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FOREWORD

A CHANGING TRANSPORTATION POLICY FOR THE 1980'S

BROCK ADAMS*

Since members of the 96th Congress took office, attention has focused increasingly on the nature and need for a transportation policy for the 1980's. In this Foreword, former Secretary of Transportation Brock Adams outlines his concerns for any such policy. Among other things, he suggests that the new market-oriented transportation systems should be focused on transporting people as well as on the shipment and receipt of commodities.

The former Secretary points out that the desire for individual mobility coupled with the power of the auto industry has left auto transportation virtually unrestrained. He therefore argues that any transportation policy for the next decade must de-emphasize such a laissez faire *attitude toward the movement of people in favor of a more comprehensive legislative and administrative effort to develop such projects as automatic people movers, new subway systems, express lanes for buses and carpools, and fuel efficient autos.*

As this article goes to print, the 96th Congress has already started making the legislative changes that will create a new transportation policy for the 1980's.** By November 1980, the new pattern will be more definite; but even now, it is clear that old days and ways are over.

The public debate on U.S. transportation policy has moved from scholarly economic and legal arguments, expounding free market management as opposed to public utility-type regulation, to a bruising legislative battle between affected interests.

This new phase started in the middle 1970's with an early announcement by the Carter Administration that it favored economic deregulation of the airlines. This was followed by the nomination of appointees to the Civil Aeronautics Board who used the powers of the agency to achieve this goal. This soon led to pressure on Congress either to shape the future of the rapid regulatory changes initiated by the new Board, or abandon the field. Thus the stage was set for the sweeping changes in transportation policy now being debated in Congress. These changes will

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** The trucking and rail deregulation legislation discussed in this article was enacted recently.

drastically alter the legal and managerial systems that direct the flow of people and goods in the United States.

I welcome the move from scholarly discussion to action, because it enables those who formulate a transportation policy to concentrate on a limited set of clear objectives. We can now move from theoretical discussions and policy papers into active implementation of our transportation goals.

The modern policy debate started with a report by the Secretary of Commerce in 1960 to President Eisenhower and Congress.[1] The debate over policy intensified during the 1960's, and the first attempt at establishing a means for coordinating the government's pursuit of uniform transportation goals was the creation of a Department of Transportation in 1968. The statute establishing the Department[2] contemplated that the Department would define the nation's transportation policy and implement it in all areas, except water transport.[3]

The first Secretary, Alan Boyd, organized the Department and advocated consolidation of all transportation-related programs in one Department. The next two Secretaries, John Volpe and Claude Brinegar, each attempted to articulate existing policy while advocating change. However, they could never achieve agreement within the Executive Branch, much less the consensus of the total government. In 1975, my predecessor in office, William T. Coleman, abandoned further attempts to define transportation policy through theoretical discussions. Instead, he produced a massive work on transportation trends and choices that might be available between now and the year 2000.[4] This document was intended to be an all-encompassing work that dealt with not only freight movement, but also the movement of people by automobile and air and the manner in which this might be funded by user charges. Although this document did not arrive at any final conclusions, or

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1 Federal Transportation Policy and Program, U.S. Department of Commerce, March 1960.

2 Department of Transportation Act, Pub. L. No. 89-670, 80 Stat. 931 (1966), 49 U.S.C. §§ 1651-1659 (1976).

3 Section 7(a) of the Department of Transportation Act, 49 U.S.C. § 1656(a) (1976).

4 National Transportation Trends and Choices, U.S. Department of Transportation, January 1977.

establish a specific transportation policy, it provided a useful analysis of current trends, as well as choices for future transportation policy.

During this time, the Congress became impatient with the lack of a specific policy statement and established its own commission to write a transportation policy for the nation. I was a member of the original commission while still in Congress and followed its activities closely when I moved from Congress to the Executive Branch. After nearly five years of work, this group issued a lengthy report setting forth general policy guidelines, but seeking no specific legislation.[5]

After spending many hours reviewing hundreds of documents and staff proposals on how to write a policy document, I decided that "policy is what policy does." I concentrated on attempting to create new policies, first by using already authorized administrative powers, and then by making specific legislative proposals. A summary of activities within the Department from 1977 to 1979 is set forth in the National Transportation Report issued in January 1979.[6]

The strategy of legislative and administrative action formulated by the Department of Transportation is now fully operational. A complete report on new policy must wait until at least the end of the 96th Congress, but for those who want to participate, the time is now.

I believe there is always a transportation policy in effect in the United States. We make it too complicated by trying to describe it in detail and by not recognizing the different policy considerations involved in the movement of goods and the movement of people.

The major debate concerning the movement of goods has focused on policy statements in existing legislation and the interpretation of these statements by the Interstate Commerce Commission and the courts. Policy statements in the statutes establishing the Interstate Commerce Commission,[7] the Civil

5 Report of the National Transportation Policy Study Commission, Bud Shuster, Chairman, June 1979.

6 National Transportation Report, Two Years of Accomplishments, January 1977 - December 1978, U.S. Department of Transportation, January 1979.

7 Section 11 of the Interstate Commerce Act, 24 Stat. 383, 49 U.S.C. § 11 (1976).

Aeronautics Board,[8] and the Federal Maritime Commission[9] have been used by these agencies and the courts to fill in gaps in the governing statutes to the benefit (or detriment) of a particular party. The debate on the movement of people focused on the automobile versus mass transportation over short distances, and auto versus bus, rail and later air for longer distances. The movement of people has been generally unregulated, with policy directed toward financial incentives and urban initiatives, rather than regulatory statutes.

The legislative debates in the 95th Congress on air transport and in the 96th Congress on surface transport have been tied together by the common theme of a reduction in government regulation and the substitution of more free market management.

The deregulation activity in 1978 began with a series of specific administrative policy changes by CAB Chairman Alfred Kahn that tilted the system toward the free market approach. This started the public debate on whether free market economics (the so-called deregulation movement of today backed by most economists) or the transportation system approach (backed by most in the transportation business) should be the national policy with respect to modes of transportation other than air transport.[10] When the administrative actions of the CAB were followed by successful Administration-backed efforts in Congress to pass legislation deregulating the airline industry, the momentum for legislative change spread to other sectors of the transportation industry.

