearance. The gloves then were physically alike only in the sense of appearance. They were not constructed the same way; the commercial value of the two types of gloves was also apparently different.

[60] 87 F. Supp. 985 (S.D. Fla. 1949), *aff'd*, 187 F.2d 919 (5th Cir.), *modified*, 190 F.2d 73 (5th Cir.), *petition for cert. dismissed*, 342 U.S. 875 (1951).

A case arose in 1944 which gave the Second Circuit an opportunity to discuss like grade and quality. The court did not accept the challenge. Package Closure Corp. v. Sealright Co., 141 F.2d 972 (2d Cir. 1944). Defendant in *Package Closure* sold bottle caps and hoods singly and in combinations. The price of the caps alone was less than the cost added to the hood cost when the bottle caps and hoods were sold in combination. The majority held there was no price discrimination. Judge Frank disagreed. Neither faction of the court addressed itself directly to the like grade and quality issue.

[61] Bruce's Juices, Inc. v. American Can Co., 87 F. Supp. 985, 987 (S.D. Fla. 1949).

[62] *Id.*

[63] American Can Co. v. Bruce's Juices, Inc., 187 F.2d 919, 924 (5th Cir. 1951).

of functional difference and commercial dissimilarity will be looked to and if significant the goods will not be of like grade and quality and there will be no jurisdiction under the Act.

The rule for goods which are physically identical yet differ in brand name also seems to be the same in the courts as in the Commission. *Hartley & Parker, Inc. v. Florida Beverage Corp.*[64] concerned the sale of liquor. Nationally advertised liquor was sold by the defendant to dealers at a certain price while identical liquor was sold by the defendant to another customer at a lower price. The lower-priced liquor did not carry the nationally advertised label. The liquors were held to be of like grade and quality and a price discrimination violation was found. The court, in line with Commission decisions,[65] held that the labels are insignificant. However, in *Hartley*, the salesmen had represented the liquor as being the same as the nationally advertised liquor. This may have influenced the court to find that the liquors were of like grade and quality. The court indicated, however, that what is significant in this type of case is whether the processes of distilling and refinement and the resulting flavor and content are similar. The indications here were that they were the same. The labels then, according to the court, were insignificant. It appears that the courts have adopted essentially the same position as the Commission on like grade and quality.[66]

III. The Borden Cases

The recently decided *Borden* cases have shed considerable light on the accepted view of "like grade and quality" at least as related to goods which are physically identical but carry a different brand name.

The Borden Company produced and sold evaporated milk under its nationally advertised brand and also sold identical milk which was relabeled by customers of Borden and sold by those customers under their private label. The milk sold without the Borden label was consistently sold at a price below

---

[64] 307 F.2d 916 (5th Cir. 1962).

[65] *See* text accompanying notes 23–26 *supra*.

[66] There are some further incidental court holdings that relate to like grade and quality under § 2(a) of the Robinson-Patman Act. In Central Ice Cream Co. v. Golden Rod Ice Cream Co., 184 F. Supp. 312, 319 (N.D. Ill. 1960), *aff'd*, 287 F.2d 265 (7th Cir.), *cert. denied*, 368 U.S. 829 (1961), a federal district court indicated in dictum that differences that are not physically observable but are chemically significant and which are meaningful to consumers would make the goods of unlike grade and quality. A seller in *Central* sold cream products, one type of which was richer in butterfat content.

The courts have also adopted the Commission's view of goods sold in lines. In Moog Indus., Inc. v. FTC, 238 F.2d 43 (8th Cir. 1956), *aff'd*, 355 U.S. 411 (1958) (per curiam), a manufacturer sold three lines of auto repair and replacement parts but discriminated in price within each line; that is, he sold one line to one customer more cheaply than to another depending on the volume sold. The court indicated that like grade and quality was intended to serve as a rough guide to separate commercial transactions insufficiently comparable, and when a line is sold as a product the transaction is "sufficiently comparable" to come within the confines of the Act. Therefore, the lines were of like grade and quality even though the products within each line would not perform *exactly* the same function. *Id.* at 49–50. The Commission and the courts, as we have seen, are attempting to determine which transactions are sufficiently comparable to be included within like grade and quality when they talk of substantial or significant functional or commercial differences. *Cf.* P. & D. Mfg. Co. v. FTC, 245 F.2d 281 (7th Cir.), *cert. denied*, 355 U.S. 884 (1957).

that obtained for milk sold under the Borden label. Borden was charged with discriminating in prices between purchasers of goods of like grade and quality.[67]

The hearing examiner found that there was a discrimination in price between purchasers of goods of like grade and quality but found no violation of the Act because there had been no injury to competition.[68] The Commission found, in accordance with its prior holdings,[69] that goods which are physically identical are goods of like grade and quality even though sold under a different brand name.[70] The Commission also found the necessary injury to competition and, accordingly, a violation of section 2(a).[71]

The Court of Appeals for the Fifth Circuit reversed the Commission.[72] The court held that the manufacturer's evaporated milk which bore Borden's own label and the private label milk were not products of like grade and quality when the manufacturer's brand name had demonstrable "commercial significance," that is, could command a higher price in the market. Although the court mentioned several factors which had entered into its consideration,[73] the crux of the opinion was that even where the physical properties of products are identical the relative public acceptance by the consumer can still differentiate the transactions for Robinson-Patman purposes.[74] The court indicated that for a determination of like grade and quality all commercially relevant considerations should be taken into account whether they be physical or promotional.[75] In attempting to rationalize its decision with the Commission decisions which had determined that brand names were not significant, the court indicated that in those Commission decisions there was no indication that the buyers paying the premium price were receiving a premium brand product.[76] Overlooked was the clear position of the Commission that labels are insignificant when the goods are physically identical — that no other factors need be looked to when there is physical identity.

---

[67] Price discrimination within the meaning of § 2(a) of the Robinson-Patman Act means a price difference. FTC v. Anheuser-Busch, Inc., 363 U.S. 536, 549 (1960).

[68] Injury to competition is another jurisdictional element of § 2(a) of the Robinson-Patman Act. *See* note 21 *supra*.

[69] *See* text accompanying note 26 *supra*.

[70] The Borden Co. [1961–1963 Transfer Binder] TRADE REG. REP. ¶ 16,191 (FTC 1962).

[71] *Id.*

[72] Borden Co. v. FTC, 339 F.2d 133 (5th Cir. 1964).

[73] The court indicated that private-label milk had always been sold at lower prices, that Borden did not promote private-label milk but had to be approached for it, and that the private label did not indicate in any way that the material was handled by Borden. These factors, according to the court, supported the position that the products were of unlike grade and quality — that the transactions in which the products were involved were not really comparable. *Id.*

[74] *Id.* at 135, 137–39.

[75] *Id.* at 136–37.

[76] *Id.* at 137 & n.7. The court distinguished Hartley & Parker, Inc. v. Florida Beverage Corp., 307 F.2d 916 (5th Cir. 1962) on the ground that in *Hartley* both labels were represented and sold as the same products. Borden Co. v. FTC, 339 F.2d 133, 137 (5th Cir. 1964). *Hartley* had been decided by the same court that decided the *Borden* case, see text accompanying notes 64–66 *supra*, and was relied on by the Commission in *Borden*.

The court was willing to concede that if different labels had no economic significance, then the products should be held to be of like grade and quality in order to prevent frivolous labeling to avoid the effects of Robinson-Patman.[77] The court attempted to read into the Commission decisions a distinction between "grade" and "quality." The Commission, according to the court, had always found that quality was concerned with physical characteristics and that grade was determined by consumer demand.[78] Clearly, then, the court reasoned, the products in *Borden* were not of like grade. Since the Act uses grade and quality in the disjunctive, the Robinson-Patman Act did not apply to the *Borden* facts.

The Supreme Court reversed the court of appeals.[79] The Court upheld the Commission's view that labels alone do not differentiate products for the purpose of determining like grade and quality even though one label may have more commercial appeal than another.[80] The Court also indicated that the plain meaning of the statute did not require a consideration of whether the Borden label or the private-label goods had more market appeal. Legislative history was relied upon to demonstrate that an amendment to the Act had been rejected which would have required the brand to be the same before jurisdiction under section 2(a) could be obtained.[81] The Court expressed fear that if a contrary holding were reached, sellers would be able to evade the intended effect of the Act. The intent was to prevent a seller from obtaining competitive advantage for himself over his own competitors, or to prevent a supplier from allowing a customer to gain a competitive advantage over *his competitors* via price discrimination among such competing customers. If jurisdiction were too easily given up there could be no examination into any possible anticompetitive effects, which might still exist even if separate labels do have a somewhat different appeal in the market place.[82] The Court indicated that commercial factors could best be dealt with under the cost justification and injury to competition portions of the statute.[83]

---

[77] Borden Co. v. FTC, 339 F.2d 133, 138 (5th Cir. 1964).

[78] *Id.* at 138–39 & n.9. The Commission had never really been as clear about the difference between grade and quality as the circuit court assumed. When products have been physically different the courts have looked to functional and commercial factors to determine whether the Act should apply. But it is not clear whether they are attempting to determine grade as separate from quality or whether the two terms are observed together as one. The latter seems to be the case because in cases wherein the products are physically identical, they have been held to be of like grade and quality — with no other factors considered.

[79] FTC v. Borden Co., 383 U.S. 637 (1966).

[80] The Court cited several Commission decisions in support of this position. Many of these have been analyzed previously in this note. *See* Page Dairy Co., 50 F.T.C. 395 (1953); United States Rubber Co., 28 F.T.C. 1489 (1939); Hansen Inoculator Co., 26 F.T.C. 303 (1938); Goodyear Tire & Rubber Co., 22 F.T.C. 232 (1936).

[81] *See Hearings on H.R. 4995 Before the House Comm. on the Judiciary,* 74th Cong., 2d Sess. 355, 421 (1926); *cf.* 80 CONG. REC. 8115 (1936) (remarks of Representative Patman).

[82] The Court indicated that it felt no necessity to reconcile the seemingly contradictory holdings under §§ 2(a) and 2(b), a point emphasized by the defense. This problem is dealt with in text accompanying notes 137–45 *infra*.

[83] This was the recommendation of the majority of the committee which made a special study of the antitrust laws. *See* ATTORNEY GENERAL'S NATIONAL COMMITTEE, REPORT ON THE ANTITRUST LAWS 159 (1955).

Justices Stewart and Harlan registered an adamant dissent. They stated that it was clear that to the purchasing public the Borden-branded milk was of a different grade than the private-label milk and that was the important factor. They also disputed the majority's construction of the legislative history of the Act. The dissent contended that all the legislative history demonstrated was that sellers should not be able to evade the Act by frivolous branding, but that if it could be demonstrated that different brands had significant commercial distinctions, the Act was not meant to apply.[84] The dissent correctly pointed out that the Commission has resorted to consumer preference or marketability as a factor to consider in like grade and quality cases when some physical variation existed between the products in question. They reasoned, in agreement with the court of appeals, that marketability should also be considered as to products that are physically identical. Finally, the dissent, in arguing for a marketability test in all questions of like grade and quality, pointed to the seemingly different tests used by the Commission in section 2(a) and 2(b) cases, and to the difficulty of establishing cost justification as a defense.

IV. PRESENT STATUS AND PROBLEMS

Borden has not changed the test that the Commission has been using for like grade and quality. There is now a clear Supreme Court ruling that goods which are physically identical are products of like grade and quality regardless of brand name or consumer preference. No other factors need be looked to when products are physically identical. The Court did not indicate in any way that it is improper for the Commission to consider functional and commercial factors when the products are not physically identical.

It is not possible to demonstrate conclusively from the legislative history what the test for like grade and quality ought to be or was really intended to be, beyond the proposition that it was intended to confine section 2(a) to comparable business transactions.[85] The best way to evaluate the merits of the present test is to examine the problems and the effects of the test as it is and to determine whether the present conditions are consistent with the antitrust laws generally, are administrable, and whether the Robinson-Patman Act is internally consistent.

If it could be shown that the cost justification and good faith meeting of competition defenses to price discrimination are highly difficult for a seller to prove, then the argument that like grade and quality should be narrowly construed has merit. The same is true if injury to competition, another jurisdictional element of section 2(a), is very easy for the Commission to show. On the other hand, if cost justification and good faith meeting are reasonable burdens for a seller to bear in demonstrating that his price differ-

[84] The dissent cited both the House and Senate Reports to support its position that differences in transactions supported by economic considerations were not meant to be covered by the Act. FTC v. Borden Co., 383 U.S. 637, 647, 653 & n.9 (1966); *see* S. REP. No. 1502, 74th Cong., 2d Sess. 3 (1936); H.R. REP. No. 2287, 74th Cong., 2d Sess. 7 (1936).

[85] *See* authorities cited notes 81, 83, and 84 *supra*.

ences are justified, like grade and quality should be construed broadly so that sales of products which are substantially similar can be brought within the jurisdiction of section 2(a). Like grade and quality was meant to measure the similarity of products. "Injury to competition" is in Robinson-Patman to determine anticompetitive effects. A case can be made that like grade and quality should be used to perform both tasks only if injury to competition (and the defenses previously mentioned) is an impossible burden upon a seller. It is necessary then to examine cost justification, good faith meeting of competition, and injury to competition as these concepts are utilized under Robinson-Patman. Only in that manner can it be determined whether it is fair and equitable to construe like grade and quality broadly and inclusively — to disregard brand names and to disregard market appeal of physically identical goods unless the difference is so significant that the type of transaction meant to be prohibited by section 2(a) is obviously not involved.

A. Cost Justification Defense

The Court suggested in the *Borden* case that " '[t]angible consumer preferences as between branded and unbranded commodities should receive due legal recognition in the more flexible . . . "cost justification" provisions of the statute.' "[86] Differences in price on commodities of like grade and quality are allowed under section 2(a) if the seller can justify the difference on the basis of cost.[87] The cost justification defense has been severely criticized, however. It has been said that the defense is ineffective,[88] unhelpful,[89] expensive,[90] and difficult to demonstrate.[91]

One of the early court cases concerning cost justification was *FTC v. Morton Salt Co.*[92] Two obvious though important principles concerning cost justification were brought out in the opinion. The Court pointed out that the purpose of the defense was to allow only those quantity price differentials which reflect actual cost differences.[93] Under the unamended Clayton Act, price differentials had been allowed buyers purchasing large

---

[86] FTC v. Borden Co., 383 U.S. 637, 646 (1966).

[87] The statute is quoted in note 1 *supra.*

[88] *See* Adelman, *The Consistency of the Robinson-Patman Act*, 6 STAN. L. REV. 3, 14 (1953).

[89] *See* Cassady & Grether, *supra* note 53, at 274.

[90] Rowe, *Price Differentials and Product Differentiation: The Issues Under the Robinson-Patman Act*, 66 YALE L.J. 1, 23 (1956).

[91] McGee, *Price Discrimination and Competitive Effects: The Standard Oil of Indiana Case*, 23 U. CHI. L. REV. 398, 453 (1956).

[92] 334 U.S. 37 (1948).

[93] *Id.* at 43–44. It is admitted that goods which are of like grade and quality, concerning which the costs of manufacture and distribution are different, which are sold for the same price, are being sold at discriminatory prices. As Professor Adelman has pointed out, only a full mandatory cost justification allowance in all cases would be nondiscriminatory. *See* Adelman, *supra* note 88, at 7–8. If the present defense is difficult to apply and test, the "mandatory" theory would be impossible. Aside from that, Congress intended no such mandatory theory of cost justification even though not imposing it allows price discrimination in an economic sense. For indications that Congress intended to allow sellers to sell goods at the same price regardless of differentials in cost or to grant *any* differentials which were not greater than the excess of the differences in cost see S. REP. No. 1502, 74th Cong., 2d Sess. (1936).

quantities. There were no criteria to determine whether the prices granted to quantity discount purchasers were actually granted as a result of the seller's cost savings. Congress determined that many quantity discounts were not based on cost,[94] and hence acted to close the quantity discount loophole of the old Clayton Act. The Court also pointed out in *Morton Salt* that the party asserting the defense bears the burden of proof.

It would appear that several cost justification defenses have been unsuccessful because the seller maintained questionable groupings of buyers to be allowed discounts. In *International Salt Co.*,[95] the seller grouped all customers but one in one group and the Great Atlantic and Pacific Tea Company in the other "group." The seller then attempted to justify the lower prices granted to A & P by comparing the cost of selling to A & P with the cost of selling to all its other customers. This grouping was rejected. There were no indications that A & P was different than the other customers or that the others were the same.[96] It is now clear that customers must be shown to be somewhat comparable before they can be classified together for the purposes of averaging the costs of serving them under a cost justification defense.

Illogical groupings of customers was also the major basis for the disallowance of the cost justification defense in *Standard Oil Co.*[97] There were actually several separate cost defenses attempted in *Standard Oil.* The first study compared all customers but Ned's Auto Supply with Ned's.[98] Also, advertising expense was allocated to every customer except Ned's, but there was no indication that the latter did not receive as much benefit from this advertising as did the other customers.[99] The larger grouping of customers was not shown to have similar characteristics concerning the seller's costs as related to them. Another separate study in *Standard* was an attempt to analyze costs in the Detroit field of operations.[100] However, the seller had ascertained the costs of selling to four customers and then allocated the remaining costs to the rest of the customers in that area. Again there was no showing of any reason why the customers should be grouped for purposes of cost allocation as the seller had grouped them.[101]

Another method of attempted cost justification which has proved unsuccessful is the use by businessmen of their own estimates of costs rather than factual cost analyses. The estimates, though they may be sound, are unacceptable to the Commission which requires factual supporting data.[102]

---

[94] *See* V. MUND, GOVERNMENT AND BUSINESS 339 (1950).

[95] 49 F.T.C. 138 (1952).

[96] *Id.* at 154–55.

[97] 41 F.T.C. 263 (1945).

[98] *Id.* at 277.

[99] *Id.*

[100] *Id.* at 279–80.

[101] *Id.*

[102] *See, e.g.*, E. B. Muller & Co., 33 F.T.C. 24 (1941), *aff'd*, 142 F.2d 511 (6th Cir. 1944); Standard Brands, Inc., 29 F.T.C. 121, 143–57, 158 (1939), *aff'd*, 189 F.2d 510 (2d Cir. 1951). In Champion Spark Plug Co., 50 F.T.C. 30 (1953), respondents were guilty of both types of condemned cost justification methods. Respondent grouped two favored buyers, Atlas Supply and Socony-Vacuum, together and grouped 485 other customers in the other group. This was a clear abuse of customer classification since

The cost justification defense has not been totally unsuccessful, however. In *Minneapolis-Honeywell Regulator Co.*,[103] the respondent was charged with discriminating in prices among customers purchasing its automatic oil burner controls. The respondent utilized the practice of entering into annual contracts with buyers. The contracts provided for the number of controls which the buyer would purchase for the year and also for the discount the buyer would receive. The prices decided upon, including the sizes of the discounts, were based both on the customers' expectations and upon past performance. On the basis of these contracts respondent set up seven separate discount brackets. However, if a customer purchased less than the number of controls contracted for there was no added charge; the customer still received his discount, which was based on a greater number of controls than the customer had actually purchased. On the other hand, if a buyer purchased more controls than he originally contracted for he was placed in a discount bracket based on what he actually purchased.[104] The respondent explained the allowances granted when customers purchased less than their contracts called for by contending that it was impossible to determine at the beginning of a year exactly how much a customer would purchase and if he purchased less than expected it was difficult to ask him to pay more.[105] The Commission answered that the respondent had chosen its classification and pricing method and that if the chosen method contained a calculated risk that respondent would flaunt the law, that was respondent's problem.[106] The respondent, though allowing certain discounts (off-scale prices) to customers who did not buy enough to warrant the usual discount, was still able to justify four of the seven discount brackets. Minus the "off-scale" practice all seven may well have been justified. However, respondent had manifested good faith by submitting a cost study in 1937 to FTC investigators (before any action was brought). The Commission indicated that such a practice should be given "great weight."[107]

Two other significant points about *Minneapolis-Honeywell* should be noted. The Commission recognized that a respondent bears a difficult burden under the cost justification defense and should, therefore, when a fair attempt is made to discharge that burden, have a "liberal measure of consideration."[108] In addition, the reason that the cost justification defense was not completely successful was that the claimed cost differentials did not exist. It makes little sense to criticize a defense which does not work when those claiming the defense have not complied with its demands.

---

there was no showing why Atlas and Socony were alike, how they were different from the rest, or how the others were alike. The *Champion* defense also failed because many of the figures relied upon were mere estimates by respondent's president.

[103] 44 F.T.C. 351 (1948), *rev'd in part on other grounds*, 191 F.2d 786 (7th Cir. 1951), *cert. dismissed*, 344 U.S. 206 (1952).

[104] *Id.* at 395.

[105] *Id.*

[106] *Id.*

[107] *Id.* at 394.

[108] *Id.*

The cost justification defense was upheld on certain goods in *United States Rubber Co.*[109] Extensive cost analysis was required, however.[110] A significant portion of the decision discussed the application of the de minimis principle. Certain price differentials of 0.0064, 0.0047, and 0.0092 per dollar of gross sales which were unjustified were disregarded by the Commission. A challenged price differential will be allowed if it is unjustified by an insignificant amount.[111]

In *Sylvania Electric Products, Inc.*[112] the respondent was charged with discriminating in the price of radio tubes between Philco, the low-priced buyer, and some 350 other customers. It was held that it was proper for Sylvania to compare the aggregate price difference on the entire line of tubes with the aggregate cost difference. This was reasonable because buyers bought the tubes not individually but as an entire replacement line. The demand was for the whole line, and therefore, cost differences on the lines could be compared. It is evident, however, that Sylvania expended considerable time and effort in its cost studies.[113]

Though the Commission requires tediously obtained cost account data to justify cost differentials, and though the defense has not often been successful, the conclusion that the defense has undergone undue criticism shines dimly through the recorded decisions.[114] It seems that the defense has often

---

[109] 46 F.T.C. 998 (1950).

[110] *Id.* at 1011.

[111] *Id.* at 1012. The de minimis rule was also applied in B. F. Goodrich Co., 50 F.T.C. 622 (1954), wherein all but one of respondent's quantity discount brackets were held to be cost justified. The one unjustified bracket was disregarded by the Commission because it constituted so small a fracfion of respondent's business. *Id.* at 623.

[112] 51 F.T.C. 282 (1954).

[113] Some of their efforts were as follows:

> Over a period of seven months more than 3,000 man hours under the supervision of corporate officers as well as independent CPA's were devoted to the preparation of Sylvania's cost study — which additionally secured the imprimatur of sound accounting practice bestowed by a knowledgeable professional authority on matters of Robinson-Patman accountancy.

Rowe, *Price Differentials and Product Differentiation: The Issues Under the Robinson-Patman Act*, 66 YALE L.J. 1, 22 (1956) (footnotes omitted). There are other cases in which successful cost justification may have played a part along with other factors. *E.g.*, Bissell Carpet Sweeper Co., 40 F.T.C. 738 (1945) (record ordered closed); Bird & Son, Inc., 25 F.T.C. 548 (1937) (loose construction of cost accounting proof); Kraft-Phenix Cheese Corp., 25 F.T.C. 537 (1937) (good faith and no injury to competition).

[114] It is apparent that the difficulties with the cost justification defense have generally arisen with respect to groupings of customers. Note, *The "Like Grade and Quality" Clause of the Robinson-Patman Act: A Construction to Effect the Objectives of the Act*, 49 MINN. L. REV. 1176, 1195 n.85 (1965). The advice has been given that sellers should concentrate on justifying cost differences in the manufacture of products and thereby escape the customer grouping problems. *Id.* This would be a highly risky method of cost justification because of the wording of the statute. The statute provides that "nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery *resulting from* the differing methods or quantities in which such commodities are to such purchasers sold or delivered . . . ." 15 U.S.C. § 13(a) (1964) (emphasis added). The "resulting from" clause only allows differences in cost to be considered which are related to and flow from methods of sale. As one authority has stated: "[T]his is really another way of saying that the cost defense is relegated to justifying *distribution costs* . . . ." Murray, *Cost Justification Under the Robinson-Patman Act: Impossibility Revisited*, 1960 WIS. L. REV. 227, 231; *see* Sawyer, *Accounting and Statistical Proof in Price Dis-*

been used in desperation, attempting to justify price differentials that were not based on cost or meant to be based on cost at the time the prices were outlined. Of course the defense should fail in such situations. It is surprising that the defense has ever been successful considering that little advance cost justification work has ever been done by respondents. It is also suggested that advance planning and advance compiling of cost information would help respondents to be ready for a cost justification defense at much less expense.[115] When the cost data must be accumulated after the fact it is difficult to keep respondents within the confines of Robinson-Patman legality.

If the cost justification defense is not overly difficult, the Court in *Borden* was correct, in a sense at least, when it suggested that like grade and quality should be relatively broad and inclusive, and that respondents could show cost justification as it related to consumer preferences to escape the effects of the Act. However, high consumer acceptance of a product may have no relationship whatsoever to costs.[116] The market price of a commodity may be based on notions as to what a commodity will bring in the market which, in turn, may be based on tradition, experience, brands, and faith.[117] For one or several of the above reasons, costs of producing and selling a similar commodity market-priced higher than the first commodity, may be lower. This could be due to different processes of manufacture or distribution. Whatever the reason, it is apparent that differences in production and distribution costs between two products are not necessarily reflected in their relative market prices. Naturally, it may be absolutely impossible for consumer preferences to receive "due legal recognition" in the cost justification portion of the statute as the Court advised. To the extent they exist, differences in costs can be shown; the defense is realistic and has been successfully used. To the extent that there are no differences in cost which can justify the price differentials, the injury to competition section may provide due legal recognition of price differences.[118]

It is submitted then that the Court in *Borden* was correct in holding premium and private brand milk, which was physically and chemically identical, to be of like grade and quality. On the basis of cost justification, which is a realistic defense, Robinson-Patman like grade and quality should be interpreted to be quite broad and inclusive because there is generally no unreasonable burden involved in justifying the action taken. The same should hold true concerning products which are not physically identical. If products are reasonably alike, reasonably interchangeable functionally, and at all competitive, they should be held to be of like grade and quality, and the respondent should have to demonstrate cost justification or lack of injury to competi-

crimination Cases, 36 IOWA L. REV. 244, 246 (1951). Hence no one has proceeded with a cost justification defense on the basis of the more easily determinable manufacturing costs. The advice referred to at the beginning of this paragraph should be ignored, unless a marketing cost difference can be shown to have been directly affected by manufacturing costs.

[115] *See* Murray, *supra* note 114, at 263.

[116] *See* Smith, *The Patman Act in Practice*, 35 MICH. L. REV. 705, 722 (1937).

[117] *See id.*

[118] Injury to competition is discussed in text accompanying notes 146–64 *infra*.

tion. The suggested test for like grade and quality for products which are not physically alike would entail a slight liberalizing of the present test.

Borden may be indicative of the proposition that generally there *is* a difference in costs between premium brand and private brand products which are otherwise identical. From the record in *Borden* it appears that Borden had justified to the Commission's satisfaction a cost differential in production and distribution of one dollar less per case on the nonpremium brand.[119] The actual price differential was 1.09 dollars per case. This, of course, left an unjustified cost differential of nine cents a case. If there were no demonstrable cost differences Borden could probably no longer compete in the private label market. Borden could not raise its private-label goods up to the premium price because the buyers would not pay that price. They would be unwilling to lower the premium price to the nonpremium price because Borden's volume is concentrated in premium milk and they could ill afford that kind of price drop on their volume product. So, if there were no demonstrable cost differentials Borden would be forced out of the private label market. Since they apparently can justify their costs, however, such will not be the result. Even if there were no cost differences, a lack of injury to competition could allow Borden to remain in the private label market.