The success of airline deregulation carried through from the 95th Congress and produced a call in the 96th Congress for change in the regulation of the movement of surface freight. The major impetus for congressional action, however, was the realization that the ICC was already moving to create a new, more competitive market for freight transportation. Those who had called for a single comprehensive transportation policy for the movement of goods during the last two decades were those who had lived with the various statutes designed to establish stability in the industry or to prevent monopolization of sectors of the transportation system

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8 Section 201 of the Civil Aeronautics Act of 1938, re-codified at 49 U.S.C. §§ 1321-1325 (1976).

9 Reorganization Plan No. 7 of 1961, 84 Stat. 1036.

10 Note 4 *supra*.

in order to protect businesses dependent on it. Regulation of air transport was originally directed primarily to aircraft safety rather than economics.[11] Conversely, regulation of surface transportation was based on an underlying economic assumption that the transportation industry is a basic public utility and that there should be strict rules governing the market. These rules sometimes controlled the movement of people (*i.e.,* railroads and aircraft), but generally the movement of people was regulated by the federal government only with respect to safety. Thus movement of people by automobile, mass transit, ferryboats, and private planes does not involve federal economic regulation. It is therefore necessary in analyzing changes presently proposed in transportation law to separate the detailed economic regulation of the movement of goods from the largely unregulated movement of people.

I. Transportation Legislation and the Movement of Goods

Much has been written over the years, describing and analyzing the statutes and regulations which govern rail, truck and air transportation. It is not the purpose of this Foreword to provide a detailed review of the development of transportation law in this country. Rather, this article is intended to focus on the significant changes in the traditional, public utility-type regulatory statutes that are currently being debated. Such changes are reflected in recent appointments to the Civil Aeronautics Board, Interstate Commerce Commission, and Federal Maritime Commission, as well as in the rail and truck legislation designed to reduce regulation and the power of regulators.

Although there have been railroad bills passed at regular intervals since the collapse of the Penn Central,[12] most of these were intended to assist the railroads by loosening regulation, not by making drastic changes in traditional regulation. Congress has taken

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11 Regulations of the Federal Aviation Administration, Code of Federal Regulations, Title 14, Parts 1-199 (1979); Regulations of the Civil Aeronautics Board, Code of Federal Regulations, Title 14, Parts 200-399 (1979).

12 Rail Passenger Service Act of 1970, Pub. L. No. 91-518, 84 Stat. 1327 (1970), 45 U.S.C. §§ 501-645 (1976); Regional Rail Reorganization Act of 1973, Pub. L. No. 96-236, 87 Stat. 985 (1974), 45 U.S.C. §§ 701-794 (1976); Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31 (1976), 45 U.S.C. §§ 801-854 (1976).

up the issues of rail and truck deregulation this session. A trucking deregulation bill embodying many of the reforms urged by economists passed both houses and was signed into law by the President early in July.[13] The initial Senate version of the bill gave more play to market forces than did the House bill. The legislation that emerged, though not so pro-competitive as the upper chamber's proposal, nonetheless eased entry restrictions considerably, introduced significant flexibility into ratemaking, removed much of trucking's antitrust immunity, and dismantled many of the cumbersome and energy-squandering route restrictions that have been the focus of so much criticism in recent years.

Senator Cannon, chairman of the Senate Committee on Commerce, Science and Transportation, and Congressman Florio, chairman of the Transportation Subcommittee of the House Interstate and Foreign Commerce Committee, have indicated that they expect a rail bill to pass as well. Even if the legislation does not pass or does not go so far as some reformers would wish, however, de facto "deregulation" is occurring in the form of recent decisions and administrative changes at the Interstate Commerce Commission.

Because of this de facto "deregulation," the momentum has changed and now support for the enactment of legislation to limit the agencies is coming from those being regulated. These groups previously have directed their energies toward maintaining the status quo so successfully that earlier rail and truck deregulation bills have not even cleared Committee. This change is attributable to the position of the Carter Administration, as well as to the general groundswell of support throughout the country for reduction of government regulation.

Transportation policy has also been dramatically affected by completion of most of the interstate highway system and the development of new types of technology for the carriage of goods, such as the sophisticated truck, the rail car capable of carrying containers transferred from ship or truck, and the real-time railroad system, which can more efficiently keep track of the movement of rail cars. These technological advances, combined with new ICC policies, Administration support and a public senti-

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13 Motor Carrier Act of 1980, Pub. L. No. 92-296, 96th Cong., 2d Sess. (1980).

ment that there is too much government regulation, have created an atmosphere in which dramatic changes in rail and trucking regulation are a real possibility.

The Senate Report and floor debate reflect the desire of the Senate to produce a rail bill that would free the railroads from rate regulation, establish through routes, and reduce regulation of mergers and acquisitions.[14] The House bill on rail deregulation takes a different approach on some issues, such as railroad accounting, but also provides for free market pricing within a zone of reasonableness and other free market-type activities. Both the House and Senate rail bills are directed toward phasing out general rate increases, the traditional public utility-type percentage increases throughout the industry. Instead the legislation mandates a move toward individual management over market-type pricing.[15]

I believe we do need a reduction in regulation to streamline the cumbersome and often inefficient system that has resulted from nearly 100 years of railroad regulation and over 40 years of truck regulation. Because of the enormous size and diversity of the transportation industry, government regulators are no longer able to regulate quickly and efficiently the millions of rates, routes and restrictions on commodities involved in the literally billions of transactions that take place in the transportation system of America every year. This means that applications are delayed because of huge backlogs, or are simply denied due to lack of staff, thereby discouraging innovation in the industry. Even with increased staff, it might well be questioned whether such a huge regulatory system can be efficiently and equitably managed within our political and socio-economic systems. I do not, however, adhere to the pure free-market theory of transportation policy espoused by many not fully familiar with transportation economics. Complete deregulation of the movement of goods would remove the legal impediments to predatory pricing or other abuses by enterprises with substantial market power. The group that is able either to prevent the movement of a competitor's goods or to cause the movement to be priced at an artificially high rate is able effectively to dominate the market. The competition for the transportation of goods is more susceptible to such dominance

14 126 CONG. REC. S3271 (daily ed. April 1, 1980).

15 S. 1946, 96th Cong., 2d Sess. (1980); H.R. 7235, 96th Cong., 2d Sess. (1980).

than the competitive production of goods in the normal market situation.

This is not to say, however, that every movement of commodities, every rate and route, must be regulated or approved. Instead, we should be moving to establish greater freedom in entry and rate setting, and a lessening of restrictions on routes that can be traveled and commodities that can be hauled. But we should continue to prohibit discrimination between shippers and protect the victims of such discrimination by a complaint procedure through a regulatory body that can enforce sanctions against monopolistic practices. I believe the present bills are moving in the right direction on route and rate freedom. I have serious doubts, however, as to whether our antitrust laws alone provide a sufficient safeguard against the misuse of economic power in the transportation industry. Antitrust enforcement procedures move far too slowly to deal effectively with an immense and rapidly changing transportation system which has thousands of units and an ever-changing price structure. Protracted litigation and crowded court dockets preclude the speedy resolution of claims of discrimination or monopoly. In addition, actions by the Justice Department in transportation matters, such as attempts to establish American antitrust laws as the transportation law for international aviation and maritime operations, have not resulted in any clear benefit.

I believe Congress will pass legislation reducing the regulation of the movement of goods, not because of the ideological arguments of the free-market advocates, but because it is incumbent upon us to reduce and improve burdensome government regulation so that the transportation system can function efficiently. This is particularly true for the highly-regulated railroads, which are operating under de facto price controls and are sustaining daily losses because they are not allowed to respond to the dictates of the marketplace. The trucking industry has had greater rate freedom, and is more volatile because of the relatively easy movement of companies in and out of the business. There must be great care exercised to balance entry, rate and route changes so as not to jeopardize this transport system which maintains the flow of goods throughout the country. It is my hope that whatever legislation is

passed will recognize that the transportation system is a service industry and, therefore, very different from manufacturing industries.

In the early 1970's, I was one of a number of congressmen who attempted to make changes in the regulation of rail, truck, and water modes of transportation through various legislative proposals. At that time, I developed a simple statement of national transportation policy in a speech to the National Industrial Traffic League — a policy which is reflected in the current legislation:

> The Nation's transportation policy should be directed toward creating and maintaining a privately-owned and operated, intermodal, interstate system regulated by the Federal Government in the public interest. The regulations should be uniform for all modes and the degree of regulation should vary with the degree of monopolization existing at any particular point in the system. Government regulations should thus take into account the importance of both transportation and shipping units in a particular market, with competition allowed to set individual prices above cost where neither shippers nor the industry have power to control rates and quality of service. Otherwise, the ceiling on rates will all be set publicly by governmental regulation.

II. TRANSPORTATION OF PEOPLE

Transportation policy for moving people has never received the degree of scrutiny applied to the movement of goods. The movement of goods was subject to early abuses, such as the use of rail transportation to control the oil industry or discrimination against western grain and other bulk products through long-haul/short-haul practices. In contrast, the movement of people, whether by walking, horseback, flat riverboats, trains, cars, or planes, was always largely seen as an individual activity not subject to abuses which would warrant governmental concern. Indeed the right to unhampered personal mobility is deeply rooted in the American character and is protected just as ardently as other individual rights.

During the last 40 years, as the automobile replaced all other forms of public movement, the desire for unrestrained individual mobility, coupled with the power of the auto industry, resulted in

minimal regulation of auto transportation. After World War II, this de facto transportation policy permitted the automobile virtually to destroy many public transportation systems across the country. In our country today, a person's car is virtually an extension of his home. Persuading the American people to break the automobile habit and to build and use public transportation presents a formidable challenge.

The only challenge to auto supremacy was the airplane, for the obvious reason that it is better-suited to the long-distance travel required by this country's size. But even the airplane was not capable of competing with the automobile for group travel, since a family of four, if they were willing to take the time, could pack up a single automobile and travel across the country for a price much less than that demanded by the airlines. Those travelling on business or under time constraints, however, began to shift to aircraft.

The advent of the wide-bodied airplanes in the 1970's created a "flying bus" which has become more and more competitive with the automobile. The primary reason it has not captured even more of the market is that the public ground transportation at takeoff and landing points is so inadequate that many people still use the automobile in order to move quickly and efficiently throughout their journey.

During the 1960's, the government recognized that the great cost of public highways, the consumption of vast amounts of petroleum, and the growing problem of air pollution and general traffic congestion meant that the free use of individual automobiles could not be sustained. Since private enterprise was both unwilling and unable to finance a public transportation system, government funding, and initiative were needed. Related legislation was passed in the mid-1960's and 1970's, reflecting the ever-increasing demands of environmental groups, urban planners, and those interested in conserving oil that more money be spent on public transportation to alleviate the harmful effects of auto transport.

The American people continued to resist using public transportation systems until the oil shortages of the 1970's and dangerous levels of air pollution compelled changes in individual transportation. Increasing amounts of money are being devoted to public transportation in an effort to provide alternatives to individual automobile traffic. Nevertheless, these amounts have not been

adequate. It has long been my position that revenues from a gasoline tax, an oil import tax, or a refining tax should be devoted mainly to research and development of different types of vehicles, such as hybrid electric/oil vehicles, true electrics, or any other type of individual transport vehicle. Our transportation policy for the 1980's should combine this type of research with a sustained effort to produce new and viable bus and urban rail transportation systems. This goal was advanced in the 1970's by the Department of Transportation's attempts to develop Transbus, a more efficient and comfortable bus. Innovative projects and concepts, such as automatic people movers, new subway systems, express lanes on freeways for buses and carpools, should all be part of a legislative and administrative effort to develop and implement this new policy.

Moreover, this policy leaves ample room for responsible use of individual automobiles, thus accommodating energy and environmental considerations, with individual freedom of movement. Our policy should include the promotion of smaller, safer, more fuel-efficient and pollution-free automobiles. This goal was advanced in 1977 and 1978 by both Congress and the Department of Transportation with the issuance of fuel economy standards that were significantly higher than those urged by the automobile industry.

Implementation of these policies will require a change in our heretofore *laissez-faire* attitude toward the movement of people. Nevertheless, I believe this area will continue to be less regulated than the movement of goods; incentives will be in the form of federal funding rather than regulations, with the continued exception of safety regulations.

Sweeping changes in U.S. transportation policy are starting this year in the 96th Congress. There is a tremendous challenge for lawyers who are prepared to break with the old ways and to adapt to this new more market-oriented transportation system as it develops. It is important that those involved in shipping and receiving goods, as well as those transporting people, should follow these actions closely and start now making preparations for a fundamentally different policy that will evolve from the changes in legislation moving through Congress this year.