There is a possibility that sellers of premium products could add advertising and promotion expenses to the costs of that product in connection with a cost justification defense. This would be consistent with the notion that the costs to be included are those that deal with distribution. The Commission has not ruled on these kinds of costs, and Borden did not include them in its defense. If these were to be allowed, then another reason could be added to those underlying the suggestion that like grade and quality be interpreted broadly and inclusively. Many price differentials between premium and nonpremium products could possibly be justified on promotion costs.[120]

B. Good Faith Meeting of Competition

Section 2(b) of the Robinson-Patman amendment to the Clayton Act provides that "nothing herein contained shall prevent a seller rebutting the prima facie case . . . by showing that his lower price . . . to any purchaser or purchasers was made in good faith to meet an equally low price of a

---

[119] *See* The Borden Co. [1961–1963 Transfer Binder], TRADE REG. REP. ¶ 16,191, at 21,024–25 (FTC 1962).

[120] There is extensive literature on the cost justification defense. For just a sampling see ATTORNEY GENERAL'S NATIONAL COMMITTEE, REPORT ON THE ANTITRUST LAWS 170–77 (1955); C. AUSTIN, PRICE DISCRIMINATION AND RELATED PROBLEMS UNDER THE ROBINSON-PATMAN ACT 56–66 (rev. ed. 1953); Adelman, *supra* note 88; Fuchs, *The Requirement of Exactness in the Justification of Price and Service Differentials Under the Robinson-Patman Act*, 30 TEXAS L. REV. 1 (1951); Murray, *supra* note 114; Note, *Proof of Cost Differentials Under the Robinson-Patman Act*, 65 HARV. L. REV. 1011 (1952); Comment, *Cost Justification Under the Robinson-Patman Act*, 49 NW. U.L. REV. 237 (1954).

See FTC v. Standard Motor Prods., Inc., 371 F.2d 613 (2d Cir. 1967), for a recent case wherein the Commission was reprimanded for demanding too much from a seller on a cost justification defense. As long as the costs allotted to one customer were near the average costs for the group he was placed in, the defense was valid. There need be no individual customer cost justification. *See also* United States v. Borden Co., 370 U.S. 460, 468 (1962).

competitor . . . ."[121] It is claimed that the Commission has not looked with favor on the meeting competition defense.[122] The Supreme Court has ruled, however, that the defense is absolute regardless of injury shown,[123] and some signs of success with the defense are apparent even in the Commission decisions.[124]

The dissent in *Borden* criticized the apparent inconsistency in interpretation between sections 2(a) and 2(b) on the part of the Commission and the majority. The dissent pointed out that under the present interpretation of section 2(b) the seller of a premium priced product is not allowed to cut the price on such a product down to the level of the price of his competitor's nonpremium product. This indicated to the dissent that appeal in the market place was determinative to the Commission under 2(b) but not under 2(a).[125] The weaknesses in the dissent's understanding of section 2(b) will be later noted. The majority in *Borden* simply stated that the 2(b) cases were not now before them, and, therefore, they were not obliged to reconcile any seeming conflict between 2(a) and 2(b).[126]

In three major cases decided by the Commission construing the meeting competition defense, commercial acceptance by the consumer has been determinative in deciding whether the sellers had legally lowered prices to certain buyers to meet or to beat competition. In *Minneapolis-Honeywell Regulator Co.*,[127] respondent was charged with selling its automatic controls to large purchasers at more favorable prices. The respondent contended that it granted low prices to certain purchasers to meet even lower prices being offered its customers by competing sellers. The Commission rejected the defense because it was determined that to allow Minneapolis-Honeywell to lower its prices too near those of its competitors would destroy competition. This result would follow because Minneapolis-Honeywell had developed a premium product with which it could compete charging higher prices. Consumer acceptance of respondent's product was a major consideration in the Commission's determination.[128]

The Commission remained consistent with *Minneapolis-Honeywell* in *Standard Oil Co.*[129] In that case respondent sold its Red Crown gasoline one-and-one-half cents cheaper to dealer-jobbers than to retail dealers in the Detroit area. An action was brought against Standard for discriminating in prices among its purchasers of products of like grade and quality. Standard

---

[121] 15 U.S.C. § 13(b) (1964).

[122] *See* Handler, *Recent Antitrust Developments — 1964*, 63 MICH. L. REV. 59, 83–85 (1964).

[123] *See* Standard Oil Co. v. FTC, 340 U.S. 231, 246–50 (1951).

[124] *See, e.g.*, Continental Baking Co. [1963–1965 Transfer Binder] TRADE REG. REP. ¶ 16,720 (FTC 1964).

[125] FTC v. Borden Co., 383 U.S. 637, 657 (1966).

[126] *See id.* at 647.

[127] 44 F.T.C. 351 (1948), *rev'd in part on other grounds*, 191 F.2d 786 (7th Cir. 1951), *cert. dismissed*, 344 U.S. 206 (1952).

[128] *See id.* at 396–97.

[129] 49 F.T.C. 923 (1953), *vacated*, 233 F.2d 649 (7th Cir. 1956), *vacation aff'd*, 355 U.S. 396 (1958).

relied on a cost justification defense and a meeting competition defense. Both failed. The respondent had lowered its prices to certain purchasers in response to offers those purchasers had received to buy Fleet Wing gasoline at one-and-one-half cents below usual Red Crown prices. The Commission held that Fleet Wing was an off-brand and to allow Standard to meet its price would destroy, not enhance, competition. The effect on competition, according to the Commission, is determined by public acceptance and not by chemical analysis.[130]

In *Anheuser-Busch, Inc.*,[131] respondent reduced the prices to buyers of its beer in the St. Louis area but maintained higher prices elsewhere. Seller's meeting competition defense was rejected because Anheuser-Busch could compete with less known beers even though it was priced higher; consequently the price cut was detrimental rather than helpful to competition. Competition was measured by what the public was willing to pay.[132]

In *Bigelow-Sanford Carpet Co.* and *Callaway Mills Co.*,[133] the respondents' meeting competition defense was rejected. The Commission attempted to import a like grade and quality test into section 2(b) of the Act; it determined that Callaway had not shown that its goods were of like grade and quality with its competitors' and so could not be allowed to lower prices on its goods which could possibly be quite dissimilar to those of its competitors. The Commission also reiterated its prior commitment to the policy that when a product normally commands a higher market price than a competitive product, the price of the premium one cannot be lowered to the price of the other to meet competition[134] as that would be detrimental to competition.

The Court of Appeals for the Fifth Circuit properly reversed the Commission.[135] The court pointed out that the importation of the like grade and

---

[130] *Id.* at 952.

[131] 54 F.T.C. 277 (1957), *rev'd on other grounds*, 265 F.2d 677 (7th Cir. 1959), *rev'd and remanded to court of appeals*, 363 U.S. 536 (1960), *FTC again rev'd on other grounds*, 289 F.2d 835 (7th Cir. 1961).

[132] *Id.* at 302.

[133] [1963–1965 Transfer Binder] TRADE REG. REP. ¶ 16,800 (FTC 1964), *rev'd sub nom.*, Callaway Mills Co. v. FTC, 362 F.2d 435 (5th Cir. 1966).

[134] *Id.* at 21,755 (dictum).

[135] Callaway Mills Co. v. FTC, 362 F.2d 435 (5th Cir. 1966). Besides the reversal on the like grade and quality issue, several other facets of the meeting competition defense were dealt with by the court. The court determined that there was nothing per se wrong in adopting a price system used by competitors. Price systems, as opposed to meeting competition by individual responses to individual offers made by competitors of the seller to seller's customers, have always been suspect. *E.g.*, FTC v. Cement Institute, 333 U.S. 683 (1948); FTC v. A. E. Staley Mfg. Co., 324 U.S. 746 (1945). The facts of *Callaway* militated against the per se systems rule. The carpeting industry had been granting discounts for years and Callaway found that adopting a pricing system was the only realistic way to break in. The court found that as long as a system is a reasonable method of meeting competition it will be allowed. *See* Callaway Mills Co. v. FTC, *supra* at 442. What influence this determination will have on courts deciding future meeting competition cases is not, of course, determinable at present. It is a good guess to say that systems will still be suspect. The fact that a new firm was being charged in *Callaway* seemed to weigh heavily with the court. *See id.* at 437.

The court also indicated that it would perhaps use a test of reasonableness in measuring whether or not competition had been met or undercut. The defense, the court said, was not meant to place an unreasonable or impossible burden on sellers. *Id.* at 442.

quality test into section 2(b) was not proper; the proper test was salability.[136] The factors to be considered under a section 2(b) defense are whether the goods are competitive and at what prices. Only then can it be shown whether or not there has been a good faith meeting of competition by the lowered price. The Commission in *Callaway* had given lip service to the old salability or consumer preference test for 2(b) and then had ignored it by confusing it with a like grade and quality test. The court of appeals decision was consistent on this point with the general line of Commission decisions preceding *Callaway*, and the Commission decision, although employing some of the traditional language, was not.

The weakness with the point of view of the dissent in *Borden*, which view is shared by other critics of the alleged section 2(a)-2(b) inconsistency,[137] is that the dissent felt that the sections are aimed at the same type of transaction. This erroneous premise led the dissent to the conclusion that the sections should be judged by the same standard. But the obvious differences between the two provisions in question require different treatment. Section 2(a) prohibits price discrimination by a single seller of his goods of like grade and quality. Section 2(b) is a defense to a discrimination charge under 2(a). It allows a seller to lower prices to purchasers of his goods who are approached by competitors of a seller and offered a lower price. There is no requirement that the seller's goods and his competitor's products be of like grade and quality. Salability is the test, not like grade and quality. Section 2(b) is intended to allow the discrimination in price by the seller. The primary-line competition (competition among sellers) is meant to be protected under 2(b). This allows secondary-line competition (competition among buyers) to suffer somewhat for the greater good of allowing the seller to meet his primary-line competition.

Apart from there being no requirement in section 2(b) that the goods be of like grade and quality,[138] the qualities to be measured under 2(b) are much broader than the requirements of like grade and quality measured under 2(a). Like grade and quality is just one of several jurisdictional requirements which must be satisfied if Robinson-Patman is to apply at all to a particular transaction. Competition, and the likely injury thereto, although taken somewhat into account under like grade and quality as an aid when the goods are not identical, is mainly measured under the injury to competition portion of section 2(a). Meeting competition in good faith under 2(b) *must measure competition*; competition must be the main part of the test, and, properly, it is. Meeting competition, as a defense to a section 2(a) violation, encompasses all the elements of 2(a) in reverse. This includes the importation of an injury to competition test, not necessary under like grade and quality because of the separate specific provision of injury to

[136] Callaway Mills Co. v. FTC, 362 F.2d 435, 441 (5th Cir. 1966).

[137] *See, e.g.*, Borden Co. v. FTC, 339 F.2d 133, 138 (5th Cir. 1964); Comment, *Like Grade and Quality: Emergence of the Commercial Standard*, 26 OHIO ST. L.J. 294, 310–11 (1965).

[138] Again, it must be remembered that, in effect, the products will usually meet the like grade and quality test of § 2(a) because, otherwise, there would be little competition between them.

competition in 2(a). So naturally it is proper that competition, measured by salability or consumer preference, remain in the background when considering like grade and quality and yet be in the forefront when meeting in good faith of competition is under consideration. The Commission then has not been inconsistent[139] when it has refused to allow a seller to price his premium product the same as his competitor's nonpremium product and claim a section 2(b) defense, and has simultaneously required a single seller of premium and nonpremium products which are of like grade and quality to sell them at the same price except insofar as the differences may be justified by cost.

It has been further pointed out that to allow any interpretation of section 2(b) which would make it "consistent" with section 2(a) could partially nullify the effect of 2(a).[140] Large manufacturers of highly salable goods could lower their prices to their customers in certain geographical areas to correspond to the prices their competitors were offering to customers. If a section 2(b) defense were allowed to the manufacturers in these instances they could snuff out small manufacturers.[141] Consumer preference under 2(b) is a highly necessary requisite to preserve competition.

Admittedly, section 2(b) is aimed at preserving competition at the primary line (among sellers).[142] A seller is allowed to discriminate in price — give one of his buyers a lower price — because a competitive product has been offered to that buyer by a competitor of the seller.[143] This provision is for the purpose of allowing the seller to compete so that primary-line competition will be preserved. When a favored buyer is approached by two sellers, each offering low prices, the buyer will profit at the expense of *his* competitors. In other words, secondary-line competition can be injured by allowing meeting of competition defenses.[144] However, the harm is not as great as might

---

[139] Except for its language of *Callaway* construing like grade and quality which was contrary to its whole line of cases interpreting § 2(b).

[140] *See* 4 DUQUESNE L. REV. 604, 608 & n.26 (1966).

[141] *Id.*

[142] *See* text accompanying note 138 *supra.*

[143] The meeting competition defense of § 2(b) is not valid unless the seller is attempting to meet *his* competition. In FTC v. Sun Oil Co., 371 U.S. 505 (1963), the seller lowered his price to only one of his customers to enable that customer to compete with someone else. The defense of meeting competition was rejected. The seller had not been attempting to meet the competition of any of *his* competitors. The Court held that this result was required by the meaning and purpose of the statute which does seem clear on this point. If sellers were allowed to judge competition with others which did not affect them personally and structure their prices accordingly, the defense could get out of control.

There is an indication in *Sun Oil* that if a competitor could show that his customer's competitor has been offered a low price by the seller's competitor, the seller could drop the price to his customer. *Cf. id.* at 512 & n.7, 520–21, 522. The defense should not be allowed in these situations unless it is realistic to assume that the seller's customers have been offered the lower price by seller's competitor and could accept the offer. This is usually not true in the gasoline industry wherein the retailer is usually tied by station, lubricants, etc., to his supplier. Since the retailer only buys gasoline from one supplier, another supplier's price drop could not induce retailers to forsake old suppliers and start buying from new ones. Consequently, suppliers are not really "competitors" within the meaning of the Robinson-Patman Act. The 2(b) defense should not be available to a seller unless another supplier has offered the seller's customer a lower price which *he could accept.*

[144] *See* 80 HARV. L. REV. 463, 466 (1966).

be suspected, as the low price had already been offered to the buyer by a competitor of the seller, and because the defense is limited to responses to individual competitive situations of which the seller must have knowledge.[145]

It is not necessary to allow consumer preference to control like grade and quality determinations as it is allowed to control meeting competition determinations. The current test for like grade and quality is consistent with the meeting competition defense.

C. Injury to Competition

1. *The Law.* The injury to competition must be shown by the Commission as one of the jurisdictional elements under section 2(a).[146] The injury may occur on the primary line,[147] the secondary line,[148] or the tertiary line.[149] The Court has indicated that the injury must be reasonably possible.[150] The adverse effects of price discrimination were meant to be corrected in their incipiency so actual harm is not an element.[151] The test generally used by the Commission, however, has been reasonable probability rather than the reasonable possibility test that *Morton Salt* seemed to approve.[152] That injury to competition be reasonably probable is a much more generous test from the point of view of the alleged discriminator.

The courts have presumed competitive injury. In *Samuel H. Moss, Inc. v. FTC*,[153] the court held that when a seller sets two prices for the same goods the seller has the burden of demonstrating that his price differentials have caused no competitive injury. The court determined that one who had discriminated in prices should know why he has done so and what the results are.[154] The inferences of possible competitive injury allowed from the evidence in *Corn Products Refining Co. v. FTC*[155] amounted to a presumption of injury before the fact. Had these rigorous tests remained in effect — whereby competitive injury was presumed and the seller had to rebut the presumption — an argument could be made that like grade and quality should be construed as narrowly as possible. A narrow construction, excluding goods physically alike but commercially different, would seem fair when a seller has an arduous burden to demonstrate lack of injury to competition.

---

[145] *See* text accompanying notes 129–32 *supra.*

[146] *See* 15 U.S.C. § 13(a) (1964).

[147] *See, e.g.*, FTC v. Anheuser-Busch, Inc., 363 U.S. 536 (1960); Volasco Prods. Co. v. Lloyd A. Fry Roofing Co., 346 F.2d 661 (6th Cir.), *cert. denied*, 382 U.S. 904 (1965).

[148] FTC v. Morton Salt Co., 334 U.S. 37 (1948); United Biscuit Co. of America v. FTC, 350 F.2d 615 (7th Cir. 1965), *cert. denied*, 383 U.S. 926 (1966).

[149] Thompson Prods., Inc., 55 F.T.C. 1252 (1959); Standard Oil Co., 41 F.T.C. 263 (1945), *modified*, 173 F.2d 210 (7th Cir. 1949), *rev'd on other grounds*, 340 U.S. 231 (1951).

[150] *See* FTC v. Morton Salt Co., 334 U.S. 37, 46 (1948).

[151] *Id.* at 46 n.14.

[152] General Foods Corp., 50 F.T.C. 885, 887 (1954).

[153] 148 F.2d 378 (2d Cir.) (per curiam), *cert. denied*, 326 U.S. 734 (1945), *modified*, 155 F.2d 1016 (2d Cir. 1946).

[154] *Id.* at 379.

[155] 324 U.S. 726, 738–42 (1945).

However, the rigorous (to seller) injury to competition doctrine has undergone some modification. In *Minneapolis-Honeywell Regulator Co. v. FTC*,[156] substantial interference with competition was required to be shown under section 2(a) along with a causal connection between the effect of price differentials and the injury.[157] In another case the Commission chose not to follow the *Moss* decision but rather left the burden to prove injury on the Commission.[158] Although the Commission and courts have wavered on the proof required to show injury to competition,[159] the trend has been to require a showing of substantial economic impact at least concerning alleged injury on the secondary line.[160] Injury to primary-line competition also remains reasonably difficult to establish. The price discrimination must be demonstrated to have caused the injury.[161] If the seller's competitor could meet the lower price without being placed in a disadvantageous competitive position, the causal connection might be refuted.[162] A substantial diversion of business to the seller from his competitors is a sufficient showing of injury on the primary line if the causal connection has been established.[163] It is submitted that so long as injury to competition under section 2(a) is only a reasonable burden on a seller, like grade and quality should be construed broadly so that effects on actual competition can be measured. Commercial differences, unless wholly incomparable, should not preclude the jurisdiction of Robinson-Patman at the outset before the in-depth inquiries concerning the potential or actual injury to competition are undertaken.[164]

---

[156] 191 F.2d 786 (7th Cir. 1951), *petition for cert. dismissed*, 344 U.S. 206 (1952).

[157] *Id.* at 789–92.

[158] General Foods Corp., 50 F.T.C. 885, 889–90 (1954).

[159] *See* Rowe, *The Evolution of the Robinson-Patman Act: A Twenty-Year Perspective*, 57 COLUM. L. REV. 1059, 1084–85 (1957).

[160] *See* American Oil Co. v. FTC, 325 F.2d 101 (7th Cir. 1963), *cert. denied*, 377 U.S. 954 (1964).

[161] *See* Balian Ice Cream Co. v. Arden Farms Co., 231 F.2d 356, 368 (9th Cir. 1955), *cert. denied*, 350 U.S. 991 (1956).

[162] *See* Samuel H. Moss, Inc. v. FTC, 148 F.2d 378 (2d Cir.) (per curiam), *cert. denied*, 326 U.S. 734 (1945), *modified*, 155 F.2d 1016 (2d Cir. 1946).

[163] *See* FTC v. Anheuser-Busch, Inc., 363 U.S. 536 (1960).

[164] The concept of relevant market under § 7 of the Clayton Act appears to be based, in great part at least, upon consumer preferences. *See, e.g.*, United States v. Continental Can Co., 378 U.S. 441, 455 (1964) (customer response brings industries within § 7); United States v. Aluminum Co. of America, 377 U.S. 271, 276–77 (1964) (little responsive price interchangeability between two products prevented combined relevant market); Brown Shoe Co. v. United States, 370 U.S. 294, 326 (1962) (product lines recognized by public are a relevant market); International Boxing Club v. United States, 358 U.S. 242, 250–51 (1959) (spectators pay more for championship fights — they are distinct market); United States v. E. I. du Pont de Nemours & Co., 353 U.S. 586, 593–94 (1957) (peculiar characteristics and uses of product create distinct market); United States v. E. I. du Pont de Nemours & Co., 351 U.S. 377, 400 (1956) (sensitivity of customers to price changes determines relevant market).

The problems of determining a relevant market under § 7 of the Clayton Act, so as to be able to make a finding of monopoly, are related to the determination of whether competition has been injured under § 2 of the Robinson-Patman Act. In both instances the inquiry should seek to determine what products are in fact in actual competition. There is much more latitude allowed under § 7 than under § 2, however. Under § 7, the inquiry need only be directed at injury to competition in a line of commerce — the relevant market. Under § 2, the jurisdictional element of like grade and quality must be met before the issue of injury to competition is explored. Since both sections aim at preventing injury to competition, the like grade and quality portion of § 2(a)

The Commission should broaden its test for like grade and quality. It is not suggested that the Commission should discontinue its consideration of physical differences, functional differences, and commercial differences in its determination of whether products are of like grade and quality, but if the physical, functional, and/or commercial similarities of products justify a reasonable belief that the products are competitive, the products should be held to be of like grade and quality. This broader test would probably have resulted in different holdings on the like grade and quality issue in the early informal Commission rulings,[165] in *Quaker Oats Co.*,[166] and possibly, though not necessarily, in *Universal-Rundle Corp.*[167] It is arguable that the significant differences, physical and commercial, in the lines of products in *Universal-Rundle* would have precluded a finding of like grade and quality even under a very broad test. However, if the test becomes so broad that the Commission is no longer measuring transactions concerning substantially similar products, the purpose of the statute will be clearly violated even though the products in question could be viewed as competitive. Further, an overly broad test would make the task of administering alleged violations of the act increasingly difficult. The task of administration of the antitrust statutes is now a difficult and arduous one, and this fact would argue against the proposition that the Robinson-Patman Act be amended to preclude only

---

should be construed, within the bounds of reason, as broadly as possible. This would allow products with physical variations, chemical variations, and functional variations, to a reasonable degree, to be brought within the jurisdiction of the Act. Thereafter cost differentials could be justified or it could possibly be shown that competition had not been injured. But the Act should not be deprived of its effect to preserve competition at the outset by a narrow reading of like grade and quality which would exclude the types of products mentioned above or physically identical products branded differently which have commercial differences.

Perhaps the Robinson-Patman Act would better serve its function if it were written to prevent price discrimination which injured competition. However, the intent seems to have been to limit the effect to transactions that were comparable. *See* ATTORNEY GENERAL'S NATIONAL COMMITTEE, REPORT ON THE ANTITRUST LAWS 157 (1955). The goods do not have to be branded exactly alike, or be exactly physically, chemically, or commercially similar for there to be comparable transactions. Like grade and quality does define an outer boundary enclosing an area within which competitive injury will be analyzed. In that respect, the Robinson-Patman Act problems, more clearly bounded than § 7 Clayton Act problems, are probably easier to administer. This is no small advantage.

Neither is it correct to say that the relevant market is determined solely by commercial considerations. In Reynolds Metals Co. v. FTC, 309 F.2d 223, 226 (D.C. Cir. 1962), it was pointed out that there are several criteria for arriving at a determination of a relevant market. Reasonable interchangeability and cross-elasticity of demand set the outer boundaries of the broad relevant market. However, within that broad market may exist relevant sub-markets. A relevant sub-market is measured by industry or public recognition, characteristics and use of a particular product, production facilities, distinct customers or price, and/or specialized vendors. If one or a combination of the above factors exists in a given case a respondent will be found to be doing business in a relevant sub-market and if his share of sales is at all large after a merger, the merger will be declared a violation of § 7.

In short, the courts have left the rules broad and flexible. It is not unfair to say that the antitrust laws are currently being aimed at bigness and whatever ills attend it. So, consumer preference is only one element of a many-sided test for relevant markets. The aim of the antitrust laws and possible conflicts in policy between them are discussed in text accompanying notes 168–91 *infra*.

[165] Those rulings can be found in 81 CONG. REC. APP. 2337–39 (1937).

[166] [1963–1965 Transfer Binder] TRADE REG. REP. ¶ 17,134 (FTC 1964).

[167] [1963–1965 Transfer Binder] TRADE REG. REP. ¶ 16,948 (FTC 1964); *see* text accompanying notes 47–49 *supra*.

price differentials which injure competition — removing the like grade and quality provision from the statute. A useful balance can be struck by leaving the statute as it now is and by construing like grade and quality broadly.

2. *Sherman Act versus Robinson-Patman Act policy.* It has been maintained that the aims of the Robinson-Patman Act are opposed to the aims of the general antitrust policy as demonstrated particularly by the Sherman Act.[168] It has also been said that the Federal Trade Commission does not really distinguish between injury to competition and injury to a competitor.[169] If the Commission does not distinguish, sellers will be prosecuted when they injure competitors even though injury to competitors may further "competition."[170]

Supporting the theory that the acts conflict is the notion that the Sherman Act is intended to remove restrictions on competitive behavior so that competition will be the force behind the determination of prices.[171] On the other hand, the Robinson-Patman Act prohibits not only discriminations in price which injure competition but also those which may injure competitors.[172] The Robinson-Patman Act assumes that certain large firms have such power in the economy that pricemaking must be regulated.[173] This assumption is inimical to the Sherman Act standard that competition ought to shape and influence prices. Competition, under this Sherman Act view, is seen as allowing aggressive pricing policies. These policies are difficult to reconcile under Robinson-Patman, as it fosters price uniformity. Moreover, the Robinson-Patman Act is accused of curbing structural changes in marketing such as increased efficiency due to size.[174] The Act, therefore, is seen as an impediment to lower prices to the consumer.[175]

The supporters of Robinson-Patman argue that the acts are not antithetical. They contend that the Sherman Act was not only meant to allow normal competitive processes but was also meant to be used to control advantages related to size. The small businessmen are supposed to be protected to some extent under the Sherman Act as well as under the Robinson-Patman Act.[176]

It is also maintained that certain advantages in the market are acquired by means other than normal competitive processes. Some of these may be from a large scale of output, size from mergers, or monopoly power from

---

[168] See the voluminous collection of authority in Rowe, *Price Differentials and Product Differentiation: The Issues Under the Robinson-Patman Act*, 66 YALE L.J. 1, 34 n.141 (1956).

[169] *See* Cassady & Grether, *The Proper Interpretation of "Like Grade and Quality" Within the Meaning of Section 2(a) of the Robinson-Patman Act*, 30 S. CAL. L. REV. 241, 276 (1957).

[170] *See id.* at 276 & n.77.

[171] J. BURNS, A STUDY OF THE ANTITRUST LAWS 118 (1958).

[172] *See* Oppenheim, *Federal Antitrust Legislation: Guideposts to a Revised National Antitrust Policy*, 50 MICH. L. REV. 1139, 1199 (1952).

[173] *See* J. BURNS, *supra* note 171, at 119.

[174] *See id.* at 121.

[175] *Id.* at 121–22.

[176] *Id.* at 123–24.

patents. To adequately regulate these large firms a pricing statute is needed.[177] If they are not regulated, competition will cease to exist because competitors will be forced out of business. The supporters of Robinson-Patman further argue that there is no evidence that the Act has had any anticompetitive effect.[178]

The Commission certainly feels that the purpose of the Robinson-Patman Act is to protect competition, not competitors.[179] This view is supported by the *Report of the Attorney General's National Committee to Study the Antitrust Laws*. The report states that competition should be protected by the Robinson-Patman Act and that every doubt in interpretation should be solved in favor of Sherman Act policy.[180] The *Report* further urges that

> analysis of the statutory "injury" center on the vigor of competition in the market rather than hardship to individual businessmen. For the essence of competition is a contest for trade among business rivals in which some must gain while others lose, to the ultimate benefit of the consuming public. Incidental hardships on individual businessmen in the normal course of commercial events can be checked by a price discrimination statute only at the serious risk of stifling the competitive process itself. Nor should a competitive price reduction be singled out as responsible for "injury" if alternative means of access to goods at the lower price are in any event available to the buyer.[181]

However, it is certainly correct, at least under present interpretations, that the Sherman Act and Clayton Act are being used to curtail advantages related to size and to protect competitors.[182] The famous rationale of Judge Hand that large competitors must be closely regulated is being followed.[183] A system of several producers, rather than a system of a few large producers is being fostered under these acts; protection of competitors *is* one of the objectives.[184] If competitors are not protected to a certain extent, the strongest competitors will prevail; when that occurs competition is destroyed. To protect competition, then, competitors must be protected. The case of *United States v. Von's Grocery Co.*[185] is a recent case in point. In *Von's* it was held that the acquisition by a corporation of its direct competitor violated section 7 of the Clayton Act. The merged corporations made a total of 7.5% of the retail grocery sales in the Los Angeles area in 1960.[186] Although this does not appear to be an excessive percentage, the Court pointed out what it felt to be the important facts in assessing the effect of the merger. First, the merger created the

---

[177] *Id.* at 125–26.