CHANGING THE TAKEOVER GAME: THE SECURITIES AND EXCHANGE COMMISSION'S PROPOSED AMENDMENTS TO THE WILLIAMS ACT

JAMES H. FOGELSON*
JOANNE R. WENIG**
BRIAN P. FRIEDMAN***

During the past decade, takeovers of public companies have become a major facet of American business activity and the preeminent mode of corporate expansion and diversification. Scarcely a month has passed in recent years during which a major takeover bid has not been announced. Many of the larger and more highly-publicized bids have involved vigorously contested struggles for corporate control.

Although Congress enacted the Williams Act in 1968 and amended it thereafter to protect securityholders confronted with tender offers and other acquisitions of beneficial ownership, members of the Senate Banking Committee recently requested that the Securities and Exchange Commission review the adequacy of that protection. The Commission conducted such a review and on February 15, 1980, submitted a proposed bill to the Committee which would effect major changes in the law. In the opinion of the authors of this Article, the general aims of the Commission's legislative proposals are to force virtually all meaningful acquisitions to be effected with pre-acquisition notice and to create exclusive federal jurisdiction in the acquisition area. While the proposed bill is formulated in terms of amendments to the Williams Act, it represents a clear departure from the scheme of regulation provided for in the existing statute. The authors suggest that there are several shortcomings in the Commission's proposals and recommend certain alternative approaches. They conclude that the Commission may be proposing an over-simplified and unduly restrictive regulatory scheme in an area that is complex and rapidly changing.

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Introduction

In July 1979, Senators Proxmire, Williams, and Sarbanes of the Senate Banking Committee requested that the Securities and Exchange Commission (Commission) review "the adequacy of existing law and policy" in seven areas relating to tender offers:[1] the role of banks in tender offers; repurchases by a company of its own securities, or "issuer repurchases"; the scope of the Williams Act;[2] filing requirements; the "best price rule";[3] the relationship between state and federal tender offer regulation; and enforcement of the Williams Act. In his response dated February 15, 1980, Commission Chairman Harold M. Williams noted that the Commission's review had led it to the conclusion that "significant legislative action is warranted to correct abuses found in several of those areas."[4] The Commission therefore submitted with Chairman Williams' response a draft of a proposed bill to amend the Williams Act.[5]

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1 Letter from Senators Proxmire, Williams, and Sarbanes requesting Securities and Exchange Commission views on tender offer laws (July 3, 1979), *reprinted in* Legislative Proposals on Tender Offers, Beneficial Ownership, Issuer Repurchases, 542 SEC. REG. & L. REP. (BNA) SPEC. SUPP. 3 (Feb. 27, 1980) [hereinafter cited as Committee Letter].

2 Securities Exchange Act of 1934 §§ 13(d), 13(e), 13(g), 14(d), 14(e), & 14(f), 15 U.S.C. §§ 78m(d), 78m(e), 78m(g), 78n(d), 78n(e), & 78n(f) (1976). *See* discussion at § I *infra.*

3 Section 14(d)(7) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(d)(7) (1976), has become known as the "best price rule." That section specifically requires that when an offeror increases the amount of consideration offered in a tender offer, the higher consideration be paid to all securityholders who tendered their securities before the increase. The Senate Banking Committee's specific concern in connection with the best price rule was "whether the wording of Section 14(d)(7) should be specifically amended to confirm that it requires any person making a tender offer to pay the same consideration to all sellers pursuant to the tender offer." Committee Letter, *supra* note 1, at 4. For a discussion of the Commission's response to this concern, *see* § II (D) (4) *infra.*

4 Letter from Chairman Williams to Senator Proxmire (Feb. 15, 1980), *reprinted in* Legislative Proposals on Tender Offers, Beneficial Ownership, Issuer Repurchases, 542 SEC. REG. & L. REP. (BNA) SPEC. SUPP. 2 (Feb. 17, 1980) [hereinafter cited as Williams Letter].

5 Proposed Bill to Amend Williams Act, *reprinted in* Legislative Proposals on Tender Offers, Beneficial Ownership, Issuer Repurchases, 542 SEC. REG. & L. REP. (BNA) SPEC. SUPP. 20 (Feb. 27, 1980) [hereinafter cited as Proposed Bill]. Along with the proposed bill, the Commission submitted a section-by-section analysis of the bill, Section-by-Section Analysis of Proposed Bill, *reprinted in* Legislative Proposals on Tender Offers, Beneficial Ownership, Issuer Repurchases, 542 SEC. REG. & L. REP. (BNA) SPEC. SUPP. 23 (Feb. 27, 1980) [hereinafter cited as Section Analysis], and two reports discussing the present state of the law and need for revision, the first on bank financing of tender offers, SEC Memorandum on Bank Financing of Tender Offers, *reprinted in* Legislative Proposals on Tender Offers, Beneficial Ownership, Issuer Repurchases, 542 SEC. REG. & L. REP. (BNA) SPEC. SUPP. 5 (Feb. 27, 1980) [hereinafter cited as Bank Memorandum], and the second on the other six

The highlights of the Commission's legislative proposals include:

— a new approach to the concept of "tender offer," which would make the formal tender offer provisions of the Williams Act generally applicable to acquisitions of ten percent or more of a company's equity securities and to most acquisitions by persons (including officers and directors) who have previously acquired a ten percent position;[6]

— a requirement that securityholders owning more than five percent of a class of a company's equity securities make a public announcement within one business day after reaching the five percent level, file an information statement within five business days and refrain from making further acquisitions until two business days after the filing is made; a similar requirement that securityholders who must file an amendment to their information statements disclosing a material change in the information previously filed do so within five business days of such material change and refrain from making further purchases until two business days after the amendment is filed;[7]

— a requirement that the identity of any bank with a present or prior commercial relationship with the company sought to be acquired, which bank is involved in the financing of a tender offer, be disclosed; and a grant of authority to the Commission to regulate the activities of commercial banks, investment bankers, financial advisers, securities analysts, and arbitrageurs;[8]

— an express preemption of state takeover laws;[9] and

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areas that were reviewed, SEC Memorandum Proposing Amendments to Williams Act, *reprinted in* Legislative Proposals on Tender Offers, Beneficial Ownership, Issuer Repurchases, 542 SEC. REG. & L. REP. (BNA) SPEC. SUPP. 12 (Feb. 27, 1980) [hereinafter cited as SEC Memorandum].

6 *See* § II(C) *infra.*

7 *See* § II(B) *infra.*

8 *See* § II(F) *infra.*

9 *See* § II(E) *infra.*

— the creation of express statutory private rights of action for damages or equitable relief for the offeree company's securityholders, the offeree company itself, and any defeated offeror.[10]

The Commission's proposals are important for several reasons. First, if they are enacted as presently drafted, they will effect major changes in the laws governing corporate takeovers. Second, in proposing that provisions contained in the Commission's recently adopted tender offer rules[11] and certain of its proposed rules[12] be placed in the statute, the Commission may be responding to questions raised as to its authority to promulgate such rules under the present statute;[13] at the very least, the Commission is clearly indicating that such major changes would more appropriately be effected through legislation. Third, because the Senate Banking Committee requested the recommendations and is therefore presumably interested in initiating legislative action in the takeover area, the Commission's proposals are likely to have a significant impact on any final legislation.[14] Finally, the Commission's proposed bill, even if never adopted, is a significant indicator of the Commission's thinking in the area of takeover regulation.

I. The Williams Act

In 1968, Congress enacted the Williams Amendments[15] to the Securities Exchange Act of 1934 (Exchange Act),[16] which added sections 14(d) and (e)[17] to regulate tender offers, and sections 13(d) and (e)[18] to require disclosure of substantial acquisitions of equity securities. This section reviews the statutory and ad-

10 *See* § II(H) *infra*.
11 *See* notes 47 to 64 and accompanying text *infra*.
12 *See* notes 113 to 117, 149, & 206 to 212 and accompanying text *infra*.
13 *See, e.g.*, Lesser, Hein & Reich, *New Tender Offer Rules: Detailed and Broad Ranging*, N.Y.L.J., Dec. 17, 1979, at 25, col. 2.
14 Notwithstanding the Senate Banking Committee's interest, the adoption by Congress of the Commission's legislative proposals (even in substantially revised form) appears to be a long way off. *See, e.g.*, Crock, *SEC Seeks Takeover Rule Changes to End Controversy, Could Increase Firms' Costs*, Wall St. J., Feb 20, 1980, at 2, col. 3.
15 Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454, *amending* Securities Exchange Act of 1934 §§ 12-14, 15 U.S.C. §§ 78*l*-n.
16 15 U.S.C. §§ 78a-kk (1976) [hereinafter cited as Exchange Act].
17 15 U.S.C. §§ 78n(d),(e) (1976).
18 15 U.S.C. §§ 78m(d),(e) (1976).

ministrative provisions which constitute the existing scheme of federal regulation governing corporate takeovers.

A. *Section 13*

The basic provisions of section 13(d)[19] are set forth in section 13(d)(1).[20] That section requires a person[21] who acquires[22] beneficial ownership[23] of more than five percent[24] of a class of equity securities of a company to file a Schedule 13D[25] with the Com-

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19 15 U.S.C. § 78m(d) (1976).

20 15 U.S.C. § 78m(d)(1) (1976).

21 Section 13(d)(3), 15 U.S.C. § 78m(d)(3) (1976), provides that "[w]hen two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of [a company's securities], such syndicate or group shall be deemed a 'person' [subject to the section 13(d) filing requirement]."

22 *See* rule 13d-5(a), 17 C.F.R. § 240.13d-5(a) (1979) (specifically bringing certain nonpurposeful acquisitions within the scope of section 13(d)).

23 Under present case law, the power to vote is the main criterion in determining beneficial ownership for Williams Act purposes. *See* Bath Indus., Inc. v. Blot, 427 F.2d 97, 112 (7th Cir. 1970); Stirling v. Chemical Bank, 382 F. Supp. 1146, 1152 (S.D.N.Y. 1974), *aff'd*, 516 F.2d 1396 (2d Cir. 1975). However, in SEC Rel. No. 34-14692, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,571 (Apr. 21, 1978), the Commission adopted new rules relating to determining and disclosing beneficial ownership.

Under rule 13d-3(a), 17 C.F.R. § 240.13d-3(a) (1979), a person is the beneficial owner of securities if he has or shares, directly or indirectly, the power to vote or direct the voting of such securities, or the power to dispose or direct the disposition of such securities. Rule 13d-3(d), 17 C.F.R. § 240.13d-3(d) (1979), further states that a person is a beneficial owner of securities if he has the right to acquire such securities by exercise of an option, warrant or right exercisable within 60 days, through conversion of securities convertible within 60 days or through revocation or automatic termination of a trust or similar arrangement. The effect of the rule cannot be circumvented by the use of a trust, proxy, power of attorney, pooling arrangement, or other device to divest a person of beneficial ownership or prevent the vesting of beneficial ownership as part of a plan or scheme to evade the reporting requirements of section 13(d).

24 As originally enacted, the threshold amount was ten percent of a class of equity securities. Congress reduced the threshold amount to its current five percent level in the 1970 amendments to the Williams Act. Act of December 22, 1970, Pub. L. No. 91-567, § 1(a)(2), *amending* Securities Exchange Act of 1934 § 13(d)(1), 15 U.S.C. § 78m(d)(1). Congress was concerned that the ten percent figure allowed buyers to make acquisitions of just under ten percent without disclosure, and that sellers were thereby being deprived of material information. A second justification for the reduction was that acquisitions of between five percent and ten percent may have a significant impact on the public market for a company's securities, and should therefore be disclosed. S. REP. No. 1125, 91st Cong., 2d Sess. 3 (1970); H.R. REP. No. 1655, 91st Cong., 2d Sess. 3 (1970). *See also* note 93 *infra*. For a critical analysis of the congressional rationales for reducing the threshold amount, *see* Stanton, *Williams Act Developments*, 4 REV. SEC. REG. 913, 914 (1971). *See also* Brown, *The Scope of the Williams Act and Its 1970 Amendments*, 26 BUS. LAW. 1637, 1637 (1971).