[178] *Id.* at 127–28.

[179] *See* Purex Corp., Ltd., 51 F.T.C. 100, 108–17 (1954).

[180] *See* ATTORNEY GENERAL'S NATIONAL COMMITTEE, REPORT ON THE ANTITRUST LAWS 131 (1955).

[181] *Id.* at 164–65 (footnotes omitted).

[182] *See* notes 176–77 *supra* and accompanying text.

[183] *See* United States v. Aluminum Co. of America, 148 F.2d 416, 429 (2d Cir. 1945).

[184] *See* Northern Pac. Ry. v. United States, 356 U.S. 1 (1958); ATTORNEY GENERAL'S NATIONAL COMMITTEE, REPORT ON THE ANTITRUST LAWS 1, 2 (1955).

[185] 384 U.S. 270 (1966).

[186] *Id.* at 272.

second largest chain in the Los Angeles area.[187] Second, the number of chains was growing while the number of single-store owners was diminishing.[188] Since the Sherman Act, the Clayton Act, and amendments thereto had been passed to prevent concentration and to keep a large number of small competitors in business, and since *Von's* demonstrated a trend toward concentration, the merger was invalid.[189]

The antitrust laws are meant to protect "competition" but in that process it is often necessary to protect competitors.[190] The problem is that unchecked competition contains the seeds of its own destruction. The possibility is inherent that competition will be so successful that all competitors could be destroyed. Then there would be no competition. To prevent this, the Court has recognized that competitors must often be protected.[191] This process of protecting competitors to preserve competition is common to the Sherman, Clayton, and Robinson-Patman acts.

If the Robinson-Patman and Sherman acts were actually opposed in policy, it could well be argued that like grade and quality should be construed very narrowly so that the "anticompetitive" effects of section 2(a) would apply to as small a number of transactions as possible. However, since they are not, it is recommended that like grade and quality be construed broadly.

V. CONCLUSIONS

The phrase "like grade and quality" should include within the purview of section 2(a) all goods that are physically identical, or physically similar and functionally interchangeable. Without emasculating the requirement of like grade and quality or making the jurisdiction of 2(a) so broad as to be unadministrable, Robinson-Patman should seek to compare transactions of substantially similar goods which may compete. The sellers can defend on cost justification grounds or by demonstrating lack of injury to competition. This would allow great differences in market appeal to be recognized under like grade and quality,[192] but would usually result in problems concerning

---

[187] *Id.*

[188] *Id.* at 272–73.

[189] *See id.* at 274–75, 277–78. The Court cited two cases which further demonstrate the proposition that competitors are to be protected under the antitrust laws. United States v. Aluminum Co. of America, 377 U.S. 271, 280 (1964); United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 362–63 (1963).

[190] The dissenting opinion of Mr. Justice Stewart in *Von's* took sharp issue with the notion that competitors are to be protected under the antitrust laws. *See* United States v. Von's Grocery Co., 384 U.S. 270, 281–82 (1966) (dissenting opinion). The dissent also pointed out that competition had not been injured in the Los Angeles area by the merger. It is possible that in an extreme case, wherein there were very few competitors left in an industry, the dissenting justices would also want to protect the remaining competitors even if no injury to competition could be shown.

[191] *See* note 189 *supra*.

[192] Some have suggested that commercial distinctions should cause products to be of unlike grade and quality. *See* Cassady & Grether, *supra* note 169, at 277–79; Comment, *Like Grade and Quality: Emergence of the Commercial Standard*, 26 OHIO ST. L.J. 294, 325 (1965). These suggestions seem to be inspired by the proposition that injury to competition and cost justification are impossible escape hatches — that once jurisdiction is taken a violation is found. This has not been the case, however.

market appeal being considered under the injury to competition portion of section 2(a).

The recommended test for like grade and quality is more liberal than the test presently used by the Federal Trade Commission. It is suggested that the broadened version of like grade and quality need not be unduly harsh on sellers due to the increasing likelihood of successful cost justification by planning ahead for defenses and due to the possibility of the sellers being able to demonstrate a lack of injury to competition. If jurisdiction is too easily given up by finding goods of unlike grade and quality, it may be possible to evade Robinson-Patman by simple variations in products. Consequently, only when it is clear that the products could not possibly compete or that they are so different that to group them together would clearly violate any broad meaning of the words "like grade and quality" should jurisdiction be refused.

Section 2(a) would perhaps better serve its purposes if it outlawed price discriminations which were injurious to competition rather than merely outlawing price discriminations on goods which are of like grade and quality and which injure competition. Such a test, however, would be difficult to administer even though tests of this type and breadth are administered under section 1 of the Sherman Act and section 7 of the Clayton Act. The removal of like grade and quality would also leave a seller in the dark as to when he was violating section 2(a). At any rate, to effect such a change the Robinson-Patman Act would have to be amended — a fearsome task.[193] A realistic approach is to broaden slightly the test for like grade and quality which is currently used.

Dale A. Kimball

[193] *See* Rowe, *Price Differentials and Product Differentiation: The Issues Under the Robinson-Patman Act*, 66 YALE L.J. 1, 35–36 n.142 (1956).

Fraudulent Financial Statements and Section 17 of the Bankruptcy Act — The Creditor's Dilemma

If a creditor prosecutes an action on a note to judgment, it is possible for the nonbusiness debtor to be adjudicated a bankrupt between the entering of the judgment and execution thereon and to raise his discharge in bankruptcy as a defense to the execution. Under section 17 of the Bankruptcy Act,[1] a creditor normally has the opportunity to object to the application of a general discharge to his debt if the debt was incurred through the bankrupt's fraud or misrepresentation. The question treated in this note is whether the creditor in such a case should be allowed to introduce evidence outside the record of the adjudication on the note in an attempt to show that the underlying obligation was in fact induced by the bankrupt's fraud. This topic is of timely interest in Utah, since the Utah Supreme Court has decided the question in several recent decisions.[2]

I. Background

Until relatively modern times, bankruptcy was essentially a creditor's remedy, providing creditors a ratable distribution of the bankrupt's assets and imposing severe sanctions on the insolvent.[3] The British were the first to introduce the concept of discharge into bankruptcy,[4] which carried over into the federal bankruptcy law of the United States.[5] The current federal Bankruptcy Act represents a sophisticated balance between the rights of creditors and debtors wrought by compromise over the years.[6]

As the Act now reads, an adjuciation of bankruptcy is automatically an application for a general discharge,[7] which is granted by the court unless

---

[1] 11 U.S.C. § 35 (1964).

[2] Beehive State Bank v. Buntine, 17 Utah 2d 351, 411 P.2d 967 (1966); Jensen v. Barrick, 15 Utah 2d 285, 391 P.2d 429 (1964); National Fin. Co. v. Daley, 14 Utah 2d 263, 382 P.2d 405 (1963).

[3] *See* 7 H. Remington, Bankruptcy § 2993, at 42 (6th ed. 1955). *See generally* J. Moore, Debtors' and Creditors' Rights — Cases and Materials 1–3 (1955). It is interesting to note that "debtor's prison" provisions are still found in the British system of jurisprudence, though abolished in many others. *See* J. Joyce, Justice at Work 212 (1952).

[4] *See* 7 H. Remington, Bankruptcy § 2993 (6th ed. 1955). From this innovation during Queen Anne's era the modern law of bankruptcy has developed. Changes made in more recent times have been essentially oriented toward liberalization of the law favoring the debtor. *See* J. Moore, *supra* note 3, at 3.
It should also be noted that ancient Israel observed what is probably the earliest law of discharge. In that society, at the end of every seven years there was a general release of debtors under ecclesiastical law. *Deuteronomy* 15:1–3.

[5] U.S. Const. art. 1, § 8 provides that Congress shall have the power to establish "uniform Laws on the subject of Bankruptcies throughout the United States . . . ." *See* Bankruptcy Act § 14, 11 U.S.C. § 32 (1964).

[6] *See* Comment, *Discharge: The Prime Mover of Bankruptcy*, 15 Sw. L.J. 308, 327 (1961). Capsulized reviews of legislation culminating in the current law are presented in the following: J. Moore, *supra* note 3, at 4–11; 1 H. Remington, Bankruptcy §§ 7–10 (5th ed. 1950). *See generally* 1 W. Collier, Bankruptcy ¶¶ 0.01–0.08 (14th ed. 1966).

[7] Bankruptcy Act § 14(a), 11 U.S.C. § 32(a) (1964).

objections under section 14(c) are raised and substantiated.[8] While section 14 provides for the debtor's general discharge, Congress has wisely provided for individual exceptions to discharge if the debtor intentionally wrongs the creditor.[9] These exceptions in section 17 clearly promote a basic policy of the Act, which is to allow the economic renaissance of the honest but unfortunate debtor while protecting the creditor from the unscrupulous.[10]

A discharge granted under section 14 does not operate to extinguish the bankrupt's debts; rather, it affords him a personal defense to their enforce-

---

[8] Bankruptcy Act § 14(c), 11 U.S.C. § 32(c) (Supp. I, 1965), reads, in pertinent part, as follows:

> The court shall grant the discharge unless satisfied that the bankrupt has . . . (3) while engaged in business as a sole proprietor, partnership, or as an executive of a corporation, obtained for such business money or property on credit or as an extension or renewal of credit by making or publishing or causing to be made or published in any manner whatsoever a materially false statement in writing respecting his financial condition or the financial condition of such partnership or corporation . . . .

Other objections under § 14(c) are based similarly on unfair or criminal practices by the bankrupt in connection with his financial affairs.

[9] Bankruptcy Act § 17, 11 U.S.C. § 35 (1964), reads, in pertinent part, as follows:

> A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as . . . (2) are liabilities for obtaining money or property by false pretenses or false representations, or for obtaining money or property on credit or obtaining an extension or renewal of credit in reliance upon a materially false statement in writing respecting his financial condition made or published or caused to be made or published in any manner whatsoever with intent to deceive, or for willful and malicious injuries to the person or property of another, or for alimony due or to become due, or for maintenance or support of wife or child, or . . . (4) were created by his fraud, embezzlement, misappropriation or defalcation while acting as an officer or in any fiduciary capacity . . . .

[10] In the leading case of Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934), the Supreme Court made this observation: "One of the primary purposes of the bankruptcy act is to 'relieve the *honest* debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.'" (Quoting Williams v. United States Fidelity & Guar. Co., 236 U.S. 549, 554–55 (1915) (emphasis added)).

The Connecticut court further clarified the policy underlying discharge with the following observation: "It was also clearly the intent of the Congress that clemency should not be so far extended as to include obligations resulting from the acts of dishonesty specified in § 17 . . . ." Fidelity & Cas. Co. v. Golombosky, 133 Conn. 317, 324, 50 A.2d 817, 820 (1946).

Particularly in the area of false financial statements, the provisions for exception to general discharge in the case of a dishonest debtor have been retained and fortified over the years. The Senate committee report recommending adoption of the Celler amendment of § 17 in 1960 made the following comment on its purpose:

> The purpose of this amendment is to assure that although the obtaining of money or property on credit through the issuance of a false financial statement is no longer to be ground for denial of a discharge to a nonbusiness bankrupt, any obligation incurred as a result of such statement [is] . . . to be nondischargeable under section 17. The addition of the elements of reliance by the creditor and intent to deceive by the debtor are merely enactments of existing case law.

S. REP. No. 1688, 86th Cong., 2d Sess. 3 (1960). The language of § 14c(3) was thus added to § 17a(2) to insure the creditor's complete protection in cases where false financial statements are used. 20 WASH. & LEE L. REV. 123, 126 (1963).

The final draft of the 1960 amendment also changed "with intent to defraud," as it appeared in the original draft, to "with intent to deceive," as it was enacted, to ease the burden on the creditor. Comment, *Effect of False Financial Statements on Debts Discharged in Bankruptcy — Section 17a(2) of the Bankruptcy Act*, 21 LA. L. REV. 638, 643–44 (1961).

There have been two other previous amendments to § 17a(2) that have had the effect of making the burden on the creditor lighter. In 1938, Congress added "obtaining

ment unless the defense is disqualified under section 17.[11] Thus, although the broad question of the general discharge is settled in the bankruptcy proceedings, whether a creditor has a legally enforceable claim surviving under section 17 is a question normally determined by the court in which the creditor attempts to enforce his claim and the bankrupt interposes the special defense of discharge.[12]

---

money" to "obtaining property by false pretenses." *Compare* Bankruptcy Act § 17a(2), ch. 575, § 17a(2), 52 Stat. 851 (1938), *with* Bankruptcy Act § 17a(2), ch. 22, § 17a(2), 42 Stat. 354 (1922). In 1903, Congress similarly moved to favor the creditor by changing the requirement that an obligation had to be reduced to a judgment in fraud prior to bankruptcy in order to qualify for exception under § 17 to a more liberal requirement of mere "liabilities for" obtaining property by false pretenses. *Compare* Bankruptcy Act § 17a(2), ch. 487, § 5, 32 Stat. 798 (1903), *with* Bankruptcy Act § 17a(2), ch. 541, § 17, 30 Stat. 550 (1898).

[11] The general rule on the effect of a discharge was set forth in Helms v. Holmes, 129 F.2d 263, 266 (4th Cir. 1942):

> It must be remembered that a discharge in bankruptcy is neither a payment nor an extinguishment of debts. It is simply a bar to their enforcement by legal proceedings. . . . And no court, other than the bankruptcy court, is bound to take judicial notice of the discharge, unless it is pleaded as a release. . . .
>
> . . . .
>
> Thus, the bankrupt is merely given a personal defense which is waived if he chooses not to avail himself of it. This rule . . . has been uniformly followed by State and Federal Court alike.

See 1 W. COLLIER, BANKRUPTCY ¶ 17.27 (14th ed. 1966). The federal form for discharge provides that the bankrupt be "discharged from all debts and claims which, by the Act of Congress relating to Bankruptcy, are made provable against his estate, except such debts as are, by said Act, excepted from the operation of a discharge in bankruptcy." Fed. Form BK-45 (6-62).

[12] 1 W. COLLIER, BANKRUPTCY ¶ 17.28 (14th ed. 1966).

Creditors have sometimes attempted to obtain specific exemption of their claims in the bankruptcy court to avoid the necessity of an additional suit in the state courts. Such petitions have been rather uniformly denied. *Id.* at 1699. However, the case of Local Loan v. Hunt, 292 U.S. 234 (1934), firmly established jurisdiction in the bankruptcy court following discharge to hear matters pertaining to the protection and enforcement of the general discharge order. The Court limited such ancillary jurisdiction to cases involving "unusual circumstances," *id.* at 241, but this standard has been broadly interpreted by the federal courts in subsequent ancillary proceedings brought by bankrupts to avoid creditors' actions in the state courts. *See, e.g.*, Personal Indus. Loan Corp. v. Forgay, 240 F.2d 18 (10th Cir. 1956), *cert. denied*, 354 U.S. 922 (1957); State Fin. Co. v. Morrow, 216 F.2d 676 (10th Cir. 1954); 1 W. COLLIER, *supra* at 1702–08.

The extension of federal jurisdiction to cover matters pertaining to discharge under the *Local Loan* doctrine has led a substantial number of authorities to recommend consolidation of jurisdiction to hear all discharge matters in the federal bankruptcy courts. *See, e.g.*, Coleman, *A Plea for "One Stop Service" in Bankruptcy*, 25 REF. J. 31 (1951); Gleick, *Qualified and Split Discharges in Bankruptcy*, 36 REF. J. 53, 55 (1962); Rifkind, *Discharge of Debts in Bankruptcy and Some Problems Relating Thereto*, 7 N.Y.L.F. 354, 369 (1961); Smedley, *Determination of the Effect of a Discharge in Bankruptcy*, 15 VAND. L. REV. 49, 59 (1961).

Difficulties such as the introduction of jury trial on a larger scale and the administrative burden that would be placed on already overloaded bankruptcy courts have been posed as objections to consolidation of jurisdiction. *See, e.g.*, Boroff, *The Proper Forum for the Determination of the Effect of a Discharge in Bankruptcy*, 34 REF. J. 81 (1960); Smedley, *Bankruptcy Courts as Forums for Determining the Dischargeability of Debts*, 39 MINN. L. REV. 651, 669 (1955).

The protracted argument among the authorities has resulted in substantial legislative activity on the subject, and three proposals involving consolidation of jurisdiction for all discharge matters are currently before the Congress. H.R. 4990, 90th Cong., 1st Sess. (1967); H.R. 2078, 90th Cong., 1st Sess. (1967); S. 578, 90th Cong., 1st Sess. (1967).

II. The Creditor's Dilemma

The most common ground alleged to except a debt from discharge under section 17a(2) is that of a fraudulent financial statement.[13] Misrepresentation of financial condition when obtaining a loan or credit may result in nondischargeability of the claim based on the obligation, allowing it to survive through bankruptcy as a legally enforceable obligation. Substantiation of the misrepresentation depends, however, upon a rather complex burden of proof which must be sustained by the creditor.[14] He must show three basic elements: (1) a material fraudulent misrepresentation; (2) moral turpitude in making the representation with intent that it be relied upon; and, (3) reliance in fact by the creditor.[15]

It is sometimes maintained that the creditor's original action brought on his note must be based specifically in fraud in order for it to survive the bankruptcy.[16] Under this view, choosing to bring the action on the note in contract waives the tort claim for fraud and subjects the judgment to dis-

---

[13] There are, of course, other objections to discharge besides false representation of financial condition. Bankruptcy Act § 14(c), 11 U.S.C. § 32(c) (Supp. I, 1965). However, the great bulk of litigation under both § 14 and § 17 is concerned with false financial statements. J. MacLachlan, Bankruptcy § 106, at 93 (1956) (§ 14); *see* Rifkind, *Bankruptcy Law: Non-Dischargeable Debts*, 45 A.B.A.J. 685, 686 (1959) (§ 17); Wisdom, *Discharge as It Affects the General Practice*, 13 Kan. L. Rev. 497, 507 (1965) (§ 17).

[14] There has been a certain amount of confusion on the matter of the burden of proof stemming largely from the difference between the standards under § 14 and those under § 17. Quite clearly, the burden of proof with regard to false financial statements shifted from plaintiff to bankrupt upon a showing that credit was obtained by a materially false statement under § 14c, and it was then up to the bankrupt to show nonreliance by the creditor. 1 W. Collier, Bankruptcy ¶ 14.43 (14th ed. 1961). Under § 17, on the other hand, the burden must be borne by the creditor once the prima facie defense of discharge has been interposed by the bankrupt. *Id.* ¶ 17.31, at 1772.

Three writers have apparently been caught up in the confusion, and have reached an erroneous conclusion regarding the burden of proof under § 17: Brendes & Schwartz, *Schlockmeister's Jubilee: Bankruptcy for the Poor*, 40 Ref. J. 69, 75 (1966); Note, *Bankruptcy Act: Abuse of Sections 14c(3) and 17a(2) by Small Loan Companies*, 32 Ind. L.J. 151, 159–60 (1957). In the former article no authority is given for the conclusion, and in the latter, the conclusion is based upon erroneous authority. Comment, *Effect of False Financial Statements on Debts Discharged in Bankruptcy — Section 17a(2) of the Bankruptcy Act*, 21 La. L. Rev. 638, 641 n.11 (1961). The majority rule is that the burden rests squarely on the creditor throughout the proceedings, without shifting at any time to the bankrupt. *Id.* at 640–42 & n.10; *see* Note, *Proof of Reliance on False Financial Statement in Actions Against Bankrupts*, 14 Personal Finance L.Q. Rep. 104 (1960).

[15] *See* 1 W. Collier, Bankruptcy ¶ 17.16, at 1616–18 (14th ed. 1961); 8 H. Remington, Bankruptcy § 3320 (6th ed. 1955); Brendes & Schwartz, *supra* note 14, at 75.

It is not required that the representation be in writing, 1 W. Collier, *supra* at 1618, but it is necessary that the fraud be intentional — implied fraud will not do. *Id.* at 1617; 8 H. Remington, *supra* § 3320. An extensive discussion of the nature and quality of representations required is found in Annot., 17 A.L.R.2d 1208 (1951).

Proof of reliance will be diluted if the bankrupt is able to show that the creditor made additional credit checks or had an established relationship with the bankrupt over a long period, but such defenses are usually difficult to prove. Brendes & Schwartz, *supra* note 14, at 75. There is also some evidence that the court will take into account the difference in advantage between a sophisticated creditor and an ignorant borrower. *See id.*; Schumacher, *Was Perry v. Commerce Loan Company Necessary? — A Bankruptcy Trustee's View*, 20 Personal Finance L.Q. Rep. 104, 105 (1966). *But see In re* Santos, 211 F.2d 887 (7th Cir. 1954).

[16] *E.g.*, Strauch v. Flynn, 108 Minn. 313, 122 N.W. 320 (1909); Personal Fin. Co. v. Schwartz, 170 S.W.2d 701 (St. Louis Ct. App. 1943); 1 W. Collier, Bankruptcy ¶ 17.16, at 1625 & n.35 (14th ed. 1961).

charge.[17] However, Utah and most jurisdictions take the position that an action on the note will suffice to satisfy section 17 as long as the fraudulent misrepresentation remains a basis of the action.[18] The latter seems to be the better-reasoned view in light of the legislative history and language of the Act. There was a time when the language of section 17 restricted its operation to judgments in causes of action for fraud. This language was broadened, however, to include all liabilities incurred through fraudulent misrepresentation.[19] It follows that the current language must be interpreted more broadly than the former restriction to judgments for fraud.[20] Therefore, the form of the cause of action should not be determinative, although the proper allegations and proof are critical.

If the creditor first brings his action after bankruptcy has been filed, he need only plead the allegations of fraud and sustain the burden of proving them.[21] In most cases, if a suit on the obligation is pending when bankruptcy is filed, the creditor will be able to amend his pleadings and show fraud under the rather liberal rules of pleading now existing in most states.

The dilemma for a creditor arises when he has prosecuted a claim on a note to judgment prior to the bankruptcy without having known of the misrepresentation by the bankrupt. If it is first discovered by an analysis of the bankrupt's schedule of debts, the majority of jurisdictions will not allow a judgment creditor to go behind the record of the judgment on the note to show fraud in the inducement which would insulate the obligation against the

---

[17] This theory appears to be largely a hangover from the days of restrictive pleadings when errors in stating the cause of action with precision at the outset were fatal. The view is often buttressed by the old concept that choosing to bring one form of action waives reliance on any other. *See* 1 W. COLLIER, BANKRUPTCY ¶ 17.16, at 1625 (14th ed. 1961).

[18] The Utah court is unanimous on this subject. National Fin. Co. v. Valdez, 11 Utah 2d 339, 359 P.2d 9 (1961), *noted*, 15 PERSONAL FINANCE L.Q. REP. 84 (1961). Most jurisdictions that have faced the issue are in accord with the Utah court, *e.g.*, Zimmern v. Blount, 238 F. 740 (5th Cir. 1917); Personal Fin. Corp. v. Robinson, 27 N.Y.S.2d 6 (Sup. Ct. 1941); Ohio Fin. Co. v. Greathouse, Ohio L. Abs. 1, 110 N.E.2d 805 (Ct. App. 1947), though Collier is rather indecisive on the matter. *See* 1 W. COLLIER, BANKRUPTCY ¶ 17.16, at 1625 (14th ed. 1961). Remington, on the other hand, clearly agrees with the Utah position. *See* 8 H. REMINGTON, BANKRUPTCY § 3324, at 184 (6th ed. 1955).

[19] *Compare* Bankruptcy Act § 17a(2), ch. 487, § 5, 32 Stat. 798 (1903), *with* Bankruptcy Act § 17a(2), 11 U.S.C. § 35a(2) (1964).

[20] It can also be reasoned that since the fraud allegations are only brought into discussion by virtue of the special defense of discharge they are not part of the plaintiff's cause of action at all. Fraud can thus be raised as a rebuttal to the special defense without violating even the strict rules of pleading common to times past. As the New York court reasoned in the early case of Argall v. Jacobs, 87 N.Y. 110, 113 (1881): "It was not needful that the plaintiff should allege the fraud in his complaint. It was no part of his cause of action. It was needful only for him to prove it, not as part of his cause of action, but as an answer to the affirmative defense set up." Note that this case was based on the Bankruptcy Act of 1867, before the limitation restricting § 17 to judgments was introduced. *See* 1 W. COLLIER, BANKRUPTCY ¶ 17.01, at 1574 (14th ed. 1961).

[21] The creditor should be cautioned to plead facts supporting the allegation of fraud with particularly in case of a default judgment. Broad allegations may result in intervention by the federal court under the *Local Loan* doctrine. *See* Personal Indus. Loan Corp. v. Forgay, 240 F.2d 18 (10th Cir. 1956), *cert. denied*, 354 U.S. 922 (1957). Jurisdictions employing the federal rules similarly require that allegations of fraud be pleaded with particularity. *E.g.*, FED. R. CIV. P. 9(b); UTAH R. CIV. P. 9(b).

effect of the discharge.[22] Thus, the judgment creditor otherwise protected by section 17 has unwittingly cut himself off by diligent prosecution of his claim. Of course, if the record shows the necessary elements of fraud, in most cases there will be no problem in asserting the protection of section 17a(2).[23] The problem arises when the record is silent regarding the fraud and the creditor attempts to show by evidence extrinsic to the record that the obligation upon which the judgment was based was induced by the bankrupt's misrepresentations.[24]

III. The Majority View

Most courts facing the issue have decided not to allow proof of fraud aliunde.[25] Although the courts have employed different means of expressing

[22] *E.g.*, AEtna Cas. & Sur. Co. v. Sentilles, 160 So. 149 (La. Ct. App. 1935); Beehive State Bank v. Buntine, 17 Utah 2d 351, 411 P.2d 967 (1966); *see* 1 W. Collier, Bankruptcy ¶ 17.16, at 1623–25 (14th ed. 1961); *cf.*, Universal C.I.T. Credit Corp. v. Woodmansee, 213 Tenn. 429, 374 S.W.2d 386 (1964) (fraud in fiduciary capacity).

Although this fact situation would seem to be a rather rare occurence, it comes up quite often. Losing the suit on the note naturally prompts a defendant in financial difficulty to turn to the remedy of bankruptcy in order to avoid execution on the judgment. Since the filing of a voluntary petition in bankruptcy automatically adjudicates the applicant a bankrupt, it is possible to sandwich the protection of the Bankruptcy Act between judgment and execution. *See* Bankruptcy Act § 18(f), 11 U.S.C. § 41(f) (1964).

[23] *See, e.g.*, Beneficial Loan Co. v. Noble, 129 F.2d 425 (10th Cir. 1942); Thomas v. Crosby, 146 F. Supp. 296 (W.D. Mo. 1956) (both are representative of cases holding that a state court record of judgment showing fraud is binding on the bankruptcy court in supplemental proceedings by bankrupt to enjoin enforcement of the state court judgment); Miller v. Rush, 155 Colo. 178, 393 P.2d 565 (1964); National Fin. Co. v. Valdez, 11 Utah 2d 339, 359 P.2d 9 (1961); Annot., 170 A.L.R. 368, 374 (1947); *cf.* Citizens Mut. Auto. Ins. Co. v. Gardner, 315 Mich. 689, 24 N.W.2d 410 (1946).

[24] There is universal agreement that the fact that an obligation is represented by a note *or* by a judgment will not alter its character. The court will look behind the note or the judgment to determine the true character of the obligation. *See* Annot., 170 A.L.R. 368–69 (1947). However, the majority of courts encounter a "metaphysical difficulty" when asked to look behind both a judgment and the note upon which it is premised, and will look no further than the judgment and record that supports it. *See* J. MacLachlan, Bankruptcy § 120 (1956); Annot., 170 A.L.R. 368, 369–70 (1947).

[25] The cases arising under § 17a(2) fraud allegations are very similar in fact and theory to those arising under the "fraud . . . in fiduciary capacity" provision of § 17a(4) and the "malicious injuries" exception of §17a(2). Bankruptcy Act § 17, 11 U.S.C. § 35 (1964). The same problem arises in each of the three cases if a suit has been prosecuted on the cause of action and brought to a judgment before the declaration of bankruptcy by the debtor. Discharge is then interposed as a special defense to execution on the judgment and the creditor is faced with the necessity of showing the character of the original obligation to be within the exceptions to discharge outlined by § 17. Should the record of the judgment be silent in *any* of these three cases regarding fraud or malice, the creditor must go outside the record for proof of the true character of the obligation or suffer the loss of his right to execution. For this reason the cases bearing on the problem of proof dehors the record in these three areas of § 17 are normally considered together.

The following are the important cases espousing the majority view: Miller v. Rush, 155 Colo. 178, 393 P.2d 565 (1964); Rice v. Guider, 275 Mich. 14, 265 N.W. 777 (1936); Jacobs v. Beatty, 165 Ohio St. 596, 138 N.E.2d 657 (1956); National Fin. Co. v. Daley, 14 Utah 2d 263, 382 P.2d 405 (1963); Shawano Fin. Corp. v. Haase, 252 Wis. 12, 30 N.W.2d 82 (1947); *cf.* Lawrence v. Wischnowsky, 344 Ill. App. 346, 100 N.E.2d 816 (1951) (willful conversion of property); AEtna Cas. & Sur. Co. v. Sentilles, 160 So. 149 (La. Ct. App. 1935) (fraud in fiduciary capacity); Universal C.I.T. Credit Corp. v. Woodmansee, 213 Tenn. 429, 374 S.W.2d 386 (1964) (fraud in fiduciary capacity).

A limited inroad is suggested by several authorities, allowing the creditor to offer proof aliunde if the record of the previous proceeding is ambiguous. Greenfield v. Tuccillio, 129 F.2d 854 (2d Cir. 1942) (dictum); Bannon v. Knauss, 57 Ohio App. 288, 13 N.E.2d 733 (1937) (dictum); 1 W. Collier, Bankruptcy ¶ 17.16, at 1623 (14th ed. 1961).

it, a central thesis threads through most of the decisions. The courts simply feel uncomfortable relitigating matters that have been the subject of a former suit supposedly laid to rest by a judgment.[26] This metaphysical difficulty, as it has been called,[27] does not prevent the courts from looking behind the judgment to the record upon which it is based,[28] but they will look no further. Piercing both the judgment *and* the record in a contract action to discover underlying elements of tort not raised in the former trial is deemed to offend common notions of res judicata,[29] collateral estoppel,[30] and election of remedies.[31] However, the courts appear to use these terms as shibboleths, without explanation of the rationale behind their use.[32]

The majority position has been adopted in Utah in spite of an early trend toward the more liberal view. In 1949, the court in *Lyon v. Lyon*[33] admitted evidence dehors the record of a divorce proceeding to show that a property settlement in that record was really alimony or support within the meaning of section 17 and thus not affected by the husband's intervening general discharge in bankruptcy.[34] Fourteen years later, the court took a different stand. In the leading case of *National Finance Co. v. Daley*,[35] the court analyzed *Lyon* as having been "grounded upon the reasoning that such family obligations should not be extinguished merely because of the terminology

---

[26] In the words of the Utah court:

> In our judgment it better comports with the orderly processes of justice to require the plaintiff to bear the responsibility of pleading, proving and claiming the full benefit of whatever character of cause of action he possesses in the original action and of being bound thereby, than to allow another trial upon the same cause of action raising issues which could have been dealt with in the original action.

National Fin. Co. v. Daley, 14 Utah 2d 263, 266, 382 P.2d 405, 407 (1963).

[27] J. MACLACHLAN, BANKRUPTCY § 120, at 111 (1956).

[28] As the court stated in Rice v. Guider, 275 Mich. 14, 265 N.W. 777, 778 (1936): "A judgment is but an adjudication upon a record. Plaintiff could go back of the judgment, but not back of the record." This view is generally accepted by most jurisdictions. J. MACLACHLAN, BANKRUPTCY § 120, at 111 (1956).

[29] *See, e.g.*, Universal C.I.T. Credit Corp. v. Woodmansee, 213 Tenn. 429, 374 S.W.2d 386 (1964); National Fin. Co. v. Daley, 14 Utah 2d 263, 382 P.2d 405 (1963).

[30] *See* Universal C.I.T. Credit Corp. v. Woodmansee, 213 Tenn. 429, 374 S.W.2d 386 (1964).

[31] *See, e.g.*, Miller v. Rush, 155 Colo. 178, 393 P.2d 565 (1964); Shawano Fin. Corp. v. Haase, 252 Wis. 12, 30 N.W.2d 82 (1947).

[32] Typical examples are found in AEtna Cas. & Sur. Co. v. Sentilles, 160 So. 149 (La. Ct. App. 1935) and Universal C.I.T. Credit Corp. v. Woodmansee, 213 Tenn. 429, 374 S.W.2d 386 (1964).

Res judicata as a ground for the majority position is discussed in greater detail by the cases than are the other two bases, but is still treated essentially in abbreviated form. The cases often adopt wholesale the opinion of a prior decision, *e.g.*, AEtna Cas. & Sur. Co. v. Sentilles, 160 So. 149 (La. Ct. App. 1935) (adopting Harrington & Goodman v. Herman, 172 Mo. 344, 72 S.W. 546 (1903)); Jensen v. Barrick, 15 Utah 2d 285, 391 P.2d 429 (1964) (adopting National Fin. Co. v. Daley, 14 Utah 2d 263, 382 P.2d 405 (1963)), or base their disposition on the strength of the annotation at 170 A.L.R. 368 (1947), *e.g.*, Lawrence v. Wischnowsky, 344 Ill. App. 346, 100 N.E.2d 816 (1951); Jacobs v. Beatty, 165 Ohio St. 596, 138 N.E.2d 657 (1956). To a very large extent, the cases take the form of an inverse pyramid built upon the strength of earlier decisions.

[33] 115 Utah 466, 206 P.2d 148 (1949).

[34] *Id.* Bankruptcy Act § 17a(2), 11 U.S.C. § 35a(2) (1964), excludes from discharge obligations for "alimony due or to become due, or for maintenance or support of wife or child . . . ."

[35] 14 Utah 2d 263, 382 P.2d 405 (1963).

used" rather than upon evidence of the nature of the settlement agreement introduced aliunde.[36] The language in *Lyon* purporting to allow introduction of evidence dehors the record to rebut a defense of discharge in bankruptcy was treated as dictum and summarily disapproved.[37] In taking this position, the court relied heavily on *Wheadon v. Pearson*,[38] a case unrelated on the facts, but purporting to set forth the Utah rule on res judicata. In that case, the court declared: "[W]hen a plaintiff has once attempted to obtain his entire relief, based upon his entire claim, then the matter should be laid at rest. He should be denied a second attempt at substantially the same objective under a different guise."[39] The majority view has been clearly established in Utah by several subsequent decisions. Each attempt to show facts within section 17 but outside the record of an adjudication prior to bankruptcy has met with failure.[40]

IV. The Minority View

A minority of jurisdictions has allowed proof extrinsic to the record to be introduced[41] based upon the reasoning found in the leading case of *Fidelity & Casualty Co. v. Golombosky*.[42] Prior to *Golombosky* the Connecticut court had held that introduction of evidence to rebut the defense of bankruptcy was confined to the contents of the record of the previous adjudication.[43] The *Golombosky* court tenuously distinguished the prior case on the basis that it dealt with a loan secured by false representations, whereas *Golombosky* was founded upon an obligation arising out of fraud in a fiduciary

---

[36] *See id.* at 264–65, 382 P.2d at 406.

[37] *Id.* The court pointed with approval to the majority view as espoused by Annot., 170 A.L.R. 368 (1947), as many courts have done since 1947.

[38] 14 Utah 2d 45, 376 P.2d 946 (1962).

[39] *Id.* at 47, 376 P.2d at 948. In the *Wheadon* case, the plaintiff was denied a second attempt to establish an easement over defendant's land. In the first trial, plaintiff proceeded on the theory of a prescriptive easement. Failing there, he brought a second action alleging an implied easement and was foreclosed by the court with the language quoted in the text above.

[40] *See* Beehive State Bank v. Buntine, 17 Utah 2d 351, 411 P.2d 967 (1966); Jensen v. Barrick, 15 Utah 2d 285, 391 P.2d 429 (1964).

[41] The most important cases are: United States Credit Bureau, Inc. v. Manning, 147 Cal. App. 2d 558, 305 P.2d 970 (1957); Fidelity & Cas. Co. v. Golombosky, 133 Conn. 317, 50 A.2d 817 (1946); Levin v. Singer, 227 Md. 47, 175 A.2d 423 (1961); Fireman's Fund Indem. Co. v. Caruso, 252 Minn. 435, 90 N.W.2d 302 (1958); Crow v. McCullen, 235 N.C. 380, 70 S.E.2d 198 (1952).

There is also a suggestion of support for this view in cases where the record of the original suit is ambiguous. *See* authorities cited note 25, *supra*.

[42] 133 Conn. 317, 50 A.2d 817 (1946).

The completeness with which the opinions set forth their views may be a natural result of going to an uphill battle fully armed. It is suggested by one authority that, in their exuberance, the courts occasionally overestimate the extent of some of the holdings of cases cited for support of their views. *See* Smedley, *Determination of the Effect of a Discharge in Bankruptcy*, 15 Vand. L. Rev. 49, 55 n.32 (1961). Nevertheless, the opinions are generally clear and detailed in their analyses.

[43] Consolidated Plan, Inc. v. Bonitatibus, 130 Conn. 199, 33 A.2d 140 (1943).

capacity.[44] Thus, the court did not directly overrule the earlier case, but the implication is certainly compelling.[45]

Subsequent cases have relied extensively on the reasoning and language of *Golombosky*,[46] and the case has evoked much favorable comment.[47] In the minority cases, reliance is also placed on dictum from an early Supreme Court decision which set up as a hypothetical situation the general facts of the "creditor's dilemma" and suggested that the minority view was the proper approach.[48] The argument is also advanced that since it is well established (1) that anytime an action is brought upon a *note* and discharge is asserted as a defense, it is proper to allow evidence showing that the underlying obligation was created by fraud, and (2) that the rendition of a judgment does not alter the character of the indebtedness it represents, then it must follow that the rendition of a judgment does not preclude proof aliunde of fraud in rebuttal to the special defense of discharge.[49] It is also asserted that revealing the inducement behind the original obligation when the record of the prior suit is silent thereon in no way attacks the first judgment. The offer of proof is directed exclusively at the extraneous special defense of discharge,[50] and in fact relies upon the prior judgment rather than objecting to it.[51] These cases also assert a conviction that the clemency of the Bankruptcy Act was in no instance intended to favor the fraudulent or dishonest, which could be the result under the majority approach.[52]

In cases involving fraudulent misrepresentations in obtaining loans, the additional argument is advanced that the language changed by the amendment of section 17 supports the minority view.[53] Section 17a(2) was liberalized by excepting *all* liabilities for obtaining property by false pretenses from the effect of the discharge, whereas it was formerly confined to judgments

---

[44] Fidelity & Cas. Co. v. Golombosky, 133 Conn. 317, 325–26, 50 A.2d 817, 820–21 (1946).

[45] There is really no material difference in the fact situations. *See* note 25, *supra*. As Judge Dickenson stated in his dissenting opinion, "In my opinion the Bonitatibus decision is sound, is applicable, and has so far become the established law of the state as to make it unwise to overrule it even by implication." Fidelity & Cas. Co. v. Golombosky, 133 Conn. 317, 329, 50 A.2d 817, 822 (1946).

[46] *See* cases cited note 41 *supra*.

[47] See 9 AM. JUR. 2d *Bankruptcy* § 821, at 616 (1963); J. MACLACHLAN, BANKRUPTCY § 120 (1956); Phillips, *Order of Discharge and Post-Bankruptcy Litigation*, 16 MERCER L. REV. 409, 411–12 (1965); 60 HARV. L. REV. 638 (1947); 33 VA. L. REV. 508 (1947).

[48] *See* Strang v. Bradner, 114 U.S. 555, 560–61 (1885).

[49] United States Credit Bureau, Inc. v. Manning, 147 Cal. App. 2d 558, 562–63, 305 P.2d 970, 973 (1957) (quoting *Golombosky*); Fidelity & Cas. Co. v. Golombosky, 133 Conn. 317, 322–23, 50 A.2d 817, 819 (1946); Levin v. Singer, 227 Md. 47, 57–58, 175 A.2d 423, 428–29 (1961) (quoting *Golombosky*).

[50] Fidelity & Cas. Co. v. Golombosky, 133 Conn. 317, 323, 50 A.2d 817, 819–20 (1946).

[51] Levin v. Singer, 277 Md. 47, 61, 175 A.2d 423, 431 (1961).

[52] *See* United States Credit Bureau, Inc. v. Manning, 147 Cal. App. 2d 558, 564, 305 P.2d 970, 974 (1957) (quoting *Golombosky*); Fidelity & Cas. Co. v. Golombosky, 133 Conn. 317, 324, 50 A.2d 817, 820 (1946); Levin v. Singer, 227 Md. 47, 58, 175 A.2d 423, 429 (1961).

[53] *See* Levin v. Singer, 227 Md. 47, 54–55, 175 A.2d 423, 427–28 (1961); *cf.* Hamby v. St. Paul Mercury Indem. Co., 217 F.2d 78, 81 (4th Cir. 1954).

for such fraud.[54] Thus it is asserted that the change to include all obligations supports a determination of their true character from sources extraneous to the record of a judgment rendered upon them.[55]

V. Resolving the Dilemma

When faced with the problem of enforcing a judgment on an obligation incurred through fraud but challenged by the defense of discharge in bankruptcy, the creditor in a majority jurisdiction has two possible alternatives: First, the creditor might try to persuade the court to change its position, since the reasoning supporting the *Golombosky* line of decisions seems persuasive. Comparison of the two approaches reveals convincing legal bases for the minority view, and an analysis of the policy considerations on both sides yields the same result. Second, it may be possible to avoid the question of evidence dehors the record entirely and still resolve the creditor's dilemma by instituting an entirely new action based in fraud.

In advocating a change of a court's position, certain concepts must be considered. The notions of res judicata, collateral estoppel, and election of remedies employed as the legal basis for the majority view have a common thesis: A party should be bound by a judicial determination rendered fairly on the facts giving rise to the cause of action and should not be allowed the privilege of thwarting an unfavorable aspect of that decision by altering its effect in a subsequent action on the same matters.[56] However, it must be considered that in executing on his judgment the creditor is not seeking by any means to attack that judgment; rather, he seeks to affirm it and offers the

---

[54] This amendment in 1903 was part of a general liberalizing trend in amendments to § 17 over the years. *See* note 10 *supra*.

Two leading opinions under the restrictive language of the 1898 Act indicated that they would have gone the other way under the more liberal language of the 1867 Act, which is similar to the current § 17:

> If the question at bar had arisen under the sections just quoted [the liberal view], a decided conflict of authority might readily be cited; but the present bankrupt law reads as follows [the restrictive view] . . .
>
> . . . .
>
> The difference in the language is striking. Under the old law "no *debt* created by the fraud or embezzlement of the bankrupt" was discharged by the proceedings in bankruptcy, but in the present act it is "judgments in actions for fraud . . ." which are not released by the discharge in bankruptcy. . . . The legislature [Congress] had some object in view in making this change. . . . Its object . . . must have been to change the law in this respect.

Hargadine-McKittrick Dry Goods Co. v. Hudson, 111 F. 361, 363 (C.C.E.D. Mo. 1901), *aff'd*, 122 F. 232 (8th Cir. 1903) (emphasis added).

> If the bankrupt act provided that *claims* created by fraud, false statements, or false pretenses were excepted out from the bar of a discharge, then the mere fact that the claim had been put into judgment *might* not preclude the holder thereof from proving its original and essential nature, in order to enable the court to determine whether it came within the exceptions of the statute.

In re Rhutassel, 96 F. 597, 599 (N.D. Iowa 1899) (emphasis added).

The language is far from conclusive, but was employed by the Maryland court in Levin v. Singer, 227 Md. 47, 57, 175 A.2d 423, 428 (1961), to draw the inference that the decisions would have been different under either the 1867 or the present liberal language. It should be noted that the word "would" was apparently inadvertently used by the Maryland court in place of "might" in the *Rhutassel* quotation above, undoubtedly facilitating the inference drawn.

[55] Levin v. Singer 227 Md. 47, 58–59, 175 A.2d 423, 429 (1961).

[56] *See* cases cited *supra* note 25. *See generally Developments in the Law — Res Judicata*, 65 Harv. L. Rev. 818 (1952).

evidence aliunde merely to rebut the extraneous defense of discharge. Introduction of evidence outside the record neither constitutes a new cause of action nor a reopening of the prior judgment.[57] This simple argument, by itself, demonstrates clearly that the majority position is incorrect.[58]

Another common denominator of most majority opinions is the metaphysical difficulty the courts encounter in piercing both the judgment and the record to allow introduction of evidence of fraud. The *Golombosky* case is often cited for its concise refutation of the majority position in this regard:

> The decisions which have held that in determining the nature of the indebtedness a court cannot go behind the judgment and record seem generally to have overlooked two principles which the cases place beyond dispute. Where an action is brought upon a note, and a discharge in bankruptcy is set up as a defense, proof is admissible to show that the underlying debt was created by fraud or one of the other excepted causes . . . and the rendition of a judgment upon an obligation does not change the character of the indebtedness. . . . In the light of these accepted principles, there would seem to be no escape from the conclusion that the rendition of a judgment based upon a note does not preclude proof by evidence extraneous to the record . . . that the underlying debt was created by fraud . . . .[59]

The majority view can thus be severely criticized on its merits. Notably, although the majority cases since *Golombosky* have recognized the existence of an opposite view, they have not refuted its challenges to the rationale of the majority position, nor rebutted the reasoning and policy determinations supporting the minority position.[60]

Without the privilege of discharge under the Bankruptcy Act there would be, of course, no hindrance to execution of the judgment on the note. But

---

[57] Fidelity & Cas. Co. v. Golombosky, 133 Conn. 317, 323, 50 A.2d 817, 819–20 (1946); Levin v. Singer, 227 Md. 47, 61, 175 A.2d 423, 431 (1961); *see* Gregory v. Williams, 106 Kan. 819, 180 P. 932 (1920).

In addition to relying on the ground that the evidence aliunde attacks the prior judgment, the Utah court appears to base its position on a narrow res judicata rule that prohibits relitigation of matters that were "triable" in the first proceeding. National Fin. Co. v. Daley, 14 Utah 2d 263, 265–66, 382 P.2d 405, 407 (1963). However, application of this restrictive rule to these kinds of cases is probably stretching the holding of *Wheadon v. Pearson* too far; in *Wheadon*, the second action was an attempt to vitiate the first. *See* note 39 *supra*.

[58] Election of remedies and collateral estoppel are treated as components of the general topic of res judicata in an outstanding piece dealing with developments of the law in this area. *Developments in the Law — Res Judicata*, 65 HARV. L. REV. 818 (1952). In the section on bankruptcy, the authors make the following comment:

> There has been some movement recently toward use of evidence beyond the record in such cases. This is not inconsistent with the principles of res judicata, for there is no attack on the judgment or contradiction of determinations actually made. The legislative policy that made the obligation involved nondischargeable is furthered by going beyond the record, and the opposite result would penalize the creditor who has been diligent enough to reduce his claim to note and judgment.

Id. at 885 (footnotes omitted).

The fact that these cases do not present fact situations to which the principles of res judicata, estoppel, or election of remedies normally apply probably accounts for the shallow treatment given to these legal bases in the majority opinions.

[59] Fidelity & Cas. Co. v. Golombosky, 133 Conn. 317, 322–23, 50 A.2d 817, 819 (1946).

[60] *See, e.g.*, Miller v. Rush, 155 Colo. 178, 187–88, 393 P.2d 565, 571 (1964); National Fin. Co. v. Daley, 14 Utah 2d 263, 382 P.2d 405 (1963).

the special defense of discharge provided by the Act bars enforcement of the obligations of the bankrupt unless the liability is grounded in fraud or one of the other exceptions of section 17. Since it is clearly the intent of section 17 to deny discharge of the dishonest debtor,[61] this policy should be respected in dealing with the rebuttal to the special defense of discharge. This intent should not be emasculated solely on the basis of a prior judgment obtained by a diligent creditor. The policy of the Bankruptcy Act should apply equally to creditor and debtor.[62]

It may, with reason, be argued that broadening the scope of the creditor's rights increases the probability of post-bankruptcy harassment. There is no doubt that the threat of garnishment or protracted lawsuits is a serious obstacle to the rehabilitative purpose of discharge.[63] The minority view would allow a creditor to threaten execution on the judgment in spite of the discharge and perhaps intimidate the debtor into reexecuting the note or paying it off entirely.[64] If the creditor's claim is valid, however, the problem of harassment would seem to be outweighed by the policy of protecting the interests of the creditor. Threatened prosecution of any valid claim is harassing; it is only in the case of unfounded claims that the harassment becomes fundamentally objectionable.

It is suggested that the proper approach to this problem lies in attempting to curb the incidence of spurious claims without cutting off the rights of legitimate claimants. Spurious threats would introduce the possibility of an injunction from the bankruptcy court under the *Local Loan* doctrine,[65] or an

---

[61] S. REP. No. 1688, 86th Cong., 2d Sess. 3 (1960) (quoted at note 10 *supra*).

[62] An argument might also be made along these lines for equitable treatment among the creditors. Since the creditor who was defrauded by the false financial statement did not go into the transaction with his eyes open, he should be preferred over creditors who were aware of the full circumstances of the bankrupt at the time the loan was made or credit given; such is the purpose of § 17.

[63] *See* Helms v. Holmes, 129 F.2d 263, 269 (4th Cir. 1942) (Paul, J., dissenting); *In re* Cleapor, 16 F. Supp. 481, 483–84 (N.D. Ga. 1936) (dictum); Brendes & Schwartz, *supra* note 14, at 69–70; Note, *Bankruptcy Act: Abuse of Sections 14c(3) and 17a(2) by Small Loan Companies*, 32 IND. L.J. 151 (1957).

[64] *In re* Cleapor, 16 F. Supp. 481, 483–84 (N.D. Ga. 1936) (dictum). One authority lists several specific instances of such harassment: Rifkind, *Discharge of Debts in Bankruptcy and Some Problems Relating Thereto*, 7 N.Y.L.F. 354, 363–64 (1961).

The threat of wage garnishment can sometimes successfully be employed to elicit a renewal of an obligation or some other form of settlement from the bankrupt. Often, however, the possibility that a bankrupt will lose his job if his wages are garnished makes the choice difficult for the creditor. In states where garnishment of a substantial portion of the paycheck is possible, however, a single garnishment before the bankrupt is fired may be worthwhile, and the threat is a realistic one. Particularly in this case, the ignorance of the bankrupt concerning the subtleties of his situation contributes substantially to the success of the creditor's harassment.

The threat of garnishment is both a great inducement for filing bankruptcy and a lever for post-bankruptcy harassment in Utah. Interview with Mr. Bruce Jenkins, Referee in Bankruptcy, in Salt Lake City, Utah, Feb. 10, 1967.

[65] The bankrupt need not exhaust his state remedies before invoking the protection of the bankruptcy court under the *Local Loan* doctrine. Personal Indus. Loan Corp. v. Forgay, 240 F.2d 18, 21 (10th Cir. 1956), *cert. denied*, 354 U.S. 922 (1957); California State Bd. of Equilization v. Coast Radio Prods., 228 F.2d 520, 523 (9th Cir. 1955). It should also be noted that the *Forgay* case adopts for the Tenth Circuit a very broad rule of protection of the bankrupt from post-bankruptcy proceedings by his creditors.

action for malicious prosecution or wrongful attachment.[66] Education of bankrupts concerning their rights and obligations after bankruptcy[67] and the extension of legal aid for the poor[68] would significantly aid the balancing process. Furthermore, several states have statutes allowing the bankrupt to apply to the state court for an order directing cancellation of judgments obtained before the bankruptcy.[69] Under this procedure, the bankrupt must wait a certain time and then may be completely discharged. If such statutes were widely adopted and had reasonably short waiting periods, potential harassment would be limited to a brief period. Thus, although harassment by unscrupulous creditors might not be entirely eliminated, it could be substantially curbed without denying the creditor protection against unscrupulous debtors.

An approach to the problem of harassment recommended by many authorities would be to consolidate jurisdiction over all matters pertaining to discharge in the bankruptcy court.[70] The creditors before the court in the bankruptcy proceeding could conveniently be required to present their objections based on section 17 as a part of the bankruptcy proceedings. Final discharge could be entered with regard to all nonobjecting creditors and the matter of section 17 objections taken up from that point without opportunity for harassment by the creditor or evasion by the bankrupt.[71]

It may, of course, have been the creditor's inducement that instigated the whole transaction. If he led the bankrupt into the misrepresentation, this fact may then be shown in the bankrupt's defense.[72] It is admittedly difficult for a bankrupt to prove that his misrepresentation of financial condition was in

[66] Actions based upon malicious prosecution if the creditor's pressure is ill-founded are discussed in Rifkind, *supra* note 64, at 364–65. There is some suggestion, however, that this type of remedy is not used much by bankrupts because of the problems of proof involved. *See* Brendes & Schwartz, *supra* note 14, at 71.

[67] The bankrupt should be made to understand the nature of his discharge before he leaves the bankruptcy court. The fact that the order of discharge does not operate as an automatic release of all of his listed obligations but permits him only an affirmative defense to their enforcement is a circumstance unusual enough to require special explanation. Furthermore, the bankrupt should understand that he has the right to petition the bankruptcy court for relief if he later should be harassed by any of his scheduled creditors. It is suggested that these matters be set forth clearly in a short pamphlet or printed on the order of discharge itself. *See* Brendes & Schwartz, *supra* note 14, at 76.

[68] *See* Note, *Determination of Exceptions to and Enforcement of the Discharge by Bankruptcy Courts*, 36 VA. L. REV. 84, 98 (1950). The problem of impecunity would also be substantially alleviated by requiring the creditor to post a bond to cover the bankrupt's expenses of litigation in the event that the creditor should lose in the ensuing litigation. If the bankrupt were informed of the insurance factor represented by this requirement, his fear of becoming involved in litigation might be reduced. Moreover, attorneys aware of this might be willing to take cases of bankrupts on a contingent fee basis.

[69] *E.g.*, CAL. CODE CIV. PROC. § 675(b) (West 1955); N.Y. DEBT. & CRED. LAW § 150 (McKinney, Supp. 1966).

[70] *See* note 12 *supra*.

[71] This procedure would undoubtedly increase the administrative burden on the bankruptcy court system and probably would require a substantial expansion. Because the bankruptcy courts are already highly overcrowded and because of the expense involved in expansion, there is some reluctance to consolidate jurisdiction of all discharge matters in the bankruptcy courts. Interview with Mr. Bruce Jenkins, Referee in Bankruptcy, in Salt Lake City, Utah, Feb. 10, 1967.

[72] *See* Brendes & Schwartz, *supra* note 14, at 75.

fact induced by the lender.[73] The courts, however, are not ignorant of the problem,[74] and it is not unusual for an attorney to be successful in defending an unsophisticated bankrupt against a professional credit organization.[75]

It is often suggested that competent counsel would take steps to discover the fraud and litigate the question in the original action.[76] As a practical matter, however, it is questionable whether the burden of ferreting out and proving fraud, if it exists, in every case of a defaulted obligation is reasonable.[77] The contingency that bankruptcy might intervene between judgment and execution compels such an approach in a majority jurisdiction in order to protect the defrauded creditor.[78] A creditor cannot adequately protect himself by mere general averments of fraud in his initial complaint, for in Utah or any other jurisdiction adopting the Federal Rules of Civil Procedure, fraud must be pleaded with particularity.[79] Even if local rules are less strict than the federal standard, the federal courts will not hesitate to exercise ancillary jurisdiction to enjoin enforcement of a state-court judgment based only on general averments of fraud.[80] The fishing expedition required in each case to investigate the possibility of fraud would not only be expensive and time consuming,[81] but might turn out to be wasted entirely if bankruptcy is not interposed as a defense. With these considerations in mind, the more reasonable approach suggests waiting until the defense of discharge raises

[73] *See* Note, *supra* note 63, at 160 & n.50.