25 2 FED. SEC. L. REP. (CCH) ¶¶ 23,683-690 (1979) (to be codified as amended in 17 C.F.R. § 240.13d-101). The Schedule 13D includes information regarding the acquirer's identity, Exchange Act § 13(d)(1)(A), 15 U.S.C. § 78m(d)(1)(A) (Supp. 1978), the source and amount of funds used to make the acquisition, Exchange Act § 13(d)(1)(B), 15 U.S.C. § 78m(d)(1)(B) (1976), the purpose of the acquisition, Exchange Act § 13(d)(1)(C), 15 U.S.C. § 78m(d)(1)(C) (1976), the amount of securities of the same class already beneficial-

mission, and to send copies to the company and the exchanges on which the securities are traded.[26] The Schedule 13D must be filed within ten days of the initial more-than-five percent acquisition and must be amended promptly, under rule 13d-2, "if any material change occurs in the facts set forth" therein, including any change in the amount of securities held by the purchaser.[27] Section 13(d)(1) does not apply to a person whose acquisition of the securities of a company, combined with all his acquisitions of the same class of securities in the preceding twelve months, does not exceed two percent of the class.[28]

Section 13(d)(5) of the Exchange Act[29] grants authority to the Commission to permit the filing of a short-form statement instead of a Schedule 13D if an acquisition is made in the ordinary course of a person's business and has neither the purpose nor the effect of changing or influencing control of a company, and is not made in connection with a transaction having such a purpose or effect. On the basis of that authority, the Commission has included in rule 13d-1[30] a provision permitting certain institutional investors and

ly owned, Exchange Act § 13(d)(1)(D), 15 U.S.C. § 78m(d)(1)(D) (1976), and any contracts or other arrangements between the acquiror and the offeree or "target" company, Exchange Act § 13(d)(1)(E), 15 U.S.C. § 78m(d)(1)(E) (1976).

26 Exchange Act § 13(d)(1), 15 U.S.C. § 78m(d)(1) (1976).

27 17 C.F.R. § 240.13d-2 (1979). Current practice allows up to ten days to file such an amendment. The rule both explicitly states that increases or decreases of at least one percent are deemed material, and makes clear that an amendment need not be filed with respect to an acquisition which increases the percentage of a class beneficially owned if the acquisition is exempt under section 13(d)(6)(B) of the Exchange Act, 15 U.S.C. § 78m(d)(6)(B) (1976), which exempts acquisitions of up to two percent of a class in any twelve-month period. In an attempt to reconcile the apparent inconsistency in the rule, the Commission has proposed an amendment to rule 13d-2(a) which would delete the exemption based on section 13(d)(6)(B) and has announced that, as an interpretive matter independent of the adoption of the amendment, it now interprets that section as applicable only to determine whether an initial beneficial ownership filing is required by a five percent beneficial owner, not to determine whether amendments are required to a previous filing. *See* SEC Rel. No. 34-16748, [CURRENT] FED. SEC. L. REP. (CCH) ¶ 82,495 (Apr. 16, 1980). The Commission notes that, under rule 13d-2(b), five percent beneficial owners eligible to use the short-form Schedule 13G annual filing in lieu of Schedule 13D (*see* notes 29 to 32 and accompanying text *infra*) must file annual amendments to reflect any changes in previously filed information and that the two-percent exemption is not applicable.

28 Exchange Act § 13(d)(6)(B), 15 U.S.C. § 78m(d)(6)(B) (1976). *See* text accompanying notes 87 to 88 *infra*. Also exempt from the requirements of section 13(d) are purchases in exchange for other securities, Exchange Act § 13(d)(6)(A), 15 U.S.C. § 78m(d)(6)(A) (1976), issuer repurchases, Exchange Act § 13(d)(6)(C), 15 U.S.C. § 78m(d)(6)(C) (1976), and any purchase which the Commission exempts as not entered into for the purpose of and not having the effect of changing or influencing control, Exchange Act § 13(d)(6)(D), 15 U.S.C. § 78m(d)(6)(D) (1976).

29 15 U.S.C. § 78m(d)(5) (1976).

30 17 C.F.R. § 240.13d-1 (1979).

employee benefit plans which acquire and hold securities in the ordinary course of their business and not with the purpose or effect of changing or influencing control of a company, or in connection with any transaction having that purpose or effect, to utilize an abbreviated acquisition notice, Schedule 13G.[31] A purchaser reporting on Schedule 13G who later concludes that he no longer holds the securities in the ordinary course of business or without the purpose or effect of changing or influencing control of the company must file a Schedule 13D not more than ten days after his change of intent, assuming he still owns more than five percent of the class of securities.[32]

The congressional purpose in enacting section 13(d) was to give notice to public investors of rapid accumulations of a company's equity securities which occur prior to a potential takeover bid or other change in control.[33] Congress determined that investors should have the benefit of full disclosure in advance of a contest

31 2 FED. SEC. L. REP. (CCH) ¶¶ 23,740A-740Q (1978) (to be codified in 17 C.F.R. § 240.13d-102). Schedule 13G requires disclosure of, among other things, the purchaser's identity, business address, type of business, amount and percentage of securities beneficially owned, the amount of securities as to which there is sole power to vote, shared power to vote, sole power to dispose and shared power to dispose, and whether any other person is known to have the right to receive or the power to direct receipt of dividends from, or the proceeds from the sale of, such securities. Schedule 13G is to be filed annually forty-five days after the end of the calendar year, unless the purchaser's beneficial ownership increases above ten percent, or thereafter increases or decreases by more than five percent, in which event an additional Schedule 13G must be filed within ten days after the end of the month in which such increase or decrease occurs.

The Commission's staff takes the position that arbitrageurs otherwise eligible to use Schedule 13G who buy a target company's securities after public announcement of a tender offer with a view to tendering them cannot use Schedule 13G to report their five percent beneficial ownership, but must file a Schedule 13D. However, to the extent that the same institution engages in non-arbitrage transactions with respect to the target company's securities, the institution may use Schedule 13G to report the latter transactions and, in determining whether it has crossed the five percent line for Schedule 13D purposes, may disregard target company securities not attributable to arbitrage activities, provided any Schedule 13D describes the method of computing the percentage of ownership attributable to arbitrage and non-arbitrage activities. *See* Faith Colish (avail. Mar. 24, 1980) (no-action letter).

32 Rule 13d-1(b)(3)(i)(B), 17 C.F.R. § 240.13d-1(b)(3)(i)(B) (1979). For the ten-day period immediately following the date of filing the Schedule 13D, such a purchaser may not vote or direct the voting of the securities or acquire an additional beneficial ownership interest in any equity securities of the company or any person controlling the company. Rule 13d-1(b)(3)(ii), 17 C.F.R. § 240.13d-1(b)(3)(ii) (1979).