[74] The oft-quoted language of *In re* Caldwell, 33 F. Supp. 631, 635–36 (N.D. Ga.), *aff'd*, 115 F.2d 189 (5th Cir. 1940), *cert. denied*, 315 U.S. 564 (1941), is indicative of the courts' awareness:

> If creditors, with their expert credit men, were as diligent in investigating the responsibility of applicants for credit and as prudent in bestowing it, as they are persistent and sometimes oppressive in attempting to collect after the indebtedness has been incurred, there would be fewer claims of fraud and attempts like this to defeat a discharge in bankruptcy.

The court in Matter of Forgay, 140 F. Supp. 473, 478 (D. Utah), *aff'd sub nom.* Personal Indus. Loan Corp. v. Forgay, 240 F.2d 18 (10th Cir. 1956), *cert. denied*, 354 U.S. 922 (1957), reflects similar concern:

> [I]n the event the loan turns sour, it will be better for him [the credit manager] and his concern if there is an omission or a misstatement in the application. At the lending stage of the transaction, with every pressure upon the loan company official to make the loan, there will be an increased temptation for carelessness, and in some cases actually for collusion. Unhappily, a judge doesn't have to be on the bench of a bankruptcy court very long before he observes both.

[75] *See* Schumacher, *supra* note 15, at 105.

[76] *See* National Fin. Co. v. Daley, 14 Utah 2d 263, 266, 382 P.2d 405, 407 (1963). An interview with Mr. William G. Fowler, prominent Salt Lake City bankruptcy attorney, on Feb. 4, 1967, similarly revealed his feeling that the basic problem is lethargy of the creditor's attorney in not pursuing proper discovery techniques before the initial trial on the matter.

[77] As an example, Household Fin. Corp. v. Suhr, 44 Ill. App. 2d 292, 193 N.E.2d 611 (1963), raises the practical problem involved with a cognovit note. When judgment is confessed, the creditor has no practical opportunity to build a record in the initial suit based on fraud. If bankruptcy then intervenes, the majority view completely emasculates the creditor's protection under § 17.

[78] *See* Phillips, *supra* note 47, at 412; Smedley, *supra* note 42, at 56.

[79] UTAH R. CIV. P. 9(b). *See* FED. R. CIV. P. 9(b); Jensen v. Barrick, 15 Utah 2d 285, 391 P.2d 429 (1964).

[80] *See* Personal Indus. Loan Co. v. Forgay, 240 F.2d 18 (10th Cir. 1956), *cert. denied*, 354 U.S. 922 (1957).

[81] Brief for Appellant at 13–14, Beehive State Bank v. Buntine, 17 Utah 2d 351, 411 P.2d 967 (1966).

the issue of fraud before requiring the extensive and difficult proof which it demands.[82]

The creditor's second alternative when faced with an intervening bankruptcy in a majority jurisdiction is to completely ignore the prior action and file a new suit based entirely on fraud. The cases that have faced this matter directly are in conflict. The courts allowing a second independent suit in fraud reason that since the cause of action and its remedies are separate and do not conflict with the prior action in contract, a second suit should be allowed as long as there is but one satisfaction of the claim.[83] In jurisdictions where a second suit is forbidden, the courts rely on a narrow concept of res judicata or election of remedies.[84]

The Utah court has not directly faced the issue, but came very close to doing so in *Beehive State Bank v. Buntine*.[85] In that case, a judgment obtained prior to bankruptcy was sued upon following discharge. Since it relied on the previous judgment, it was not a "new" cause of action, but it was nevertheless based exclusively upon fraud. The creditor asserted that, under the Utah statute of limitations,[86] the cause of action in fraud did not accrue until discovered, and since the fraud was not discovered until the creditor examined the debtor's bankruptcy schedule, the issue of fraud could not reasonably have been raised until after the bankruptcy. Thus, the creditor was essentially raising a "new" cause of action in fraud as a rebuttal to the bankrupt's special defense of discharge. In rejecting the creditor's claim based on fraud, the court said:

> The question is whether because of the fact that respondent had filed a prior action in which no issue of fraud was presented and obtained a judgment on a contractual obligation, it is now precluded from going behind this judgment in another action based on the same debts and prove that these debts were actually not dischargeable in bankruptcy . . . .[87]

---

[82] Proof of misrepresentation is often greatly facilitated for the wronged creditor when a discrepancy is discovered in the bankruptcy schedules. In fact, this is usually the point in time at which the fraud comes to light.

[83] *See, e.g.*, Gehlen v. Patterson, 83 N.H. 328, 141 A. 914 (1928); Chester-Neal Co. v. Generazzo, 20 N.J. Misc. 296, 26 A.2d 876 (C.P. Essex County 1942); Russel v. Wilber, 150 App. Div. 52, 134 N.Y.S. 463 (1912); Consolidated Plan, Inc. v. Bonitatibus, 130 Conn. 199, 33 A.2d 140 (1943) (dictum).

The language of Gehlen v. Patterson, *supra* at 333, 141 A. at 917, is classic: "That the plaintiff should suffer by having reduced the note to judgment before the bankruptcy would be to impose a vicarious penalty which Congress is not to be assumed to have intended, in the absence of language clearly showing such a purpose."

[84] *See. e.g.*, Gehlen v. Patterson, 83 N.H. 328, 141 A. 914 (1928); Chester-Neal Co. Public Fin. Corp. v. Ockerman, 119 Ohio App. 525, 200 N.E.2d 808 (1963); Shawano Fin. Corp. v. Haase, 252 Wis. 12, 30 N.W.2d 82 (1947).

The *Ockerman* court said:

> [W]e do not believe that Section 35 . . . creates any new liability or cause of action. . . . We therefore conclude that all questions regarding the dischargeability of the debt should be resolved in the action to collect the judgment; not . . . by instituting a new cause of action in contract or tort to create an additional or different indebtedness of record.

Public Fin. Corp. v. Ockerman, *supra* at 527, 200 N.E.2d at 810.

[85] 17 Utah 2d 351, 411 P.2d 967 (1966).

[86] UTAH CODE ANN. § 78-12-26(3) (1953).

[87] Beehive State Bank v. Buntine, 17 Utah 2d 351, 352, 411 P.2d 967, 968 (1966).

Since the Utah court has applied the principle of res judicata to a wide scope of situations,[88] the prospects of success in a second suit in fraud do not appear to be good.[89]

The same policy of fundamental fairness underlies both the minority view on introduction of evidence aliunde in a suit on the former judgment and the view that a second cause of action in fraud is not barred by the prior contract judgment or the defense of discharge. As stated by one court:

> If a creditor takes judgment on a note and this judgment is subsequently discharged in bankruptcy, the creditor is virtually precluded from taking advantage of the exceptions to discharge listed in [section 17] . . . . The approach the plaintiff has taken, a separate action in tort, gets around the holding of the Lawrence case [the majority view not permitting evidence dehors the record] . . . .[90]

Fundamental fairness to the creditor who promptly prosecutes his claim is relied upon by several jurisdictions which recognize the need for protection of the creditor, but which have adopted the majority view regarding a suit on the judgment in contract after bankruptcy and do not allow evidence of fraud extrinsic to the record of the initial trial.[91] Essentially, the approach of allowing the second suit in fraud has been employed as a stop-gap to prevent injustice to the creditor where the majority rule is followed.

It is submitted that the better course would be to adopt the position of the minority jurisdictions. The minority view is clear and convincing and does not circumvent the prior action. However, the second alternative of a separate suit in fraud should appeal to courts which feel bound by stare decisis but which can be made to recognize the creditor's dilemma.

Stuart T. Waldrip

---

[88] *See* note 39 *supra* and accompanying text.

[89] If the creditor were to receive favorable treatment in the state court, however, it does not appear that the federal court would enjoin execution under the *Local Loan* doctrine of ancillary jurisdiction. The language of the court in State Fin. Co. v. Morrow, 216 F.2d 676, 680 (10th Cir. 1954), seems to approve of an independent tort claim.

[90] Household Fin. Corp. v. Suhr, 44 Ill. App. 2d 292, 297, 193 N.E.2d 611, 614 (1963).

[91] *See, e.g.*, Household Fin. Corp. v. Suhr, 44 Ill. App. 2d 292, 193 N.E.2d 611 (1963); Chester-Neal Co. v. Generazzo, 20 N.J. Misc. 296, 26 A.2d 876 (C.P. Essex County 1942). *Contra*, Public Fin. Corp. v. Ockerman, 119 Ohio App. 525, 200 N.E.2d 808 (1963).

The Latin American Free Trade Association — An Attempt at Economic Integration

Until recently the initiative toward economic development in Latin America has been left to each of the Latin American countries. By separately seeking foreign trade, investment, and aid, primarily through bilateral agreements with the United States, the Latin nations have sought the economic advancement of their own countries.[1] Gradually, however, the belief that economic growth must come from the efforts of the Latin American states acting together has been replacing the idea that advancement depends wholly upon the aid and trade concessions each country can pry from the world's major industrial states.[2]

The concept of economic integration[3] is one expression of the new spirit of cooperation in Latin America and is regarded by some leaders as indispensable to growth. In 1960, the Latin American Free Trade Association (LAFTA) emerged as the intergovernmental institution to implement this

---

[1] *See* W. WITHERS, THE ECONOMIC CRISIS IN LATIN AMERICA 150 (1964); de Onis, *Latin American Unity at Stake in Market Decision*, N.Y. Times, April 10, 1967, at 20, col. 4 (city ed.); N.Y. Times, April 11, 1967, at 14, cols. 2–3 (city ed.).

[2] "There is a growing conviction in Latin America that, while we do need ample international coöperation, development has to be brought about by our own efforts and our own determination to introduce fundamental changes in the economic and social structure of our countries." Prebisch, *Joint Responsibilities for Latin American Progress*, 39 FOREIGN AFF. 622 (1961); *see* W. WITHERS, *supra* note 1, at 150; de Onis, *supra* note 1, at 20, col. 4.

[3] With economic integration, "the nation-state ceases to be an autonomous decision-making unit with respect to certain important policies; the locus of economic problem solving is to some extent shifted from the state to an intergovernmental or supranational body." Gregg, *The UN Economic Commissions and Integration in the Underdeveloped Regions*, 20 INT'L ORGANIZATION 208–09 (1966).

Economic integration has become a popular concept during the last fifteen years, although an East African Common Market has been functioning since the 1920's. Wionczek, *Latin American Free Trade Association*, 551 *Int'l Conciliation* 3, 4 (1965). In 1952, the European Coal and Steel Community (ECSC) was formed; in 1958, the European Economic Community (EEC), the European Atomic Energy Community (EURATOM), and the Central American Common Market (CACM); and in 1960, the European Free Trade Area (EFTA) and LAFTA. W. BISHOP, INTERNATIONAL LAW — CASES AND MATERIALS 259–61 (1962); Committee on Foreign Law, *Economic Integration in Latin America*, 17 RECORD OF N.Y.C.B.A. 5 (Supp. 1962). Other regional trade areas include the Council for Mutual Economic Aid, the Nordic Council, the Association of Southeast Asia (ASA), L'Union Domacrere Equatoriale (UDE), and the Arab League.

The precise effect of the developments in Europe on the ultimate creation of LAFTA is disputed. In some quarters it is argued that the nations creating LAFTA were acting in self-defense, fearing that the formation of the European regional markets would divert trade to Africa because of the trade preferences some members have there. *See, e.g.*, H. STARK, SOCIAL AND ECONOMIC FRONTIERS IN LATIN AMERICA 204 (1961); Mikesell, *The Movement Toward Regional Trading Groups in Latin America*, in LATIN AMERICAN ISSUES: ESSAYS AND COMMENTS 125, 129 (A. Hirschman ed. 1961). Recent economic data have demonstrated that these fears were well founded. *See* ECONOMIC COMM'N FOR LATIN AMERICA, ECONOMIC SURVEY OF LATIN AMERICA, 1964, at 187–88, U.N. Doc. E/CN. 12/711/Rev. 1 (1966) [hereinafter cited as 1964 ECONOMIC SURVEY OF LATIN AMERICA].

Other writers contend that the signing of the European treaties provided a concrete example of integration programs and made the concept of a free trade area seem worth trying. *E.g.*, W. GORDON, THE POLITICAL ECONOMY OF LATIN AMERICA 325 (1965); Wionczek, *supra* at 11.

economic program.[4] The Association is presently composed of eleven nations — Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela — which together account for more than eighty percent of the population and the output of goods and services in Latin America.[5] By forming a regional market and expanding intraregional trade, it was hoped to speed the industrialization of Latin America. The goal remains: to achieve as quickly as possible a state of economic development equivalent to that of the major nations of the world.

The meeting of the Organization of American States (OAS) at Punta del Este in April 1967, attended by the presidents of the member states, confirmed that LAFTA had not brought the rejuvenation of the Latin American economy for which its signatories had hoped. The signing of an agreement to replace LAFTA with a common market embracing all the Latin nations except Cuba presents an occasion to review the economic theories which are held to govern the development of Latin America and to examine the institution which was drawn to implement those theories. The purpose of this note is to present the major economic and institutional concepts of LAFTA in a critical light. By asking why LAFTA failed, and by comparing it to the proposed common market, a basis is laid for understanding and evaluating the new international efforts at encouraging economic integration.

I. The Road to Economic Integration in Latin America

As early as 1939, limited efforts toward regional trading arrangements were made in Latin America when Argentina and Brazil negotiated a treaty of free commerce and industrial complementarity.[6] In 1941, Argentina proposed a customs union[7] with Brazil which would have included neighboring countries as well.[8] But deficient transportation on both sea and land, a low state of industrialization in many countries, inflation, multiple exchange rate surpluses, the lack of foreign exchange, inefficient operation of bilateral compensation agreements, political instability, and economic nationalism all contributed to discouraging widespread regional trading.[9] As an examination

[4] The Central American Common Market, because of its relatively small economic and geographical size, is not nearly as important as LAFTA and is not discussed in this note. CACM is composed of Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua. The market was set up through a number of multilateral treaties beginning in 1952. *See generally* Duvall, *Latin American Economic Integration Developments*, 9 Int'l & Comp. L. Bull., Dec. 1964, at 34; Norberg & Lliteras, *Central American Economic Integration*, in A.B.A., 1965 Proceedings of the Section of Int'l & Comp. L. 38.

[5] Wionczek, *supra* note 3, at 4; Welles, *20 Latin Nations Back Trade Bloc*, N.Y. Times, March 29, 1967, at 18, col. 4 (city ed.).

[6] Economic complementarity results when one geographical area specializes in those economic activities which it does most efficiently and trades with other areas within a region doing likewise. Johnson, *The Montevideo Treaty for a Latin American Free Trade Area*, 1965 U. Ill. L.F. 715, 724.

[7] A customs union results when a group of countries agree to lower restrictions on intraregional trade and to impose a uniform restriction on trade between union members and outside countries. *See* Committee on Foreign Law, *supra* note 3, at 12.

[8] *See* Mikesell, *supra* note 3, at 125–26. For a more extensive history see Committee on Foreign Law, *supra* note 3, at 7–11.

[9] *See* V. Urquidi, Free Trade and Economic Integration in Latin America 20–22 (1964); Mikesell, *supra* note 3, at 129.

of the factors impelling integration will show, the passage of time has not greatly alleviated these difficulties.

A. Economic Factors Leading to Integration

The period from 1950 to 1957 was one of unparalled economic progress in Latin America — the national income, in aggregate and per capita, rose to an all time high level, foreign investment of both public and private funds in Latin America was unprecedented,[10] capital accumulation was followed by unequaled investment, and industrial production exceeded agricultural production for the first time.[11] This spectacular growth has been attributed[12] to nonrepeating conditions which permitted the rapid generation of capital:

(1) The purchasing power of exports from Latin America was high, which created favorable terms of trade.[13] The rise in value was based mainly on favorable trade to the United States, brought about by World War II and continued by the Korean War. Substantial exchange reserves were built up during the war period, partly because of the high exports of strategic materials to the United States and other Western nations. The value of exports rose an average of 5.4 percent over the 1946–55 period,[14] which was the approximate growth rate of the United States during the same period.

(2) Import substitution[15] was responsible for establishing exchange reserves which increased the import capacity of Latin America during the 1950–57 period. Scarcity of shipping and the production of war materials in industrial centers decreased imports to Latin America and demand had to be satisfied from domestic sources.

(3) Foreign loans and investment flooding into Latin America after 1950 greatly increased the capacity to import and the capital for industrial development.[16] After 1957, however, increasing costs of maintaining foreign

[10] Total gross annual inflow increased from $588 million in 1947 to $2240 million in 1957, most of it from the United States. W. WITHERS, *supra* note 1, at 126.

[11] H. STARK, *supra* note 3, at 206.

[12] *See* ECONOMIC COMM'N FOR LATIN AMERICA, THE LATIN AMERICAN COMMON MARKET 53–57, U.N. Doc. E/CN. 12/531 (1959) [hereinafter cited as THE LATIN AMERICAN COMMON MARKET].

[13] Balance of trade is to be distinguished from balance of payments. Balance of trade covers the movement of tangible goods into and out of a country in terms of the value of exports and imports. A favorable balance of trade occurs when the value of exports is greater than the value of imports. The standard balance of payments records inflows and outflows of money resulting from imports and exports and their connected services. *See* H. STARK, *supra* note 3, at 283, 292.

[14] While the value of exports rose only 2.3% above 1950 levels, an increase in prices amounting to 3.1% made the purchasing power of exports increase to 5.4%. THE LATIN AMERICAN COMMON MARKET 56.

[15] Import substitution occurs when a country requires that the demand for imported products be satisfied from domestic production.

[16] The net inflow of capital in millions of dollars into Latin America during this period was as follows:

1955	760	1960	100
1956	1080	1961	250
1957	1730	1962	–100
1958	715	1963	–200
1959	600		

See W. WITHERS, *supra* note 1, at 127.

investment, the absence of capital to create basic power generating facilities, the propensity to expand consumption, which competes for capital, and a long-term worsening in terms of trade, along with a sudden decrease in foreign investment, were factors which slowed capital formation and foreign trade.[17]

As prosperity began to wane in 1957, several economic factors combined with political and social unrest to provide a suitable breeding ground for the creation of LAFTA:[18]

1. Population and gross product. Although Latin America is a relatively unpopulated region,[19] it is marked with urban pockets of high population density.[20] The population growth rate is the highest in the world,[21] which contributes much to the region's economic difficulties. In order for an economy to grow beyond the subsistence level, income must increase faster than population or substantial capital must be imported, otherwise savings will not be accumulated for investment in capital-producing activities. During the post-war years, income in Latin America grew faster than population; but in 1959, the region's economy began moving backward as the growth rate of the population overtook that of income.[22]

2. Foreign trade. Foreign trade is an important element in the economy of each Latin state, amounting to approximately one quarter of the region's gross product.[23] Trade is often the difference between prosperity and depression.

The Latin American region is foremost an exporter of primary commodities — foodstuffs and raw materials — to the major industrial centers of the world.[24] Trade between the Latin American countries has never been inten-

---

[17] THE LATIN AMERICAN COMMON MARKET 5–13; H. STARK, *supra* note 3, at 198–99.

[18] *See generally* THE LATIN AMERICAN COMMON MARKET 53–89.

[19] W. GORDON, *supra* note 3, at 136.

[20] W. WITHERS, *supra* note 1, at 54.

[21] For example, during the period of 1960–64, the estimated rate of population growth for the world was 1.8 percent per year, for North America it was 1.6 percent per year, for Africa it was 2.4 percent per year, for Europe it was 0.9 percent per year, and for Latin America, it was 2.8 percent per year. U.N. DEP'T OF ECON. & SOCIAL AFFAIRS, DEMOGRAPHIC YEARBOOK 1965, at 103 (17th ed. 1966). Among individual nations in Latin America, the growth rate varies from 1.85 percent per year to 3.37 percent per year. *See* H. STARK, *supra* note 3, at 25.

[22] *See* W. WITHERS, *supra* note 1, at 96–97; 1964 ECONOMIC SURVEY OF LATIN AMERICA 6.

The labor force in Latin America remains small and ineffective because there is poor health, widespread illiteracy, a lack of educational or occupational training, and in many countries over forty percent of the population is under fifteen years of age. *See* W. WITHERS, *supra* note 1, at 50, 93.

[23] W. WITHERS, *supra* note 1, at 138.

[24] The major sectors of the Latin American export economy are broken down as follows (in millions of dollars):

Commodity	*1955–56*	*1975 (projected)*
Foodstuffs	269	277
Agricultural raw materials	98	272
Mining products	366	676
Unspecified	126	555
Total	859	1780

See THE LATIN AMERICAN COMMON MARKET 58 (Table 3).

sive, consisting mainly of agricultural food products, fuels, and other raw materials. Barely three percent of it is in manufactured products.[25] Intraregional trade has been more an expression of natural complementarity, of geographic proximity, and of isolated and sporadic efforts to sell surpluses of agricultural or industrial production than the expression of a systematic exchange of goods.[26] Before 1960, most of the intraregional trade was conducted by the seven southern countries.[27] Apart from structural causes, one reason for this concentration was that trade had been carried on in this area for many years through bilateral agreements. These arrangements have a tendency to limit and distort trade because of payments problems,[28] the necessity of reciprocal concessions, and most-favored nation clauses in treaties with other countries.

3. Fragmented markets. One explanation for the restricted industrial development is that economies of scale, made possible by large markets for industrial products, have not been achieved. What little industrial production exists in each country is protected by tariffs and trade restrictions because production costs are generally higher than prices for substitutes in the import markets. Thus there exists a regional economy consisting of "twenty watertight compartments."[29] With high internal demand in each of the twenty countries, what little capital is available for investment finds its way into facilities for producing light consumer goods rather than into more basic industries. Finally, slow capital formation is itself a real limitation on industrial growth.[30] Small markets in the less developed countries provide little incentive to foreign investors, and the elite classes in Latin America seem to

---

See generally W. GORDON, *supra* note 3, at 295–325; H. STARK, *supra* note 3, at 283–309; W. WITHERS, *supra* note 1, at 138–53. The best source for raw data on the economies of the Latin American countries are the annual surveys published by the United Nations Economic Commission for Latin America.

[25] V. URQUIDI, *supra* note 9, at 15–18.

Trade among Latin American countries, in percent of total trade, has been as follows:

1946–57 average	11.0	1962	6.7
1953	9.5	1964	10.0
1955	11.0	1965	9.8
1958	10.0	1966	8.3
1960	6.8		

See id. at 11; de Onis, *The Goal is a Latin Market*, N.Y. Times, April 2, 1967, § 4, at 4, col. 1 (city ed.); Duvall, *Latin American Economic Integration Developments*, 10 INT'L & COMP. L. BULL., Dec. 1965, at 46; *Latin America — To Get Bolder or Give Up*, TIME, Oct. 30, 1964, at 103; Nattier, *LAFTA — The Latin American Free Trade Association*, 10 INT'L & COMP. L. BULL., May 1966, at 20, 24–25.

[26] V. URQUIDI, *supra* note 9, at 12.

[27] Argentina, Brazil, Chile, Peru, Uruguay, Bolivia, and Paraguay. *Id.* at 12–13. The center of trade is, however, moving toward the north. THE LATIN AMERICAN COMMON MARKET 54.

[28] V. URQUIDI, *supra* note 9, at 14–15.

[29] *See* ECONOMIC COMM'N FOR LATIN AMERICA, MULTILATERAL ECONOMIC COOPERATION IN LATIN AMERICA 35, U.N. Doc. E/CN. 12/621 (1962) [hereinafter cited as MULTILATERAL ECONOMIC COOPERATION].

[30] *See* Huelin, *Economic Integration in Latin America — Progress and Problems*, 40 INT'L AFF. 430, 434–35 (1964); Prebisch, *Joint Responsibilities for Latin American Progress*, 39 FOREIGN AFF. 623–28 (1961).

prefer investing their money outside the region, or in real estate, or in luxuries in the import market, or in foreign travel.[31]

4. Economic nationalism. A factor which helps to perpetuate the "watertight compartments" in the Latin American economy is the prevalent belief that each country should develop certain prestige industries regardless of the economic feasibility.[32] This spirit manifests itself in trade restrictions more than ample to protect infant industries and in laws which channel foreign investment into areas to which national planning or political whim has given priority.[33] Operating in conjunction with this practice is the belief that national resources and power generating plants should be in national hands.[34] The conversion from foreign or private ownership is made possible through deficit financing, and, along with publicly funded projects, this monetary policy has a tendency to cause chronic inflation without economic growth.[35]

B. The Prebisch Theory of Economic Stagnation

In 1948, the United Nations Economic and Social Council established the Economic Commission for Latin America (ECLA), whose responsibility was to study systematically the economies of the Latin American states and to suggest programs which would bring economic growth.[36] With the creation of ECLA came the first comprehensive and reliable compilation of economic data for Latin America as well as economic planning programs for each country and proposals for regional economic integration. The role of ECLA is central to the formation of LAFTA, and the theoretical work of Raúl Prebisch, who also acted as ECLA's secretary general during much of the period after 1950, forms the economic basis underlying LAFTA.[37]

---

[31] W. GORDON, *supra* note 3, at 215–17; Huelin, *supra* note 30, at 434; *see* Prebisch, *Joint Responsibilities for Latin American Progress*, 39 FOREIGN AFF. 622, 624–25 (1961).

[32] *See, e.g.*, HERRERA, SANZ DE SANTAMARIA, MAYOBRE & PREBISCH, PROPOSALS FOR THE CREATION OF A LATIN AMERICAN COMMON MARKET 1–2, 7–8, U.N. DOC. TD/B/11 (1965) [hereinafter cited as PROPOSALS FOR A COMMON MARKET]; Huelin, *supra* note 30, at 433. For example, there are twenty automobile producers in Argentina, eleven in Brazil. The region's purchasing power is not sufficient to support ten on a full time basis. *Id.*

[33] *See* W. GORDON, *supra* note 3, at 307–10, 313; PREBISCH, TOWARDS A DYNAMIC DEVELOPMENT POLICY 71–72, U.N. Doc. E/CN. 12/680/Rev. 1 (1963); PROPOSALS FOR A COMMON MARKET 7–10, 12. For a good statement of the national policies behind the various kinds of investment and trade restrictions in undeveloped countries and the problems they pose for the foreign investor see Meier, *Legal-Economic Problems of Private Foreign Investment in Developing Countries*, 33 U. CHI. L. REV. 463 (1966).

[34] *E.g.*, Huelin, *supra* note 30, at 434; Prebisch, *Joint Responsibilities for Latin American Progress*, 39 FOREIGN AFF. 622, 631–33 (1961).

[35] *See* W. WITHERS, *supra* note 1, at 29, 163–64; Prebisch, *Joint Responsibilities for Latin American Progress*, 39 FOREIGN AFF. 622, 627–28 (1961).

[36] Resolution 106 (VI), 3 UN ECOSOC 4; Gregg, *supra* note 3, at 208–12.

[37] *See* Hirschman, *Ideologies of Economic Development in Latin America*, in LATIN AMERICAN ISSUES: ESSAYS AND COMMENTS 3, 12–13 (A. Hirschman ed. 1961). Professor Hirschman also summarizes the various economic philosophies which have pervaded Latin American history. *Id.* at 3–12.

The basic tenet of the Prebisch theory is that the only way to speed economic development in Latin America is rapid industrialization.[38] Prebisch's call for industrialization is based on his conclusion that there is a continual deterioration in the terms of trade between undeveloped and industrialized countries, and that the gains from increases in productivity in undeveloped countries, if unaccompanied by industrialization, are transferred to the industrial countries through the market mechanism.[39] The industrialization required to reverse these effects is to be brought about by government intervention in foreign trade, by domestic economic planning, by the formation of a common market, and by seeking the cooperation of industrial states.[40] It will be necessary to examine the fundamentals of the Prebisch theory more closely in order to understand its significance for economic integration.

1. The deterioration in terms of trade. Prebisch begins by postulating that the uneven spread of technical progress through the community has divided the world economically into centers which mainly produce industrial products and peripheries which generate primary commodities.[41] Trade is maintained between the centers and the peripheries.

According to traditional economic teaching, the basis of sound development in a periphery is to maintain the division of labor between the center and the periphery. Technical advances in the periphery are employed to improve efficiency in the production of primary materials and to increase exports to the centers.[42]

The objection to traditional theory is that there is a disparity of income elasticity of demand for imports between the center and the periphery. As income rises at the center, a smaller percentage is spent on primary materials.[43] In addition, protective policies and increases in production efficiency at the center heighten the disparity. At the periphery, however, as income

[38] PREBISCH, THE ECONOMIC DEVELOPMENT OF LATIN AMERICA AND ITS PRINCIPAL PROBLEMS 1–2, U.N. Doc. E/CN. 12/89/Rev. 1 (1950). This document is the basic manifesto of the Prebisch theory. The theory is elaborated, refined, and restated in the following publications from which the material in this section is taken: PREBISCH, THEORETICAL AND PRACTICAL PROBLEMS OF ECONOMIC GROWTH, U.N. Doc. E/CN. 12/221 (1951); ECONOMIC COMM'N FOR LATIN AMERICA, INTERNATIONAL CO-OPERATION IN A LATIN AMERICAN DEVELOPMENT POLICY, U.N. Doc. E/CN. 12/359 (1954); THE LATIN AMERICAN COMMON MARKET; Prebisch, *Commercial Policy in the Underdeveloped Countries*, in PAPERS AND PROCEEDINGS OF THE AMERICAN ECONOMIC ASSOCIATION, 49 AM. ECON. REV., May 1959, at 251 [hereinafter cited as *Commercial Policy in the Underdeveloped Countries*]; PREBISCH, TOWARDS A DYNAMIC DEVELOPMENT POLICY FOR LATIN AMERICA, U.N. Doc. E/CN. 12/680/Rev. 1 (1963).

[39] PREBISCH, THE ECONOMIC DEVELOPMENT OF LATIN AMERICA AND ITS PRINCIPAL PROBLEMS 8–10, U.N. Doc. E/CN. 12/89/Rev. 1 (1950); *Commercial Policy in the Underdeveloped Countries* 251–54.

[40] *See* ECONOMIC COMM'N FOR LATIN AMERICA, INTERNATIONAL CO-OPERATION IN A LATIN AMERICAN DEVELOPMENT POLICY 60–74, 140–42, U.N. Doc. E/CN. 12/359 (1954).

[41] The classical theory of economics assumes that technical progress is evenly distributed throughout the community either by falling prices or by increasing income. PREBISCH, THE ECONOMIC DEVELOPMENT OF LATIN AMERICA AND ITS PRINCIPAL PROBLEMS 1, U.N. Doc. E/CN. 12/89/Rev. 1 (1950).

[42] *Commercial Policy in the Underdeveloped Countries*, 251–52.

[43] *Id.* at 252. This is attributed to Engels' law which states that the percentage expenditure on food is on the average a decreasing function of income. Hirschman, *supra* note 37, at 15 n.20.

rises, a larger percentage of income is spent on industrial imports, reflecting a higher income elasticity of demand.

The consequences of this disparity are a downward pressure on the prices of exports from the periphery despite rising income and, unless productivity at the center increases at the same rate as its imports to the periphery, an upward pressure on the prices of imports to the periphery. This pressure is increased by the existence of monopolistic practices at the center. The resulting disequilibrium in the terms of trade at the periphery reduces its capacity to import and adversely affects further growth in export activities.

The proposed solution is import substitution — the periphery would limit imports from the center to the external capacity to pay for them through the purchasing power of the periphery's exports, and excess demand for industrial products would be satisfied from domestic sources.[44] Domestic industry is thus required.

2. *The transfer of productivity gains to the center.* To understand this theory it is necessary to consider the economy of the periphery as divided into a sector exporting primary materials and a domestic industrial sector. Since the periphery is underdeveloped, it is reasonable to assume that wage increases will not match productivity gains because of the vast source of marginally employed labor. As development proceeds in the periphery, less manpower is required to maintain existing levels of activity, and a smaller percentage of the increasing labor force is required to expand exports. The manpower thus set free along with the unemployed and those engaged in unproductive activities must be absorbed in new jobs in the domestic sector.

Since there is a disparity in elasticities which causes imports to grow faster than exports at the periphery and since the demand elasticity for exports is very low, a depreciation in the exchange rate must occur if there is to be full employment at the periphery. Thus, if there is an increase in productivity of exports, part of the increment created will be transferred to the center by falling prices. Higher import prices will cause spontaneous industrialization and equilibrium will be reached when the profits of exporters equals that of industrialists in the domestic sector. This is not the optimum operating point for the periphery, however, because the efficiency of the export sector is higher than that in the domestic sector, while price levels are set by the rate at which the less efficient industries can absorb surplus manpower and satisfy domestic demand. The difference in productivity is transferred to the center through market forces.[45] Thus, industrialization must necessarily accompany

[44] *See* ECONOMIC COMM'N FOR LATIN AMERICA, INTERNATIONAL CO-OPERATION IN A LATIN AMERICAN DEVELOPMENT POLICY 61, U.N. Doc. E/CN. 12/359 (1954); *Commercial Policy in the Underdeveloped Countries* 254.

[45] *See Commercial Policy in the Underdeveloped Countries* 256–59. Prebisch's generalization is that:

> Whenever the productivity ratio in exports is higher than in the marginal industries needed to employ the full surplus manpower, the real income corresponding to the difference in productivity will tend to be transferred abroad in the unrestricted play of market forces. This occurs either when the surplus manpower has to be employed in industrial branches where the productivity ratio is lower than in exports of primary commodities, or when the latter improves faster than does the ratio of industrial productivity.

Id. at 259.

technical progress in primary activities to absorb surplus manpower and to prevent the transfer of the fruits of development to the center.

3. The protection policy. Since import substitution and industrialization are necessary to reverse the deterioration in the terms of trade and to prevent the transfer of productivity gains, it is necessary to advance these objectives as rapidly as possible. Under the Prebisch theory, select trade restrictions are one means of advancing both goals.

Under a policy of tariff protection, infant industries may grow without fear of competition from abroad, and by shaping the policy, investment can be directed into those industries which are most essential to growth. Protection helps to establish the equilibrium point between export and import activities where it is most advantageous to the periphery.[46]

4. The need for international cooperation. The center-periphery interaction, which Prebisch terms "reciprocity," requires that both cooperate to bring growth to the periphery. Under the ECLA theory, protection at the periphery is a necessary instrument for the correction of disparities in elasticity of demand between periphery and center and for effecting an optimum allocation of resources because, due to the inelastic demand at the center, the periphery cannot stimulate the purchase of primary commodities at the center by lowering prices. While a broad, arbitrary protection policy enforced by all the periphery countries would affect the trade of the center, it is argued that a selective policy of protection at the periphery, changing with its growth, would affect world trade imperceptibly.

The center, on the other hand, can greatly affect the growth of the periphery through its trade policies. If the center establishes trade restrictions against primary products, the opportunity for increased exports from the periphery is diminished because marginal producers at the center are not driven out and an inefficient allocation of resources results. Also, as industrialization progresses at the periphery, there is a decreasing demand for light consumer goods and an increasing demand for capital goods and durables. Duty concessions at the center often do not reflect this change, but rather, attempts are made to crystallize existing trade patterns, for to do otherwise would collide with short term trading interests.[47]

5. The need for a common market. Two basic ideas support the Prebisch call for a common market in Latin America, which he treats as a periphery: (1) Industrialization and import substitution have progressed as far as possible without a larger market; and (2) the nature of multilateral trade has changed radically since the nineteenth century while Latin American trade practices have altered very little.

Prebisch points out that before modern industry can be developed fully in Latin America there must be large markets to foster economies of scale.

---

[46] *See* ECONOMIC COMM'N FOR LATIN AMERICA, INTERNATIONAL CO-OPERATION IN A LATIN AMERICAN DEVELOPMENT POLICY 60–68, U.N. Doc. E/CN. 12/359 (1954); *Commercial Policy in the Underdeveloped Countries* 254–61.

[47] *Commercial Policy in the Underdeveloped Countries* 264–66; *see* ECONOMIC COMM'N FOR LATIN AMERICA, INTERNATIONAL CO-OPERATION IN A LATIN AMERICAN DEVELOPMENT POLICY 62–64, U.N. Doc. E/CN. 12/359 (1954).

In addition, a means for facilitating the planned growth of industrial complementarity is needed to achieve maximum efficiency. Import substitution without a common market is limited to the narrow confines of national markets and their attendant inefficiencies.[48]

Prebisch also argues that the old trade patterns based on multilateral trade and directed toward industrial centers no longer function to the advantage of Latin America.[49] He points out that there has always been one country which is the industrial center of the world around which multilateral trade flourishes. When the United States became the primary center, however, its restrictive policy toward importation ended an era of prosperous multilateral trade. Regional trade areas, granting trade preferences to members and generating intense intraregional trade, have arisen as a replacement for the crumbling channels of multilateral trade.

Finally, it is contended, the creation of a regional market among periphery countries will permit the controlled growth of trade and industrialization in a balanced fashion: the establishment of an equilibrium which would allow each participating country to trade in proportion to its individual degree of development and provide easy access to all the benefits inherent in a common market.[50]

C. Criticism of the Prebisch Theory

Criticism of the Prebisch theory on economic grounds has been substantial, and generally it has fallen into two categories: (1) specific disagreement with one or more aspects of his economic analysis, and (2) a general distrust of the state's capabilities in economic planning.

A major criticism has been that the terms-of-trade theory and the transfer-of-productivity-gains doctrine are not substantiated by empirical research.[51] In recent years, however, many factors which militate against the expansion of primary commodities have come to light, such as the low elasticity of demand for foodstuffs, the self-sufficiency of industrial nations and their expansion of primary trade, the substitution of synthetics, and the discovery of rich mineral deposits in industrial countries.[52]

---

[48] *See* PREBISCH, ECONOMIC DEVELOPMENT OF LATIN AMERICA AND ITS PRINCIPAL PROBLEMS 6–7; U.N. Doc. E/CN. 12/89/Rev. 1 (1950); PREBISCH, INTERNATIONAL CO-OPERATION IN A LATIN AMERICAN DEVELOPMENT POLICY 72–74, 122–24, U.N. Doc. E/CN. 12/359 (1954); THE LATIN AMERICAN COMMON MARKET 66–68.

[49] *See Commercial Policy in the Underdeveloped Countries* 266–69.

[50] THE LATIN AMERICAN COMMON MARKET 83–89.

[51] Cohen, *ECLA and the Economic Development of Peru*, 17 INTER-AM. ECON. AFF., Summer 1963, at 3, 11; Hirschman, *supra* note 37, at 38; Wionczek, *Latin American Free Trade Association*, 551 INT'L CONCILIATION 3, 6 (1965).

> ECLA is to perform a missionary function. Moreover, the missionary-type attitudes of ECLA have been responsible for the periodic area and national surveys. These surveys reflect the theoretical and policy formulations of the Commission. The missionary function is further facilitated by training programs in economic development problems. . . . Both the publications and the training programs have spread the ECLA doctrines, and, subsequently, have increased their acceptance among the leading political figures of the region.

Cohen, *supra* at 6–7.

[52] Wionczek, *supra* note 51, at 6–7. One writer who has investigated the deterioration of the terms of trade concluded that Prebisch's theory is not empirically supported during the period from 1876 to 1905, but that there is evidence to support it during the

Other critics have argued that the Prebisch theory overemphasizes industrialization and import substitution, that it has ignored agriculture and the necessity for a revolution in that sector, that the possibility of export diversification has not been adequately analyzed, and that the effect of the diverse population has not been fully considered.[53] One writer has suggested that import substitution functions properly within very narrow limits set by a country's capacity to import, by its natural resources and technological state, and by the size of the domestic market.[54] Others simply point out that the entire Latin American economy is backward, not merely its industry, and that the theory of "the victimization of Latin America by industrial nations" is used by Latin leaders to avoid facing tremendous internal problems.[55] Under these views, development must start with self-discovery and acceptance of responsibility for internal problems.

Finally, it has been observed that Prebisch's analysis is misleading in that it refuses to recognize that many economic variables are subject to change through policy decisions and political leadership.[56]

Both Latin American critics and observers in the United States have voiced the opinion that Latin American states have consistently demonstrated ineptness in the discharge of economic functions. In the United States, there is also a fear of statism and the socialistic concepts which central governmental planning entails.[57]

While this criticism does suggest that certain details of economic analysis should be considered in forming a new common market, it is important to note that the Prebisch theory is well entrenched in Latin American thought,[58] and nineteen years of progress along this economic path will not readily be surrendered at the threshold of the ultimate test.

---

time from 1920 to 1940 and after World War II. *See* Ellsworth, *The Terms of Trade Between Primary Producing and Industrial Countries*, 10 INTER-AM. ECON. AFF., Summer 1956, at 47.

[53] *See* Cohen, *supra* note 51, at 8–13, 27; Hirschman, *supra* note 37, at 29–33, 38.

[54] *See* Humphrey, *Note on Import Substitution: The Case of Brazil*, 3 J. OF DEVELOPMENT STUDIES 76 (1966). Mr. Humphrey's conclusions on the limits to import substitution as a path to industrialization do not seem to be diametrically opposed to Prebisch's theory, at least as it pertains to the common market. One justification for a common market under the Prebisch theory seems to be that, by enlarging the effective national market, the limits on industrialization present in one country are expanded to the limits of the region. *See* 1964 ECONOMIC SURVEY OF LATIN AMERICA 1; ECONOMIC COMM'N FOR LATIN AMERICA INTERNATIONAL CO-OPERATION IN A LATIN AMERICAN DEVELOPMENT POLICY 72–74, U.N. Doc. E/CN. 12/359 (1954); *Commercial Policy for the Underdeveloped Countries* 268.

[55] *See* Cohen, *supra* note 51, at 6; Hansen, *The Fatal Barrier to Growth and Reform: Latin America's Economic Philosophy*, 20 INTER-AM. ECON. AFF., Autumn 1966, at 47, 50–58, 68; Hirschman, *supra* note 37, at 27–29, 33–35.

[56] *See* Hirschman, *supra* note 37, at 27–29. America's businessmen object to integration in Latin America apparently on the basis that a policy of free trade and competition rather than government planning and protection would do the most to bring economic development. *See* Moore, *200 Million Consumers in Search of a Market*, 1 COLUM. J. OF WORLD BUS., Spring 1966, at 113, 119.

[57] Hirschman, *supra* note 37, at 23–27; *see* Wionczek, *supra* note 51, at 6–7.

It should be noted that while there is disagreement with the Prebisch theory, some American economists have developed similar theories. *See* Hirschman, *supra* note 37, at 37–42.

[58] Wionczek, *supra* note 51, at 7.

II. The Institutional Machinery of Integration

A. The Basic Forms of Economic Integration

Economic integration in its narrowest sense means the reduction or elimination of customs duties and other impediments to trade within a group of countries.[59] Even in the narrowest form, integration presents a host of legal problems. The member countries must start by setting up uniform practices on commercial policy and by establishing administrative policy and machinery. The parties must also consider the development of uniform laws on commercial transactions, patents, copyrights, corporations, investment, and competition. Regional policies concerning immigration, labor law, social security, taxation, and fiscal and monetary policy may also be formulated. In its broadest form, economic integration means a supranational organization unifying the members' economic and legal systems and perhaps their political institutions. The four basic forms of integration are the free trade area, the customs union, the common market, and the economic union.[60]

1. The free trade area. In a free trade area, restrictions on goods exchanged between members are eliminated; however, each member-state is left free to set its own trade policy toward nonmember nations. There is usually a very loose institutional structure: decisions are made by unanimous consent, policy is formulated as needed, and withdrawal is made easy. Tariffs are abolished between members on a reciprocal basis, and so special concessions may be extended to the less economically developed parties. Political implications of joining a free trade area are minimal.[61]

2. The customs union. This form requires the elimination of all trade barriers between members and the setting of a common customs policy vis à vis the outside world. The organization of a customs union is difficult because a common customs policy will be enforced against a background of diverse internal commercial policies. As there is usually no means to adjust trade flow between members, economically disadvantaged countries are reluctant to join a customs union because they fear the flooding of their markets by the more advanced countries.[62]

3. The common market. The distinguishing feature of a common market is that trade barriers may be lowered only on a narrow group of commodities. It requires that members deal uniformly with each other in commercial transactions inside the region and uniformly with the outside world in trade

---

[59] *See* Committee on Foreign Law, *Economic Integration in Latin America*, 17 Record of N.Y.C.B.A. 5, 12 (Supp. 1962).

[60] Some writers do not include the economic union as a form of economic integration but rather view it as a refinement of the common market form.

[61] *See* Figgures, *Objects and Organizations of the European Free Trade Association*, in Legal Problems of the Common Market and European Free Trade Area 19 (1962) [hereinafter cited as The Common Market].

It has been asserted that political implications are always associated with economic integration, and that the extent of political adaptability determines the success of the attempted integration. Haas & Schmitter, *Economics and Differential Patterns of Political Integration*, 18 Int'l Organization 705, 707 (1964).

[62] *See* Valentine, *The Free Trade Association and the Common Market Compared*, 23 Modern L. Rev. 295 (1960); van Kleffens, *Objects and Organizations of the European Economic Community*, in The Common Market 8, 9.

matters concerning commodities covered by the agreement. Cooperation demands an internal structure with power to set and administer market policies. The organization may take the form of an intergovernmental association, with each member having a direct voice in administration and policy, or it may be a supranational institution in which administration is carried out by an executive board representing the market rather than individual countries.[63]

4. The economic union. The economic union is the most tightly structured form of integration. It provides not only for the movement of goods within the region but also for the movement of labor and capital. This form presupposes close cooperation in setting an economic policy, including taxation, social security, fiscal, and monetary policy. The result is often a supranational organization with its own executive branch, parliament, and judicial system. Plainly, the economic union has strong political implications.[64]

B. Special Factors Confronting Integration in Latin America

LAFTA stands out as a first attempt to establish a continent-wide economic integration among countries which share a common political and cultural background.[65] Other factors which produce a political climate receptive to integration are: a long post-colonial history, a common concern for the economic and geopolitical viability of the hemisphere, a relative lack of interregional quarrels, and a lack of regional diversions from the task of growth and development.[66]

On the other hand, LAFTA's geographical coverage and long-term objectives may be overly ambitious. The European experiment suggests that urban-industrial societies with a relatively high level of economic diversification are better candidates for integration than are underdeveloped, monocultural societies. Moreover, since the economic pattern of intraregional trade in Latin America is geared to agriculture while its industrial trade is directed primarily toward outside industrial nations, members will experience more difficulty in altering trade patterns than would countries trading together which were economically diversified.[67] The great economic disparities among Latin states and their lack of experience in institutional cooperation weighs against these countries as candidates for integration.

---

[63] *See* Committee on Foreign Law, *supra* note 59, at 12; Figgures, *supra* note 61, at 23; Wortley, *Some Legal Problems Arising Out of the E.E.C. and E.F.T.A.*, in THE COMMON MARKET 24 *passim.*

[64] *See* van Kleffens, *supra* note 62; Wortley, *supra* note 63.

[65] Wionczek, *supra* note 51, at 3–4.

[66] Gregg, *The UN Economic Commissions and Integration in the Underdeveloped Regions*, 20 INT'L ORGANIZATION 208, 215 (1966).

[67] *See* Gregg, *supra* note 66, at 213; Johnson, *The Montevideo Treaty for a Latin American Free Trade Area*, 1965 U. ILL. L.F. 715.

Haas & Schmitter, *supra* note 61, at 732–37, conclude that without closer cooperation among LAFTA members and a tighter political organization, the Association will be unable to avert economic stagnation.

III. The Montevideo Treaty

A. Events Leading Up to the Treaty

The Montevideo Treaty[68] creating LAFTA was signed on February 18, 1960, by seven nations.[69] By May 2, 1960, the treaty was ratified and it went into effect on June 1, 1961. Since that time, four countries have acceded to the treaty[70] and Cuba's bid for accession has been rejected on the ground that her economic structure was incompatible with the Treaty's objectives.[71]

The Montevideo Treaty was the result of two competing forces. In 1956, ECLA set up the Trade Committee as a permanent organ for the study of a common market. A "Group of Experts" (known as the Working Group) was appointed to formulate the principles to which an agreement for a regional market should conform.[72] The Working Group reported its guidelines in February 1958,[73] and in February 1959 presented a draft treaty.[74] Basically they proposed a free trade area comprised of all Latin American nations.[75] The integration would begin with preferential trading arrangements and evolve into a customs union in two stages. The first stage would be ten years, during which time trade restrictions would gradually be lowered and wider markets established. The details of the second stage were to be negotiated toward the end of the first stage.[76]

---

[68] Treaty Establishing A Free-Trade Area and Instituting the Latin American Free-Trade Association, Feb. 18, 1960 [hereinafter cited as the Montevideo Treaty]. An English translation is found in Multilateral Economic Cooperation 57–70, and also in V. Urquidi, Free Trade and Economic Integration in Latin America 136–63 (1964), and in Wionczek, *supra* note 51, at 63–79.

[69] Argentina, Brazil, Chile, Mexico, Paraguay, Peru, and Uruguay.

[70] Colombia and Ecuador acceded late in 1961; Venezuela and Bolivia joined in late 1966. The late accession of these two countries, who had long studied the advantages and disadvantages for them in LAFTA, was more likely prompted by the desire to participate fully in the planning of the new common market than by the hope of immediate economic gain.

[71] Association Latino Americano de Libre Comercio (ALALC) Resolućion 37(II) (1962).

[72] For a more comprehensive history of events see V. Urquidi, *supra* note 68, at 47–73, 129–35; Committee on Foreign Law, *supra* note 59, at 42–45; Mikesell, *The Movement Toward Regional Trading Groups in Latin America*, in Latin American Issues: Essays and Comments 125, 126–27, 129–31 (A. Hirschman ed. 1961).

[73] Multilateral Economic Cooperation 34–45. The working group was headed by Galo Plaza, former President of Ecuador and Ambassador to the United States, and included experts from Brazil, Chile, Argentina, Peru, and Colombia. Mikesell, *supra* note 72, at 130.

[74] Multilateral Economic Cooperation 46–56. The results of the Working Group were, of course, carefully guided by Raúl Prebisch, Executive Secretary of ECLA. Mikesell, *supra* note 72, at 130.

[75] The Working Group was faced with a dilemma. Subregional groupings were more likely to be created than a region-wide common market; however, the discord and discrimination of the separate groups after a few years' operation might prevent later unification. *Id.* at 129–30.

[76] Professor Mikesell, who was an invited observer from the United States to the Working Group's sessions, dissented from the draft agreement. He maintained that there should have been a specific date set for the realization of the customs union, that a preferential trade area rather than a free trade area or customs union was likely to be created, that the draft allowed discriminatory bilateral agreements which would injure the operation of the agreement, and that the agreement did not meet the requirements of GATT art. XXIV to qualify as a free trade area exception to the GATT treaty. Multilateral Economic Cooperation 56–57; *see* note 77 *infra*.

Meanwhile, at the instigation of ECLA, experts from Argentina, Brazil, Chile, and Uruguay met and drafted an agreement for a subregional free trade area. These countries had long traded mutually on a preferential basis, but they wished to relax these restrictions without destroying the existing trade channels. A free trade area was a desirable means to accomplish this end.[77] These Southern Zone countries subsequently agreed that their draft might be a point of departure for a more comprehensive agreement, and, in July and September of 1959, further discussions were held with representatives of Bolivia and Paraguay in attendance and with observers from Mexico, Peru, and Venezuela. The Montevideo Treaty was drafted at these meetings.[78]

B. The Treaty Provisions

As is usual in attempting to convert a theoretical model into a viable institution, a fair amount of political compromise was required to bring LAFTA into being. The economic realities of Latin America, however, dictated that certain problems be faced. The vast economic disparities between the relatively industrialized countries and the essentially agrarian nations required that the latter be protected from economic exploitation and that they be given some inducements to join the Association. The promise of balanced growth in the Prebisch theory has been attractive to the less developed countries for it holds out the possibility of industrialization where otherwise there would be none.

[77] The General Agreement on Tariffs and Trade (GATT) provides an exception to the most favored nations clause for groups of countries which form free trade areas or customs unions provided (a) that duties to nonmembers do not rise, and (b) that duties on "substantially all" trade between members of the proposed trade area be eliminated within a reasonable time. *See* GATT arts. XXIV(5)–(10), March 24, 1948, 62 Stat. 2013, T.I.A.S. No. 1765, 62 U.N.T.S. 56.

Four LAFTA members belong to GATT, including Brazil. The Southern Zone countries could have created a free trade area and greatly liberalized their trade by eliminating the restrictions which GATT imposes on preferential agreements as an exception to the most-favored-nation clause. For this reason the subregional free trade area was very attractive.

Although LAFTA was approved as a bona fide exception to GATT art. XXIV, there has been criticism first that for political reasons the GATT nations could not have denied granting the exception, and second, that the states drafting LAFTA showed more concern about meeting the GATT requirements than about achieving true economic integration. It was argued that higher tariffs were inevitable for nonmembers of the Association, and that duties under the Montevideo Treaty could not ever be removed on "substantially all" trade. *See* Gregg, *supra* note 66, at 218; Mikesell, *supra* note 72, at 145–47; Sumberg, *Free-Trade Zone in Latin America*, 14 INTER-AM. ECON. AFF., Summer 1960, at 51, 59. *Contra*, Urquidi, *The Montevideo Treaty: A Comment on Mr. Sumberg's Views*, 14 INTER-AM. ECON. AFF., Autumn 1960, at 19, 21–26.

[78] Wionczek, *supra* note 51, at 18, suggests that it may not have been accidental that ECLA experts helped to elaborate two seemingly contradictory schemes for integration in Latin America. Left with only a common market proposal for all Latin America and without the pressure of two concrete but competitive plans compelling a decision, the countries might have quibbled endlessly over the details.

Professor Mikesell takes a slightly different position. He claims that the accession of Mexico to the Montevideo Treaty was a surprise to ECLA, whose preference was the creation of a number of subregional free trade areas which would later be combined. To ECLA, Mexico's action seemed to spoil both plans. Mikesell, *supra* note 72, at 131. Wionczek, however, maintains that the discussions begun by the Southern Zone countries were expanded at the prodding of ECLA. Wionczek, *supra* note 51, at 16–17. The new proposals for a common market joining LAFTA, CACM, and the uncommitted Latin American nations shows at least that Prebisch's concept of one large market was never put aside.

Since Latin America itself is a complex of industrial centers and peripheries, the treaty had to find a vehicle by which a less industrial nation could set a policy of protection which would encourage industrialization according to national demands without arousing a retaliatory reaction by the more industrial countries. To counter overconcern with national interests, there also had to be some path by which regional complementarity and development would take place. One answer was the principle of reciprocity, central to LAFTA organization, which holds that no country should derive greater trade advantages than it grants to others. This idea is reflected in the provisions for negotiated schedules, complementarity agreements, and saving clauses, which allow each country to determine to a large extent the impact of free trade on its own economy.

1. The negotiated schedules. The treaty commits the contracting parties to the creation of a free trade area by 1973.[79] This is to be accomplished primarily through the annual negotiation of "National Schedules" and "Common Schedules."