33 S. REP. NO. 550, 90th Cong., 1st Sess. 7 (1967); H.R. REP. NO. 1711, 90th Cong., 2d Sess. 8 (1968). For an extensive discussion of the congressional purpose in enacting section 13(d), *see, e.g.*, Comment, *Section 13(d) and Disclosure of Corporate Equity Ownership*, 119 U. PA. L. REV. 853, 857-66 (1971). *See also* SEC Rel. No. 34-14692, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,571, at 80,300 (Apr. 21, 1978).

for control, to enable them to make informed decisions about whether or not to sell their securities.[34]

Section 13(g) of the Exchange Act,[35] enacted by Congress as part of the Domestic and Foreign Investment Improved Disclosure Act of 1977,[36] authorizes the Commission to promulgate rules to close any gaps in the section 13(d) reporting requirements. Thus, rule 13d-1 has been amended to require that persons who own more than five percent of a class of equity securities, and who are currently not required to file a Schedule 13D reflecting the acquisition of additional securities, file a statement on Schedule 13G.[37]

B. *Section 14*

Section 14(d) of the Exchange Act,[38] which prescribes certain substantive and procedural requirements in connection with most tender offers for equity securities,[39] requires that an offeror file an information statement with the Commission and send a copy to the offeree or "target" company before or at the same time that

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34 *See* note 96 *infra*.

35 15 U.S.C. § 78m(g) (Supp. 1978).

36 Pub. L. No. 95-213, tit. II, 91 Stat. 1499, *amending* Exchange Act § 13, 15 U.S.C. § 78m (1976).

37 Generally, such persons are those who acquired beneficial ownership of their securities prior to December 22, 1970; acquired not more than two percent of a class of securities within a twelve-month period; or acquired securities through a stock-for-stock exchange registered under the Securities Act of 1933, 15 U.S.C. §§ 77a-aa (1976) [hereinafter cited as Securities Act].

38 15 U.S.C. § 78n(d) (1976).

39 Section 14(d) of the Exchange Act regulates any tender offer for any class of equity securities which is either registered under section 12 of the Exchange Act, 15 U.S.C. § 78*l*(1976), exempted from registration because it is issued by a state-regulated insurance company, or issued by a closed-end investment company registered under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-52 (1976) [hereinafter cited as Investment Company Act], if, after consummation of the offer, the person making it would be the beneficial owner of more than five percent of the class. Exchange Act § 14(d)(2), 15 U.S.C. § 78n(d)(2) (1976), defines the term "person" for purposes of section 14(d) to include "two or more persons act[ing] as a partnership, limited partnership, syndicate or other group for the purpose of acquiring, holding or disposing of securities of an issuer." Exchange Act § 14(d)(3), 15 U.S.C. § 78n(d)(3) (1976), provides that "[i]n determining . . . any percentage of a class of any security, such class shall be deemed to consist of the amount of the outstanding securities of such class, exclusive of any securities of such class held by or for the account of the issuer or a subsidiary of the issurer."

Exchange Act § 14(d)(8), 15 U.S.C. § 78n(d)(8) (1976), exempts from the requirements of section 14(d) offers for any security if the acquisition of such security together with all other acquisitions by the offeror during the preceding twelve months, would not exceed two percent of the class; issuer repurchases; and any offer which the Commission exempts as not entered into for the purpose of and not having the effect of changing or influencing control of the company or otherwise as not comprehended within the purpose of section 14(d).

an offer is first published, sent, or given to securityholders.[40] Tendering securityholders may withdraw their tendered securities during the first seven days and after sixty days from the date the offer is first published, sent or given to the target company's securityholders, except as otherwise prescribed by the Commission.[41] In an offer for less than all the outstanding securities of a class of a company, securities tendered during the first ten days of the offer or within ten days after notice of an increase in the consideration being offered is first published, sent, or given to securityholders must be purchased on a pro rata basis.[42] When an offeror increases the consideration offered in a tender offer, the higher consideration must also be paid to all securityholders who tendered their securities before the increase.[43]

Section 14(e) of the Exchange Act,[44] which applies to all tender offers (including those not subject to section 14(d)[45]), prohibits fraudulent, deceptive, or manipulative acts or practices in connection with tender offers and mandates the Commission, by rule-making, to prescribe means reasonably designed to prevent such acts and practices.[46]

The Commission has promulgated a series of new administrative rules governing tender offers, which became effective on January 7, 1980.[47] Regulation 14D[48] governs tender offers subject to Section 14(d), and promulgates definitions applicable throughout the rules. Regulation 14E[49] governs tender offers which are subject to section 14(e).

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40 Exchange Act § 14(d)(1), 15 US.C. § 78n(d)(1) (1976).

41 Exchange Act § 14(d)(5), 15 U.S.C. § 78n(d)(5) (1976).

42 Exchange Act § 14(d)(6), 15 U.S.C. § 78n(d)(6) (1976).

43 Exchange Act § 14(d)(7), 15 U.S.C. § 78n(d)(7) (1976). *See* note 3 *supra*.

44 15 U.S.C. § 78n(e) (1976).

45 *See* note 39 *supra*.

46 15 U.S.C. § 78n(e) (1976). Section 14(e) provides:

> It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation.

47 *See* SEC Rel. No. 34-16384, [CURRENT] FED. SEC. L. REP. (CCH) ¶ 82,373 (Nov. 29, 1979).

48 3 FED. SEC. L. REP. (CCH) ¶¶ 24,281A to 24,288B (1979) (to be codified in 17 C.F.R. §§ 240.14d-1 to 240.14d-101).

49 3 FED. SEC. L. REP. (CCH) ¶¶ 24,295 to 24,296 (1979) (to be codified in 17 C.F.R. §§ 240.14e-1 to 240.14e-2).