The national schedules are agreements made by individual member-nations which list specific products exchanged between the negotiating parties on which tariffs, duties, and other trade restrictions will be reduced.[80] Under the treaty's most-favored-nation clause, the concessions of individual countries are extended to every other member.[81] Goods placed on the national schedules may be withdrawn in subsequent years upon the giving of adequate compensation.[82]

Article 5 requires each member to reduce charges and duties each year by at least eight percent of a weighted average.[83] Since "quotas" do not strictly fall within "duties and charges," there is some dispute concerning whether quantitative concessions may go into the calculation of the weighted average.[84]

Every three years, the members gather to negotiate common schedules. Products placed on this list are not subject to withdrawal, and if the same commodity appears on both the national and common schedules, it is irrevocably on both lists.[85] Article 7 stipulates that twenty-five percent in value of the intraregional trade must be placed on the list at the end of each three-year period so that by the end of twelve years, "substantially all" trade restrictions will have been removed on all LAFTA trade. However, there is

[79] *See* Montevideo Treaty, art. 2.

[80] *See* Montevideo Treaty, arts. 4–6.

[81] Montevideo Treaty, art. 18.

[82] Montevideo Treaty, art. 8.

[83] The method by which the weighted average is to be calculated is set out in Protocol No. 1, tit. I, Feb. 18, 1960, Montevideo Treaty, located in MULTILATERAL ECONOMIC COOPERATION 65.

[84] *See* Johnson, *supra* note 67, at 720. The average level of customs in Latin America is 100%, with many running as high as 200% to 300%. Trade barriers take the form of tariffs, exchange quotas, exchange surpluses, taxes on remittances of funds, consular fees, prior deposit requirements, and licenses. *See* PROPOSALS FOR A COMMON MARKET 11–12; U.N. Doc. E/CN. 12/554 (1961).

[85] Montevideo Treaty, arts. 4(b), 8; Protocol No. 1, tit. IV, Feb. 18, 1960, Montevideo Treaty.

no obligation to lower tariffs on products on the common schedule until 1973.

The five years of LAFTA experience have now shown that the commodity-by-commodity negotiations contemplated by the national and common schedules are too cumbersome to eliminate all zonal trade restrictions.[86] There has been a tendency among the LAFTA members to lower trade barriers only on primary products traditionally traded among themselves or on items that are not hotly competitive, while industrial products remain safe behind tariff walls. Moreover, the provisions allowing products to be moved on and off the national schedules, defining the averaging formula, and providing for reciprocity have proven to be useful escape clauses. It has also been observed that a vested interest seeking protection for a particular product often holds more sway over its country's representative than a host of producers from other states who are willing to give substantial concessions for a market entry.

The treatment accorded products which were not traded between LAFTA countries at the time the treaty was signed has been another major hindrance. While the treaty exhorts its members to add products to the schedules which were not subject to reciprocal trade in 1960, there is no specific obligation to reduce barriers or to make concessions with regard to such products.[87] These goods, however, may be made the subject of negotiations.[88] The result has been that countries may continue to protect new industries, or they may reduce tariffs on the new commodities, and, by adding their value to the value of total trade, they can meet the weighted average requirement on overall reduction without actually liberalizing trade.[89] This practice clearly violates the spirit of the treaty, but it reflects the common tendency to give national policies consideration ahead of regional objectives.

The special treatment of agricultural products presents another obstacle to trade expansion. Articles 27 to 31 allow trade restrictions to be applied to agricultural products providing that inefficient production is not increased or that consumption in a country is not decreased, or as long as the purpose is to meet deficits in internal production or to equalize domestic and import prices. But it is impossible to enforce these provisions because the statistics necessary to compute deficits or changes in consumption or production are unreliable and unrefined. Consequently, the only goods which could be competitive throughout the zone are eliminated from the negotiations, inefficient producers are protected, and countries whose major productive sector is agri-

[86] *See generally* PROPOSALS FOR A COMMON MARKET 11–12; Committee on Foreign Law, *supra* note 59, at 47–49; Johnson, *supra* note 67, at 722–23; Mikesell, *supra* note 72, at 135–39; Wionczek, *supra* note 51, at 23, 33–35.

[87] *See* Montevideo Treaty, arts. 14(c), 16; Protocol No. 1, tit. I, Feb. 18, 1960, Montevideo Treaty. The confusion arises because Protocol No. 1, which sets out the procedures for calculating the weighted averages, indicates that new trade is included but presents a formula which accounts only for trade existing at the signing of the treaty. *See* Dosik, *The Montevideo Treaty and "New" Trade*, 14 INTER-AM. ECON. AFF., Winter 1960, at 117, 118.

[88] Montevideo Treaty, art. 14(c); *see id.* art. 3.

[89] *See* Dosik, *supra* note 87, at 119; Sumberg, *supra* note 77, at 57–58. *But see* Urquidi, *The Montevideo Treaty: A Comment on Mr. Sumberg's Views*, 14 INTER-AM. ECON. AFF., Autumn 1960, at 19, 24–25.

cultural are limited in expansion. The sector of the economy that is the weakest is thus protected at the expense of complementarity.[90]

2. *Complementarity agreements.* Article 16(b) provides that complementarity agreements between contracting parties may be employed as a means of trade expansion. These agreements are intended to liberalize trade by providing investment incentives on a regional basis, by getting restrictions lowered on products not yet traded regionally, and by removing varying national restrictions with respect to the vertical or horizontal functioning of a particular industry. Through such agreements it is hoped to encourage specialization based on maximum economic efficiency by allowing suppliers, manufacturers, and distributors who are closely related to a particular industry to deal with each other without hindrance of import restrictions.[91] It was once thought that the most-favored-nation clause made concessions in complementarity agreements available to all members. In 1965, however, the Committee determined that the benefits would be available to members not party to the agreement only if they made equivalent compensative concessions to the parties. The scarcity of complementarity agreements apparently made this additional incentive necessary.[92]

Unfortunately, complementarity agreements have not been the rule. Only two agreements have been executed, one covering electronic vacuum tubes, the other computers; both were fostered by branches of foreign companies on their own initiative.[93] The large state-owned monopolies have not participated in such agreements although it was anticipated that such industries would find complementarity agreements most useful. Rather, each nation has proceeded with national policies to develop its own basic industries. In addition, the few meetings that have been held among business leaders on developing complementarity have produced high-sounding reports unaccompanied by any actual progress.[94] At least this lack of interest has quieted initial fears that article 16 would produce international cartels inimical to the interests of LAFTA countries.[95]

Complementarity agreements as set out in the treaty are open to a number of criticisms. The Working Group originally proposed that these agreements be produced through the free play of market forces, reasoning that no country had the right to install certain industries to the exclusion of all others, and that specialization would be created by the regional market. But

[90] *See, e.g.*, Committee on Foreign Law, *supra* note 59, at 53–54; Sumberg, *supra note* 77, at 52–55; *cf.* MULTILATERAL ECONOMIC COOPERATION 40.

[91] These agreements have the status of protocols and may not go into force until approved by the Conference. Notice of intent must be given to the Committee, and the negotiations must be open to all members. In addition, the agreement must have an accession clause and be compatible with the creation of free trade by 1973. Montevideo Treaty, art. 17; ALALC/Resolución 99, paras. 4, 9, 16, 18, 19, 26 (IV) (1964); Johnson, *supra* note 67, at 724–25.

[92] *See* PROPOSALS FOR A COMMON MARKET 15–16.

[93] Johnson, *supra* note 67, at 724 & n.50; Wionczek, *supra* note 51, at 47–51. It has been reported that there are more complementarity agreements now being negotiated. de Onis, *Latin-American Unity at Stake in Market Decision*, N.Y. Times, April 10, 1967, at 20, cols. 7–8 (city ed.).

[94] *See* Wionczek, *supra* note 53, at 47–51.

[95] *See, e.g.*, Johnson, *supra* note 67, at 725; Sumberg, *supra* note 77, at 57.

the treaty avoids the use of the word "competition." Instead of placing the initiative to develop complementarity in regional or national hands, the treaty is silent and thus leaves business free to pursue its own narrow interests.

Complementarity also means continual bargaining; it means measuring gains and losses by industries rather than by the nation as a whole; it engenders fears between opposing industries in the various countries; it means decisions on a short term basis. In essence, this scheme in the treaty puts balanced growth ahead of efficient allocation of resources, negotiation and accommodation of national policies ahead of economic forces. As a result, a tool which could be used to lower tariffs very rapidly and bring about industrialization remains unused.[96]

3. Exceptions, exemptions, and special circumstances. One limitation on the reduction of trade barriers is expressed in articles 11 to 13, which permit a party experiencing significant unfavorable terms of trade within the area as a result of concessions he has granted in the schedules to request the use of restrictive measures to remedy the situation. While these articles merely provide the basis for a request for relief, they do not prohibit the petitioner from acting in self-defense should other parties refuse to respond to the plea for help.

In addition to allowing the withdrawal of products from the national schedules, the saving clauses in articles 23 through 26 allow a member to impose nondiscriminatory restrictions upon products already included in the national schedule if the importation of the products may have serious repercussions on its economy, or if the country has adopted measures to correct its unfavorable over-all balance of payments. While it is intended by the treaty that a member in difficulty should apply to the Conference before acting, he may act unilaterally if an emergency exists, and the restrictions so set up can continue in force for one year before being investigated by the Committee. The sole qualification is that the restriction should not lower the customary level of consumption in the importing country. Because the treaty provides no institutional means for the resolution of disputes other than negotiation, a dispute over these matters is serious.[97] In effect, these saving clauses allow a member to slow down, if not reverse, the progress toward a free trade area.

In order to induce the less developed countries to join the Association, it was necessary to provide special measures of protection which would enable these countries to catch up economically with the other countries. If all trade barriers in such countries were lowered, their inefficient industries would be eliminated and a severe balance of payments deficit would develop from the flood of imports.

The treaty provides that members may grant special advantages in the way of trade concessions, financial aid, or technical assistance to countries

[96] *See, e.g.*, Haas & Schmitter, *supra* note 61, at 728–30; Mikesell, *supra* note 72, at 141–42; Wionczek, *supra* note 51, at 47–51.

[97] In 1964, a resolution directed that a means of settling disputes be studied. ALALC/Resolución 102 (IV) (1964).

classified as underdeveloped in order to promote industrialization.[98] An undeveloped country may also be authorized to lower trade barriers at a slower rate than other members, or to adopt measures to correct balance of payments or to protect vital industries so long as there is no corresponding decrease in the country's customary consumption.[99] Again, unreliable economic data make enforcement of the limitation impossible.

After five years of operation, it has been discovered that not only the small but also the intermediate countries need protection. Special treatment in reducing tariffs, however, is inadaquate. There is still a great need for capital and technical assistance, and complementarity agreements emphasizing a country's particular advantages are needed to create markets and start industrialization.[100]

4. Institutional machinery. LAFTA has no federal or supranational structure; its supreme organ is the Conference of the Contracting Parties. The Conference acts on a one country, one vote principle, and decisions are valid if passed by an affirmative vote of two-thirds and no negative vote is cast.[101] The Conference meets annually; its main responsibilities are presiding over the annual tariff negotiations, defining procedures, interpreting the treaty, and deciding policy questions.[102]

The Executive Committee is a permanent administrative body whose responsibility is supervising the treaty's implementation. Its membership is drawn from all the countries. It has a secretariat headed by an executive secretary with a staff of technical assistants. A number of subsidiary organs have been created under the Committee for making studies and formulating recommendations. ECLA and OAS representatives act as technical advisors.[103] Each member-nation also has a national LAFTA commission whose job it is to coordinate national planning with regional objectives.[104]

Amendments to the treaty take the form of protocols, which enter into force upon ratification by the members. Decisions by the Conference and recommendations by the Committee take the form of resolutions.[105] Article

---

[98] Montevideo Treaty, art. 32. Protocol No. 5, Feb. 18, 1960, Montevideo Treaty, granted Paraguay and Bolivia the status of relatively undeveloped countries qualified to invoke the provisions of article 32. Bolivia, however, did not choose to join the Association even though she participated in the negotiations; she declared that since the country had to depend on outside sources of supply and had nothing to sell to the other members, a program of import substitution could not aid her. *See* Wionczek, *supra* note 51, at 52–53. Ecuador was made eligible for special treatment under article 32 when she joined LAFTA. Johnson, *supra* note 67, at 729.

[99] Montevideo Treaty, art. 32.

[100] PROPOSALS FOR A COMMON MARKET 21–26; Huelin, *Economic Integration in Latin America — Progress and Problems*, 40 INT'L AFF. 430, 432–33 (1964).

[101] Montevideo Treaty, arts. 33, 35; *see id.* arts. 37, 38. ALALC/Resolución 68 (III) (1963) provides that in special, enumerated cases, a mere two-thirds vote is sufficient.

[102] *See* Montevideo Treaty, arts. 34, 36, 39.

[103] Montevideo Treaty, arts. 39, 40, 41; *see id.* arts. 42–45. The relationship of ECLA and OAS committees is fixed by Protocol No. 3, Feb. 18, 1960, Montevideo Treaty, located in MULTILATERAL ECONOMIC COOPERATION 68.

[104] Wionczek, *Latin American Free Trade Association*, 551 INT'L CONCILIATION 3, 58; *see* Nattier, *LAFTA — The Latin American Free Trade Association*, 10 INT'L & COMP. L. BULL., May 1966, at 20, 24.

[105] Art. 60; ALALC/Resolución 5 (I) (1961).

46 establishes the juridical personality, giving it power to contract, acquire property, and hold funds.

The institutional machinery of LAFTA is very weak, but it has been claimed that this was the best which could be attained in 1960.[106] The signatories' reliance on the ephemeral spirit of cooperation and negotiation has proven to be a serious obstacle to success. The ambitious goals and the tremendous task that have fallen to LAFTA plainly call for maximum cooperation and commitment to specific policies, yet the treaty is phrased in vague terms and loaded with exemptions and escape clauses. The Conference and Committee are unable to act on any matters of substance, first because the representatives are not authorized to discuss more than procedural matters, and second, because the veto power means that the nation with the least faith in LAFTA will set its policies.[107] Thus, while the treaty may be an agreement in principle, there may actually be no working agreement at all. These roadblocks force important measures to be taken up jointly or separately by member governments. Here, the national LAFTA commissions are often ignored and regional problems are solved in light of domestic circumstances rather than regional needs.[108] If integration is to make progress, the institutional machinery must be strengthened so that policies are set and administered by organs whose first allegiance is to regional goals rather than national preferences. Moreover, only by surrendering some sovereignty to a regional body can the participating governments develop the tradition of institutional cooperation necessary to such a massive integration effort.

IV. THE NEW PROPOSALS

A. The Present Economic Picture

While intra-LAFTA trade has increased since the formation of LAFTA, the opinion is now widespread, among official[109] as well as unofficial circles,[110] that expansion is not progressing nearly fast enough and that new steps must be taken. Tariffs have been reduced on over 8,500 items, but mostly on goods which are either not competitive or are overly protected. While regional trade is up 40 percent over the 1959–61 average, this is only 10 percent of the total trade of the members, barely the level of a decade before.[111] Moreover, with each successive round of bargaining, the concessions grow fewer and the negotiations more strained.[112] The trade increase has also been

[106] Committee on Foreign Law, *Economic Integration in Latin America*, 17 RECORD OF N.Y.C.B.A. 5, 57 (Supp. 1962); Wionczek, *supra* note 104, at 24.

[107] *See, e.g.*, Sumberg, *supra* note 77, at 63–64; Wionczek, *supra* note 104, at 56–62; *cf.* PROPOSALS FOR A COMMON MARKET 2, 3, 4–7.

[108] Wionczek, *supra* note 104, at 58–59.

[109] *See* Declaration of Bogotá by the Presidents of Chile, Colombia, Venezuela, Ecuador, and Peru, Aug. 16, 1966, printed in 20 INTER-AM. ECON. AFF., Winter 1966, at 88; 1964 ECONOMIC SURVEY OF LATIN AMERICA 181–87; PROPOSALS FOR A COMMON MARKET.

[110] *E.g., Latin America — To Get Bolder or Give Up*, TIME, Oct. 30, 1964, at 103; Welles, *20 Latin Nations Back Trade Bloc*, N.Y. Times, March 29, 1967, at 1, col. 7 (city ed.); Wionczek, *supra* note 104, at 29–51 (1965).

[111] *See* table and sources cited note 25 *supra*.

[112] Moore, *200 Million Consumers in Search of a Market*, 1 COLUM. J. OF WORLD BUS., Spring 1966, at 113, 115.

extremely unbalanced. Argentina, Mexico, and Ecuador continue to be LAFTA creditors; Brazil, Chile, Colombia, and Uruguay are still net importers.[113] Finally, tariff concessions have had a very limited effect on the composition and direction of trade, except in the two most dynamic economies of Mexico and Peru.[114]

B. The New Proposals for a Common Market

Since the time the Montevideo Treaty was signed, its plan for economic integration has been subjected to criticism.[115] The major contentions have been that the organization of LAFTA is too weak — that the treaty provides no more than an opportunity for negotiation, and that many measures crucial to integration, such as a fixed timetable for tariff reductions, a regional payments system, and techniques for elimination of nontrade restrictions to industrialization, were left open.

In 1964, concrete proposals for revamping LAFTA began to be seriously discussed,[116] culminating recently in the "Declaration of the Presidents of the Americas" at Punta del Este this April.[117] In this declaration, the presidents of seventeen Latin nations have pledged themselves to the founding of a common market by 1970 which would become an economic union by 1985.

The new proposals, which contemplate the merger of LAFTA and CACM, suggest as a major thesis that a regional integration policy must be clearly formulated by the Latin American nations and that each party must be fully committed to achieving regional goals. The "Integration Policy" proposed by Prebisch and others[118] is broken down into a trade policy, a regional investment policy, and a monetary and fiscal policy.

The trade policy calls for adopting a scheme of automatic tariff reductions in place of the negotiated schedules, the adoption of quantitative targets for the maximum level of intraregional customs, the elimination of quotas and other nontrade restrictions, and a common tariff to countries outside the union.[119] One controversial provision calls for a system of reciprocal preferences for regional trade until a definitive preference on a common tariff is established.[120]

---

[113] *See* Wionczek, *supra* note 104, at 29–32; *cf.* Huelin, *supra* note 100, at 432; Nattier, *supra* note 104, at 24–25.

[114] *See* Huelin, *supra* note 100, at 432; Wionczek, *supra* note 104, at 29–33.

[115] *See, e.g.*, Mikesell, *supra* note 72, at 148–51; Sumberg, *supra* note 77.

[116] *See* Declaration of Bogotá, *supra* note 109; *Latin America — To Get Bolder or Give Up*, TIME, Oct. 30, 1964, at 103; Wionczek, *supra* note 104, at 56–57.

[117] The Declaration of Presidents of the Americas was signed on April 14, 1967, at Punta del Este, Uruguay. *See* N.Y. Times, April 16, 1967, § 4, at 1, col. 3.

[118] *See* PROPOSALS FOR A COMMON MARKET; Declaration of Bogotá, *supra* note 109; de Onis, *Latin-American Unity at Stake in Market Decision*, N.Y. Times, April 10, 1967, at 20, cols. 4–8 (city ed.); N.Y. Times, April 11, 1967, at 1, col. 8 (city ed.).

The document *Proposals for the Creation of the Latin American Common Market* was authored by Felipé Herrera, President of the Inter-American Development Bank, Carlos Sanz de Santamariá, Chairman of the Inter-American Committee for the Alliance for Progress, José Antonio Mayobre, Executive-Secretary of ECLA, and Raúl Prebisch, now Secretary-General of the U.N. Conference on Trade and Development.

[119] *See* PROPOSALS FOR A COMMON MARKET 10–14.

[120] *Cf.* Moore, *supra* note 112, at 116–18; PROPOSALS FOR A COMMON MARKET 14.

The regional investment policy will be designed to direct investments, promote integration activities, and encourage import substitution. Complementarity and sectorial agreements would be induced through financial, technical, and fiscal incentives rather than by state ownership and tariffs. The goal of the investment policy would be to develop regional transportation and communication as well as to furnish capital and technology for industrialization.[121]

The objective of the regional monetary and fiscal policy would be to establish a payments system to deal with inflation and disequilibria in payments. The less developed nations would get preferential margins for imports from the zone, longer periods in which to reduce tariffs, and special technical and financial aid, along with special protection from competition. It is also proposed that to attract foreign capital, uniform statutes defining the terms of investment offered by Latin America be enacted.[122]

It has recently been suggested that the United States establish preferential trade arrangements with the Latin nations to compensate them for the loss of trade caused by preferential agreements in the European markets.[123]

To implement these changes, the following amendments of LAFTA's institutional structure have been suggested:[124]

(a) A Council of Ministers operating on a one country, one vote basis would be established as the supreme organ of the new market. The veto power would be restricted.

(b) An Executive Board whose members would be selected by the Council on the basis of technical competence rather than national origin would be made the administrative authority. The Board's duties would be to assure that the objectives of the integration policy are attained through the reciprocity principle, tariff adjustment, and preferential measures; to coordinate policies, promote negotiations, decide on the application of safeguards and readjustments, and to act as a court in the first instance.

(c) A Latin American Parliament would be created.

(d) A conciliation procedure must be set out.

(e) Instruments for the promotion of regional investments would be negotiated.

(f) A regional court might eventually be established.

V. CONCLUSIONS

The April Conference of Presidents at Punta del Este has underscored the hemispheric concern with the lack of economic growth in Latin America. The success of economic integration, however, is far from assured.

The current proposals suggest that LAFTA should be extensively amended rather than a new treaty negotiated.[125] While LAFTA has marshalled the

---

[121] *See* PROPOSALS FOR A COMMON MARKET 14–18.

[122] *See id.* at 19–20, 22–24, 25; Declaration of Bogotá, *supra* note 109, at 91.

[123] Moore, *supra* note 112, at 119–20; *see* N.Y. Times, April 11, 1967, at 14, col. 1 (city ed.).

[124] PROPOSALS FOR A COMMON MARKET 26–29.

[125] *See id.* at 5–6; Declaration of Bogotá, *supra* note 109, at 89–92; N.Y. Times, April 12, 1967, at 1, col. 8 (city ed.).

concentration of many subsidiary organs, commissions, and private groups — both regional and national — on regional economic programs, and will have gained a great deal of experience in operating a regional market, it might be questioned whether retaining and revising LAFTA is the best approach. The basic economic concepts underlying LAFTA are unlikely to change, yet the means of implementation would be vastly different. Attempts to make a radical changeover in political philosophy, in operational devices, and in basic policies may be met with opposition, confusion, and disenchantment. Moreover, in the past the Conference and the Committee have been unable to act on matters of substance. Although a declaration of agreement in principle by the heads of states is promising, the delegation of the drafting and implementation tasks to LAFTA could stall progress. In addition, the LAFTA organization will be too preoccupied with current economic problems to assure that the progress already secured is not lost.

However the details for establishing a common market are handled, the one ingredient absolutely necessary to its success is close cooperation at the political level among the Latin American nations.[126] LAFTA did not seek a firm commitment to integration objectives from the contracting parties. This attitude may be justified on the ground that the magnitude and novelty of the task required caution. Now, however, anything less than a full dedication to an operational common market materially weakens its chances of success. The change in attitude must start with the political leaders, who must be willing to surrender some national sovereignty to an intergovernmental organization in exchange for the many benefits held out by integration. But the new spirit must also reach down to business and labor leaders, even to the people themselves. Support for LAFTA in the past has been concentrated in small groups of technical advisers and economists whose views rarely prevailed.[127] While some support has come from the class of new entrepreneurs who have been educated abroad and who are aware of the advantages of large markets and mass production, anti-LAFTA groups made up of agricultural interests oriented toward outside markets, consumer industries, and inefficient entrepreneurs afraid of competition, remain strong. These groups must be inculcated with the spirit of progress and made aware of the promises of economic integration.

The meeting at Punta del Este may have added one factor the absence of which previously hampered integration: The United States promised to support economic integration. Hopefully this attitude will carry over to other

---

[126] *See* PROPOSALS FOR A COMMON MARKET 3, 5; Declaration of Bogotá, *supra* note 109, at 91–93; de Onis, *Latin American Unity at Stake in Market Decision*, N.Y. Times, April 10, 1967, at 20, cols. 7–8 (city ed.).

[127] Wionczek, *supra* note 104, at 59–62.

> In the language of traditional politics, the radical right and the radical left are against LAFTA: the propertied right because it is afraid of the consequences of social and economic change, the intellectual left because it predicts that the Latin American common market eventually will be taken over by powerful foreign interests.

Id. at 61.

international institutions.[128] While the OAS has voiced support for integration, there has never been much actual progress made, and, of course, some competition between OAS and ECLA groups was inevitable because of their differing philosophies.[129] This could only make the path of LAFTA more difficult. The position of the United States toward Latin American integration in the early 1960's was ambiguous, and this resulted in an ambivalent investment policy in Latin America on the part of institutions financed primarily by United States funds. Projects were planned without any recognition or consideration of existing or needful regional programs.[130] The OAS should be clearly established as an organization to delineate the relationship between Latin America and the United States rather than as a group competing with integration projects.[131]

Despite the optimistic spirit that has dominated discussions of economic integration, the outlook is far from cheerful or clear. Steps are being taken toward economic advancement at a pace unequaled in the past, but the economic and social problems of Latin America may be spreading even faster.[132] The period of theory and discussion is long past in Latin America; the years which follow must be devoted to the full implementation of the theories which have remained so long in the embryonic stage.

Gary L. Wixom

[128] N.Y. Times, April 17, 1967, at 3, cols. 1, 2 (city ed.); N.Y. Times, April 16, 1967, § 4, at 1, col. 3 (city ed.).

[129] *See* Gregg, *supra* note 66, at 218–19; Wionczek, *supra* note 104, at 10–11, 24–28.

[130] Wionczek, *supra* note 104, at 27–28.

[131] *See* Declaration of Bogotá, *supra* note 109, at 91, 93–94; Gordon, *Inter-American Cooperation: The Road Ahead*, 55 DEP'T STATE BULL. 946 (1966).

[132] See Mikesell, *supra* note 72, at 151.

CASES NOTED

Defendant's Conspiracy Conviction Upheld Although Co-conspirators Not Convicted — Defendant Required To Be First Defense Witness or Surrender His Right To Testify

The defendant was president of a company engaged in the interstate sale of vending machines. No machines were ever delivered and money collected in advance was not refunded. With the apparent intent of mollifying a customer, a letter containing factual misrepresentation was written under the company's letterhead and deposited in the United States mails. The federal court for the Western District of Tennessee convicted the defendant of mail fraud and of conspiring to violate the mail fraud statutes. Errors alleged on appeal were, *inter alia*: (1) the conspiracy conviction was invalid because the alleged co-conspirators had been granted a severance, a *nolle prosequi*, or had been aquitted; and (2) the trial court committed reversible error by requiring the defendant to be the first defense witness or forego his right to testify. The United States Sixth Circuit Court of Appeals *held*, affirmed. The granting of a *nolle prosequi* to one co-defendant and the pending indictment against another were sufficient to sustain the conspiracy conviction, notwithstanding the lack of a convicted co-conspirator. It was within the trial judge's discretion to require the defendant to be his own first witness. *United States v. Shipp*, 359 F.2d 185 (6th Cir.), *cert. denied*, 385 U.S. 903 (1966).

By definition conspiracy is a crime involving a plurality of actors.[1] When all accused conspirators are named in the indictment and are available for trial, successful prosecution requires conviction of a minimum of two defendants.[2] Solitary conspiracy convictions have been upheld, however, if the co-conspirators are unknown,[3] unapprehended,[4] dead,[5] immune from prose-

[1] Rogers v. United States, 340 U.S. 367, 375 (1951); J. MILLER, CRIMINAL LAW 108 (1934); 3 H. UNDERHILL, CRIMINAL EVIDENCE § 855 (5th ed. 1957); G. WILLIAMS, CRIMINAL LAW § 213 (2d ed. 1961).

[2] *E.g.*, Bartkus v. United States, 21 F.2d 425, 428 (7th Cir. 1927); Van Tress v. United States, 292 F. 513, 521 (6th Cir. 1923); State v. Breau, 222 A.2d 774 (Me. 1966).

[3] Grove v. United States, 3 F.2d 965, 967 (4th Cir.), *cert. denied*, 268 U.S. 691 (1925); Donegan v. United States, 287 F. 641, 648–49 (2d. Cir.), *cert. denied*, 260 U.S. 751 (1922); United States v. Hamilton, 26 F. Cas. 90 (No. 15,288) (C.C.S.D. Ohio 1876).

The theory of conspiracy with "persons unknown" attained the status of the ultimate absurdity in United States v. General Motors Corp., 121 F.2d 376 (7th Cir. 1941). The indictment alleged that nineteen individuals, three corporations, and persons and corporations to the jurors unknown had conspired. The nineteen individuals were officers, employees, or agents of the corporation. They were acquitted. The three corporations were found guilty. Because the corporate entity cannot conspire without acting through an agent, United States v. Santa Rita Store, 16 N.M. 3, 113 P. 620 (1911), the *General Motors* case arrives at the ludicrous conclusion that "persons unknown" conspired with "persons unknown."

[4] Rosenthal v. United States, 45 F.2d 1000 (8th Cir. 1930).

[5] People v. Olcott, 2 Johns. Cas. 523, 526 (N.Y. 1801); State v. Davenport, 227 N.C. 475, 42 S.E.2d 686 (1947); State v. Alridge, 206 N.C. 850, 175 S.E. 191 (1934).

cution,[6] indicted and awaiting trial,[7] known and apprehended but unindicted,[8] or, according to one line of cases, granted *nolle prosequis*.[9] If the indictment purports to include all accused consipirators and they are all available for trial, they are tried separately, and if only one is found guilty, appellate courts have usually reversed the solitary conspiracy conviction.[10] A minority of appellate courts have, however, upheld the trial court and the solitary conviction.[11] In addition, where an action is still pending against an accused co-conspirator, the appellate courts have considered the solitary conspirator's conviction to be conditional upon the outcome of the co-conspirator's trial.[12] Appellate court decisions have been inconsistent in treating appeals from solitary conspiracy convictions when accused co-conspirators are granted *nolle prosequis*.[13]

---

[6] Berry v. State, 173 N.E. 705 (Ind. 1930); Hurwitz v. State, 200 Md. 578, 92 A.2d 575 (1952); Bradshaw v. Territory, 3 Wash. Terr. 265, 14 P. 594 (1887).

[7] DeCamp v. United States, 10 F.2d 984, 985 (D.C. Cir. 1926); United States v. Koritan, 182 F. Supp. 143, 145 (E.D. Pa.), *aff'd*, 283 F.2d 516 (3d Cir. 1960).

[8] A curious case arose in Kentucky where a co-conspirator was apprehended but was not indicted because of a Kentucky law which prevented a wife from testifying against her husband. The prosecution's chief witness was the wife of the defendant's co-conspirator. If indictments were obtained against both conspirators, the wife would not have been able to testify against her husband, and he would have been acquitted, forcing acquittal of the defendant. As a result, the prosecution apparently decided they could only convict one conspirator; an indictment apparently was not sought against the defendant's co-conspirator. Rutland v. Commonwealth, 160 Ky. 77, 169 S.W. 584 (1914).

[9] United States v. Fox, 130 F.2d 56 (3d Cir.), *cert. denied*, 317 U.S. 666 (1942) (defendant confessed); United States v. Lieberman, 8 F.2d 318 (E.D.N.Y. 1925) (defendant confessed); People v. Bryant, 342 Ill. App. 90, 95 N.E.2d 620 (1950), *aff'd*, 409 Ill. 467, 100 N.E.2d 598 (1951) (prosecution's motion was "striking . . . cause with leave to reinstate" rather than *nolle prosequi*); State v. Lockhart, 241 Iowa 635, 39 N.W.2d 636 (1949), *cert. denied*, 340 U.S. 817 (1950) (defendant confessed — indictments dismissed against five co-defendants); State v. Keul, 233 Iowa 852, 5 N.W.2d 849 (1942) (dictum) (majority terms "dismissal of indictment" — only dissent uses *nolle prosequi*); Cline v. State, 204 Tenn. 251, 319 S.W.2d 227 (1958); *cf.* Commonwealth v. Edwards, 135 Pa. 474, 19 A. 1064 (1890) (dictum) (where conspiracy conviction is obtained by confession); Bradshaw v. Territory, 3 Wash. Terr. 265, 14 P. 594 (1887); State v. Lloyd, 152 Wis. 24, 139 N.W. 514 (1913).

[10] Eyman v. Deutsch, 92 Ariz. 82, 373 P.2d 716 (1962) (court granted acquittal after defendant had entered guilty plea); People v. Regan, 351 Ill. App. 550, 115 N.E.2d 817 (1953); Sherman v. State, 113 Neb. 173, 202 N.W. 413 (1925). The *Sherman* case was expressly overruled by the Nebraska Supreme Court in Platt v. State, 143 Neb. 131, 8 N.W.2d 849 (1943).

[11] Platt v. State, 143 Neb. 131, 8 N.W.2d 849 (1943); State v. Oats, 32 N.J. Super. 435, 108 A.2d 641 (Super. Ct. 1954) (dictum) (defendant entered a plea of *non vult*); State v. Lloyd, 152 Wis. 24, 139 N.W. 514 (1913) (dictum) (*nolle prosequi* granted co-conspirator — this apparently did not affect holding).

The argument that these are different trials with different evidence does not withstand logical analysis unless the proponent of the argument contends that evidence introduced at the group trial is the same for all defendants. If the proponent admits that the evidence introduced in a joint trial of *A* and *B* is not identical for each defendant then he must explain away the inconsistency of acquitting *A* if *A* and *B* are tried together but holding *A* guilty if *A* and *B* are tried separately. There does not seem to be any logical fallacy in treating the defendants the same in the group and severed trials once it is recognized that the evidence will not be identical for all defendants in either the group or the severed trials.

[12] People v. Levy, 229 Ill. App. 453, 20 N.E.2d 171 (1939); Casper v. State, 47 Wis. 535, 2 N.W. 1117 (1879).

[13] Both federal and state court cases which have held that a *nolle prosequi* would support a solitary conspiracy conviction are cited, note 9 *supra*.

Federal and state court cases which have held that a *nolle prosequi* will not support a solitary conspiracy conviction are State v. Jackson, 7 S.C. 283 (1876); Miller v. United States, 277 F. 721 (4th Cir. 1921) (dictum); Feder v. United States, 257 F.

The trial procedure adopted in the instant case — requiring the defendant to be the first defense witness — is one resolution of a dilemma. As jury trial evolved, procedures developed that were calculated to assure the veracity of witnesses' testimony.[14] One procedure was sequestration, the seclusion of witnesses from the courtroom and each other until they testified.[15] A second procedure was to consider any person with an interest in the outcome of the trial to be incompetent as a witness.[16] Before 1900, however, most common-law jurisdictions had abolished the interested-party incompetency rules,[17] established the defendant's right to be in continual attendance at his trial,[18] and accepted the procedure-of-witness sequestration.[19] This created the dilemma. As a witness the accused could be sequestered, but as a defendant he had a right to stay in the courtroom. The federal courts and most states have resolved the dilemma by exempting the defendant from the sequestration rule.[20] Tennessee and Kentucky require the defendant to be the first defense witness or forego his right to testify.[21]

---

694 (2d Cir. 1919) (dictum); *cf.* State v. Lloyd, 152 Wis. 214, 139 N.W. 514 (1913). In *Lloyd* the trial court quashed the indictment against the accused. The appellate court ruled that the accused would have to stand trial on the conspiracy charge even though his only accused co-conspirator had been granted a *nolle prosequi*. The language of the opinion implies that this disposition of the co-conspirator's case did not have any bearing on the defendant's case.

[14] 9 W. HOLDSWORTH, A HISTORY OF ENGLISH LAW 130–31 (1926); Wigmore, *A General Survey of the History of the Rules of Evidence*, in 2 SELECT ESSAYS IN ANGLO-AMERICAN LEGAL HISTORY 691, 692 (1908).

[15] 6 J. WIGMORE, EVIDENCE § 1837 (3d ed. 1940).

[16] In a discussion of antiquated trial practices in England during the Victorian Period, Baron Bowen made the following comments regarding incompetency of witnesses:

> Perhaps the most serious blemish of all consisted in the established law of evidence, which excluded from giving testimony all witnesses who had even the minutest interest in the result, and, as a crowning paradox, even the parties to the suit themselves. "The evidence of interested witnesses," it was said, "can never induce any rational belief." The merchant whose name was forged to a bill of exchange had to sit by, silent and unheard, while his acquaintances were called to offer conjectures and beliefs as to the authenticity of the disputed signature from what they knew of his other writings. If a farmer in his gig ran over a foot-passenger in the road, the two persons whom the law singled out to prohibit from becoming witnesses were the farmer and the foot-passenger. In spite of the vigorous efforts of Lord Denman and others, to which the country owes so much, this final absurdity, which closed in court the mouths of those who knew most about the matter, was not removed till the year 1851.

Bowen, *Progress in the Administration of Justice During the Victorian Period*, in 1 SELECTED ESSAYS IN ANGLO-AMERICAN LEGAL HISTORY 516, 521 (1907); *see* G. RUDD, THE ENGLISH LEGAL SYSTEM 196 (1962); 1 H. UNDERHILL, CRIMINAL EVIDENCE § 160 (5th ed. 1956).

[17] 9 W. HOLDSWORTH, *supra* note 14, at 196.

A curious variant is discussed in 1 H. UNDERHILL, CRIMINAL EVIDENCE § 160 n.2 (5th ed. 1956): "Georgia remains an exception. [Ga.] Ann. Code 1937, §§ 38–415, 38–416. The accused may, however, make a statement in his own behalf, but not under oath, and on cross-examination he may decline to answer any or all questions." *But cf.* Ferguson v. Georgia, 365 U.S. 570 (1961).

[18] *See, e.g.*, Brown v. State, 24 Ark. 620, 627 (1867); Holton v. State, 2 Fla. 476, 500 (1849); Dougherty v. Commonwealth, 69 Pa. 286, 290–91 (1871).

[19] 2 H. UNDERHILL, CRIMINAL EVIDENCE § 510 (5th ed. 1956); 6 J. WIGMORE, *supra* note 15, § 1839; 13 RUTGERS L. REV. 610, 611 (1959).

[20] 6 J. WIGMORE, *supra* note 15, § 1841, at 364.

[21] KY. REV. STAT. § 421.225(2) (1963); TENN. CODE ANN. § 40–2403 (1955).

In the instant case the appellate court concluded that the defendant's conspiracy conviction was valid notwithstanding the lack of convicted co-conspirators. The court indicated that one co-defendant was still under indictment,[22] making a second conspiracy conviction a possibility, and that a second co-defendant had been granted a *nolle prosequi* which, the court held, was not an acquittal for purposes of abrogating the defendant's conspiracy conviction.[23]

On appeal the defendant alleged that the conspiracy conviction was erroneous because, of the seven defendants originally indicted, he was the only one remaining in the case. Four co-defendants had been acquitted; defendant Hewitt was still under indictment; and defendant Scoggins had been granted a *nolle prosequi.* Hewitt changed his plea to guilty before trial, claiming he could not afford an attorney. The trial court set aside his guilty plea and remanded his case to the docket because he was exonerated by trial testimony.[24] In this context the possibility that Hewitt would be convicted was doubtful, a fact tacitly recognized by the court. When the court upheld the defendant's conspiracy conviction, it emphasized Scoggins' *nolle prosequi* rather than Hewitt's pending indictment. Normally it would seem that the pending indictment would be emphasized rather than the *nolle prosequi.*

In the instant case the court's authority for determining that a solitary conspiracy conviction could be sustained by a *nolle prosequi* was based on *United States v. Fox.*[25] In *Fox* the defendant pleaded guilty to conspiracy. Subsequently, his accused co-conspirators were granted *nolle prosequis,* whereupon Fox moved to withdraw his guilty plea. The court in *Fox* said that a *nolle prosequi,* unlike an aquittal, was not a disposal of the indictment on the merits. Fox's co-conspirators could be retried, and therefore a *nolle prosequi* could support a solitary conspiracy conviction.[26]

---

[22] Instant case at 189, citing DeCamp v. United States, 10 F.2d 984, 985 (D.C. Cir. 1926), and United States v. Koritan, 182 F. Supp. 143, 145 (E.D. Pa.), *aff'd,* 283 F.2d 516 (3d. Cir. 1960).

[23] Instant case at 189, relying on United States v. Fox, 130 F.2d 56 (3d Cir.), *cert. denied,* 317 U.S. 666 (1942).

The court in *Fox* said:

> [T]he acquittal of the alleged conspirator does free the accused from further prosecution for the offense charged. The nolle prosequi does not. As in the case of disagreement of a jury, "The prisoner has not been convicted or acquitted, and may again be put upon his defense" . . . . It is a very considerable step which has to be taken to apply the rule as to acquittal to the termination of proceedings by a nolle prosequi.

Id. at 58 (footnotes omitted).

[24] Brief for Appellant at 2.

[25] 130 F.2d 56 (3d Cir.), *cert. denied,* 317 U.S. 666 (1942).

[26] The court in *Fox* reached the right result for the wrong reason. Existing case law supported two theories applicable to the *Fox* fact situation. First, a solitary conspirator's conviction can be sustained if it is based on a confession. *See* United States v. Lieberman, 8 F.2d 318 (E.D.N.Y. 1925); Commonwealth v. Edwards, 135 Pa. 474, 19 A. 1064 (1890) (dictum). Second, a conspirator's guilty verdict must be set aside if *nolle prosequis* have been granted the accused co-conspirators. State v. Jackson, 7 S.C. 283 (1876); Miller v. United States, 277 F. 721 (4th Cir. 1921) (dictum); Feder v. United States, 257 F. 694 (2d Cir. 1919) (dictum).

The *Fox* court should have relied on existing case law which considered a confession sufficient proof of guilt to override the requirement of plural convictions for conspiracy. Instead the court overruled what, at that time, was considered the better view, i.e., a *nolle prosequi* could not support a solitary conspiracy conviction. A 1931

In *Fox* and in the instant case, a *nolle prosequi* was considered to be sufficient support for a solitary conspiracy conviction. Generally, however, if acquittals were granted all accused and available co-conspirators, a solitary conspiracy conviction would have to be reversed. These two results seem to be logically inconsistent because there is an implicit assumption in these results that an acquittal is stronger proof of an accused co-conspirator's innocence than a *nolle prosequi.* Notwithstanding the legal finality the law accords a verdict of innocent, it does not necessarily follow that an acquitted party was not involved in a crime. All that can affirmatively be said is that the acquitted defendant was not guilty beyond a reasonable doubt. Reasoning from this premise it is difficult to see how a court can reverse a conspiracy conviction because all the accused conspirators have been found innocent (that is, they have not been found guilty beyond a reasonable doubt), but uphold a conspiracy conviction because a co-defendant has been granted a *nolle prosequi.* Frequently the prosecution moves for a *nolle prosequi* because it feels its case is too weak to obtain a conviction.[27] Under these circumstances the prosecution's case against the accused would probably be stronger in the case of the acquittal than in the case of the *nolle prosequi.* In the first instance the prosecution would feel there was a reasonable chance of conviction, while in the second the prosecution would not be willing to risk its case before a jury. It follows that a *nolle prosequi* granted a co-conspirator under these circumstances is less valid than an acquittal as a reason for upholding a solitary conspiracy conviction. Granting that it was within the court's dis-

---

A.L.R. annotation said, "a majority of the cases subscribe to the rule that, if the prosecutor enter a nolle prosequi as to one of two defendants accused of conspiracy, the other must be acquitted." Annot., A.L.R. 1180, 1187–88 (1931).

Fox was decided in 1942, and in 1963 another *A.L.R.* annotation stated, "The entry of a nolle prosequi as to all except one of the defendants to a charge of conspiracy will not ordinarily vitiate the conviction of the remaining defendant." Annot., A.L.R.2d 700, 711 (1963). The reversal of this point of law seems to have been largely the result of the *Fox* decision.

[27] People v. Covelli, 415 Ill. 79, 89, 112 N.E.2d 156, 161 (1953); United States v. Doe, 101 F. Supp. 609, 611 (D. Conn. 1951) (dictum).

The following quotation enumerates some uses of a *nolle prosequi*:

> (1) There is a statutorily prescribed use of a *nol. pros.* with leave in all criminal actions where an indictment has been pending for two terms of criminal court, the defendant has not been apprehended, and a *nol. pros.* has not been entered.
>
> (2) The solicitor may enter a *nol. pros.* with or without leave against one or more multiple defendants in a case in order to obtain testimony against co-defendants.
>
> (3) A *nol. pros.* with or without leave may be entered by the solicitor if he finds available evidence insufficient to support a conviction.

44 N.C.L. Rev. 1126, 1128 (1966).

The use of the North Carolina statute referred to in the foregoing quotation, to delay unduly a criminal prosecution, has recently been held to be unconstitutional as a violation of the 6th amendment right to a speedy trial. Klopfer v. North Carolina, 87 S. Ct. 988 (1967).

A *nolle prosequi* may also be utilized in a criminal case to excise one or more counts from a multiple count indictment. United States v. Rossi, 39 F.2d 432, 433 (9th Cir. 1930).

cretion to uphold the defendant's conspiracy conviction, it is submitted that a conditional verdict of guilty, or a reversal would have been a better result.[28]

The most serious fault with the practice of granting an accused co-conspirator a *nolle prosequi* in a conspiracy trial is the possibility of abuse by the prosecution. Consider the problems of an accused conspirator confronted at trial with the testimony of an accused co-conspirator who has been granted a *nolle prosequi*; the transformation from a friendly to a hostile witness is apparent.[29] The accused co-conspirator is no longer actively interested in establishing his innocence. In addition if there is no allegation of other conspirators known or unknown, for purposes of establishing the defendant's guilt the law *assumes* the co-conspirator's guilt.[30] Inasmuch as the defendant may be innocent, it does not seem unreasonable to require that the prosecution obtain conviction of both alleged conspirators.

Under the precedent of the instant case a prosecutor can avoid the problem of the solitary conspiracy conviction by entering a *nolle prosequi* as to one accused co-conspirator. More specifically, the prosecution may have granted a *nolle prosequi* to Scoggins as a means of avoiding the problem which would have been created by having all of the defendant's accused co-conspirators found innocent as the result of trials on the merits. In order to avoid this particular abuse in the future it is proposed that a *nolle prosequi* should not be allowed to support a solitary co-defendant's conspiracy conviction.[31]

In sustaining the trial court's ruling which required the defendant to be his own first witness, the appellate court held that the order of appearance of the defendant as a witness was a matter within the discretion of the trial

---

[28] The court might have considered the defendant's conspiracy conviction to be conditional until final disposal of the indictment against Hewitt and the *nolle prosequi* against Scoggins. Justification for such a ruling can be found in People v. Levy, 299 Ill. App. 453, 20 N.E.2d 171 (1939); Commonwealth v. Faulknier, 89 Pa. Super. 454 (1926); Casper v. State, 47 Wis. 535, 2 N.W. 1117 (1879). Inasmuch as the defendant was sentenced to two concurrent sentences of three years, conditional reversal of one would not have presented any necessity for determining whether the defendant should have been freed during the pendency of the action against Hewitt and Scoggins.

[29] For an illustration of the problem see Cline v. State, 204 Tenn. 251, 319 S.W.2d 227 (1958).

[30] An even more unjust result occurs when a solitary conspiracy conviction is upheld because the indictment included "persons to the grand jurors unknown." In this instance for purposes of the solitary conspiracy conviction the law assumes the unknown persons are guilty. The obvious question is, how can you justify the assumption of guilt of a conspirator when you can not produce enough evidence to identify him?

[31] The basic fault with this limited suggestion is that it only treats a symptom, rather than the disease, i.e., conspiracy. A discussion of "What's Wrong With Conspiracy" is outside the scope of this case note; however, it seems appropriate to suggest that the best way to cure the many ills of conspiracy is by surgery; eliminate it entirely. It is submitted that the following, and in many cases, overlapping, crimes are adequate to supplant conspiracy, without being infected by the many ills common to conspiracy: solicitation, instigation, inducement, incitement, attempt, aiding and abetting, accessory before the fact, and accessory after the fact.

Any inchoate or preparatory criminal activity which is not indictable under one of these crimes is probably innocuous enough to be ignored, and if not it could be the subject of special statutory enactment which hopefully would include rules of evidence applicable to the specific crime involved.

For a brief discussion of the crime of conspiracy which infers that the wide utilization of conspiracy in the United States is unnecessary, *see* Wagner, *Conspiracy in Civil Law Countries*, 42 J. CRIM. L.C. & P.S. 171 (1951).

judge. The seven cases cited[32] in the opinion to support this conclusion are all distinguishable from the instant case for two reasons. First, the cited cases merely hold that the order of admission of evidence is within the discretion of the trial judge. It must be recognized that there is an important difference between the order of admission of *evidence* and the order of appearance of *witnesses*. Witnesses produce evidence; the reverse is not true. To the extent that the judge controls the order and substance of evidence introduced at trial he will have control over a witness' testimony, but it does not follow that the judge has any authority to tell trial counsel when he must call any particular witness, or to dictate order in which he must call a group of witnesses. Thus, the instant case represents a substantial extension of the law. In the instant case there was no allegation that the trial judge erred in ruling on the order of introduction of evidence, nor indeed did the defendant quarrel with the court's authority to specify when each defendant must present his case in reply. Rather, the defendant contended that the trial judge exceeded his authority when he ruled that the defendant be the first defense witness or sacrifice the right to testify.

Second, the cited cases applied to the presentation of the prosecution's case in chief, rather than the presentation of the defendant's case in reply. Certainly in this country the defense strategy, including the order of appearance of defense witnesses, is customarily left to the discretion and control of the defendant's counsel.[33] In the instant case this extension of existing case law which permits the court to dictate to the defendant when he must testify, if he is to testify at all, is at best an abuse of judicial discretion and at worst a violation of the defendant's right to due process.[34] This conclusion stands unrebutted by the opinion because the court did not explain its reasoning in extending the holdings in the cited cases from the judge's authority to control the order of presentation of evidence to the order of appearance of the defendant as a witness.

---

[32] Strauss v. United States, 311 F.2d 926 (5th Cir.), *cert. denied*, 373 U.S. 910 (1963); United States v. Copeland, 295 F.2d 635 (4th Cir. 1961), *cert. denied*, 368 U.S. 955 (1962); Cwach v. United States, 212 F.2d 520 (8th Cir. 1954); Braatelien v. United States, 147 F.2d 888 (8th Cir. 1945); United States v. Manton, 107 F.2d 834 (2d Cir. 1938); Tingle v. United States, 38 F.2d 573 (8th Cir. 1930); Cohen v. United States, 157 F. 651 (2d Cir. 1907).

[33] *Cf.* United States *ex rel.* Dorcy v. Handy, 203 F.2d 407, 427 (3d Cir. 1953), *aff'd*, 351 U.S. 454 (1956); Coplon v. United States, 191 F.2d 749, 760 (D.C. Cir. 1951), *cert. denied*, 342 U.S. 926 (1952); Cass v. Commonwealth, 236 Ky. 462, 33 S.W.2d 332 (1930).

[34] In Edwards v. United States, 312 U.S. 473, 482 (1941), Mr. Justice Reed said:

> The refusal to permit the accused to prove his defense may prove trivial when the facts are developed. Procedural errors often are. But procedure is the skeleton which forms and supports the whole structure of a case. . . . The parties must be given an opportunity to plead and prove their contentions or else the impression of the judge arising from sources outside the record dominates results. The requirement that allegations must be supported by evidence tested by cross-examination protects against falsehood. The opportunity to assert rights through pleading and testimony is essential to their successful protection. Infringement of that opportunity is forbidden.

Cf. 1 P. MATTHEWS, HOW TO TRY A FEDERAL CRIMINAL CASE § 336, at 476–77 (1960); H. SILVING, ESSAYS ON CRIMINAL PROCEDURE 196, 206 (1964).

In addition, the court failed to address itself to *Nassif v. District of Columbia*[35] and *Bell v. State*,[36] two cases directly in point. Both cases dealt with appeals from trial court decisions requiring the defendant to be the first defense witness or not testify. The *Nassif* and *Bell* courts overruled the trial judges and remanded for new trials. The *Nassif* opinion was based almost entirely on *Bell* and made the observation that "in its seventy-five years of existence . . . [the *Bell* opinion] has not been disapproved by any other court."[37] *Bell* was grounded on the defendant's right in a felony trial to make a "free and unrestricted choice"[38] whether and when he would testify; this decision being "beyond the control or discretion of the presiding judge."[39] The court in the instant case ignored *Nassif* and *Bell* and relied on seven cases it was not obliged to follow, all of which were clearly distinguishable.

The court's inability to qualify a defendant as a witness by sequestration because he has a right to continual trial attendance does create a dilemma, but the trial court's resolution was improper. The authority given a federal judge to comment on evidence should have been sufficient to solve the problem.[40] The judge could have called the jury's attention to the fact that the defendant testified after hearing the testimony of other witnesses and instructed them to weigh the defendant's testimony accordingly. To counterbalance any disadvantage that might accrue to the defendant from this procedure, the defendant should have the option of self-sequestration to reinforce the impression his testimony might make on the judge or jury.[41]

---

[35] 201 A.2d 519 (D.C. Ct. App. 1964).

[36] 66 Miss. 192, 5 So. 389 (1889).

[37] Nassif v. District of Columbia, 201 A.2d 519, 520 (D.C. Ct. App. 1964).

[38] Bell v. State, 66 Miss. 192, 5 So. 389 (1889).

[39] *Id.*

[40] Although state court practices vary widely, federal judges are given considerable latitude in making comments on evidence. One author says: "Federal judges are allowed to and do comment on the weight and credibility of the evidence in the case before them. And so long as the ultimate conclusion is left to the jury [judicial commentary] . . . is not error." 1 P. MATTHEWS, *supra* note 34, § 439.

Two recent cases, Battle v. United States, 345 F.2d 438 (D.C. Cir. 1965), and Hardy v. United States, 335 F.2d 288 (D.C. Cir. 1964), reversed district court decisions because of comments made by the trial judge. The limits set forth in those cases, however, would not preclude comment by the trial judge in a federal district court to the extent suggested here.

[41] Although it does not appear to have been the subject of a federal court ruling, the propriety of a defendant's self-sequestration does not seem to present any logical objections, provided such sequestration is volitional, in good faith, undertaken with the court's approval, and upon motion by the defendant.

A competing consideration may be a technical concern with the sixth amendment right of an accused person to attend trial. This seems relatively inconsequential; the defendant's request that he be allowed to sequester himself would constitute a waiver of his right to continual trial attendance. *Cf.* Daniels v. Baldwin, 115 Cal. App. 2d 487, 489, 252 P.2d 351, 352 (1953).

In the future, the order of a defendant's appearance as a defense witness should be controlled by the *Nassif-Bell* rationale rather than the instant case.[42] In a federal court any other criminal trial procedure is inconsistent with the defendant's rights.[43]

J.R.G.

[42] Obvious current exceptions are Tennessee and Kentucky, where the order of the defendant's appearance as a witness is governed by statute. KY. REV. STAT. § 421.225(2) (1963); TENN. CODE ANN. § 40–2403 (1955).

[43] This may present a stare decisis problem in the Sixth Circuit, but the equivocating language in the last paragraph of the majority opinion affords an adequate basis for distinguishing future cases:

> Although we do not hold that it is a desirable or permissible practice in all cases to require that a defendant who elects to testify on his own behalf must take the stand before any other proof is introduced, we are unable to say that the district court abused its discretion or committed prejudicial error in prescribing this order of proof in this case.

Instant case at 190.

THE UTAH LAW REVIEW

Printed on campus by the

UNIVERSITY PRINTING SERVICE

PRINTING • DUPLICATING • LITHOGRAPHING

TRACY-COLLINS
BANK & TRUST COMPANY
Organized in 1884

COMPLETE
BANKING and TRUST
SERVICES

TRACY-COLLINS BANK & TRUST CO.

Member Federal Deposit Insurance Corporation

151 South Main Street • 475 East 2nd South

4707 Holladay Blvd. • 888 East 45th South