1. Regulation 14D

Under the Commission's new rules, an offeror must file an information statement on Schedule 14D-1[50] with the Commission as soon as practicable on the date the offeror commences[51] its tender offer.[52] An offer must be commenced or abandoned within five

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50 3 FED. SEC. L. REP. (CCH) ¶ 24,284C (1979) (to be codified as amended in 17 C.F.R. § 240.14d-100). Schedule 14D-1 requires disclosure of certain information concerning the background and identity of the target company (Item 1), as well as the offeror (Item 2); information concerning certain past contracts, transactions, or negotiations between the offeror and the target company or any of its officers or directors (Item 3); the source and amount of funds or other consideration to be used for the purchase of securities pursuant to the offer (Item 4); the purpose of the offer and any plans or proposals of the offeror to effect an extraordinary corporate transaction (such as a merger, reorganization, liquidation, or sale or transfer of a material amount of the target company's assets), or to change the present board of directors, capitalization, or dividend policy of the target company, or which would result in the delisting of any target company securities from a national securities exchange, the ineligibility of such securities to be quoted on NASDAQ or the eligibility for termination of registration of such securities pursuant to section 12(g)(4) of the Exchange Act, 15 U.S.C. § 78l(g)(4) (1976) (Item 5); the offeror's interest in the target company's securities, including the particular facts of any transactions effected during the past sixty days by or on behalf of the offeror or its affiliates (Item 6); the terms of any contract, understanding, or relationship between the offeror and any person with respect to the target company's securities (Item 7); the names of any persons retained, employed, or to be compensated to solicit tenders pursuant to the offer (Item 8); the financial statements of the offeror, if it is not a natural person and its financial condition is material to a decision by the target company's securityholders whether or not to tender their shares (Item 9); and any additional material information (Item 10). Rule 14d-1, 3 FED. SEC. L. REP. (CCH) ¶ 24,281A (1979), requires the offeror promptly to amend its Schedule 14D-1 if any material change occurs in the facts set forth therein.

51 Rule 14d-2, 3 FED. SEC. L. REP. (CCH) ¶ 24,282A (1979) (to be codified in 17 C.F.R. § 240.14d-2), provides that a tender offer commences at 12:01 A.M. on the date when the first of the following occurs: long-form newspaper publication (*i.e.*, publication of the offer to purchase and letter of transmittal); summary advertisement, coupled with the subsequent furnishing of the tender offer materials to requesting securityholders; dissemination of tender offer materials to securityholders (applicable only in exchange offers in which the consideration consists of securities registered under the Securities Act); or dissemination by the offeror by any other means. A press release, newspaper advertisement, or other public statement by the offeror which identifies itself and the target company and states the amount and class of securities being sought in the tender offer and the price or range of prices being offered commences the offer pursuant to the last-mentioned procedure. However, no tender offer will be deemed to have commenced if, within five business days, the offeror issues an announcement that it is not continuing with the offer. If the offeror files a Schedule 14D-1 and disseminates its tender offer materials to securityholders within the same five-business-day period, the offer is deemed to have commenced on the date of first dissemination, except for the purposes of the "best price rule," *see* note 3 *supra*.

52 Rule 14d-3, 3 FED. SEC. L. REP. (CCH) ¶ 24,282B (1979) (to be codified in 17 C.F.R. § 240.14d-3). The offeror must also hand-deliver a copy of the Schedule 14D-1 to the target company and to any competing offeror, and must give telephonic notice of the offer to each exchange on which the class of the target company's securities is listed (and, if that class is quoted through their automated quotation system, to the National Association of Securities Dealers) and mail a copy of the Schedule 14D-1 to each such entity. Rule

business days after a prospective offeror announces the price to be offered and the amount of securities it will seek.[53] Under the tender offer rules, tendered securities may be withdrawn during the first fifteen business days after commencement of an offer and, if not already accepted for payment, during the ten business days following commencement by dissemination of a competing offer.[54] These new periods run concurrently. An offeror may extend (but not shorten) the statutory proration requirements,[55] in whole or in part, by specifying in the initial tender offer materials that it will accept securities on a pro rata basis during any period greater than ten days from the commencement of the offer or the dissemination of a notice of an increase in the consideration being offered.[56]

14d-3(a), 3 FED. SEC. L. REP. (CCH) ¶ 24,282B (1979) (to be codified in 17 C.F.R. § 240.14d-3(a)).

53 Rule 14d-2, 3 FED. SEC. L. REP. (CCH) ¶ 24,282A (1979) [to be codified in 17 C.F.R. § 240.14d-2]. Once a public announcement that triggers the commencement of an offer under rule 14d-2 has been made, the offeror must, within five business days, either abandon the offer or file its Schedule 14D-1 and disseminate the offer as required under the rules, *see* rule 14d-4, 3 FED. SEC. L. REP. (CCH) ¶ 24,284A (1979) (to be codified in 17 C.F.R. § 240.14d-4), notwithstanding the need to obtain clearance from a particular state under its statutes regulating tender offers or acquisitions of regulated companies, such as insurance companies, *see* notes 195 to 196 and accompanying text *infra.*

Rule 14d-4 applies only to all-cash offers and offers of securities that are exempt from registration under section 3 of the Securities Act. Exchange offers in which the consideration includes securities registered under the Securities Act are governed by the Securities Act. Thus, if any of the consideration offered includes securities registered under the Securities Act, the offeror may announce only the information specified by rule 135(a)(4), 17 C.F.R. § 230.135(a)(4) (1979), thereunder (*i.e.,* the name of the target company, the title of the securities and the exchange ratio) without commencing an offer under rule 14d-2. Presumably, a state-required legend permitted by rule 135(a)(6), 17 C.F.R. § 230.135(a)(6) (1979), could also be used, although rule 14d-2 is silent on this point. In effect, in the context of the Securities Act, rule 14d-2 defers commencement of an offer until after the registration statement has been cleared. By contrast, however, an offer not involving a security that must be registered under the Securities Act is deemed to have commenced upon announcement.

A public announcement by an offeror does not commence an offer if it only identifies the offeror and the target company and states that the offeror intends to make a tender offer in the future for a class of equity securities of the target company without specifying the amount to be sought or the consideration to be offered. Rule 14d-2(d), 3 FED. SEC. L. REP. (CCH) ¶ 24,282A (1979) (to be codified in 17 C.F.R. 240.14d-2(d)).

For a discussion of the effect of rule 14d-2 on state takeover regulation, *see* notes 180 to 188 and accompanying text *infra.*

54 Rule 14d-7, 3 FED. SEC. L. REP. (CCH) ¶ 24,287A (1979) (to be codified in 17 C.F.R. § 240.14d-7). Rule 14d-7 does not affect the statutory withdrawal right period under section 14(d)(5). *See* note 41 and accompanying text *supra.*

55 *See* note 42 and accompanying text *supra.*

56 Rule 14d-8, 3 FED. SEC. L. REP. (CCH) ¶ 24,288A (1979) (to be codified in 17 C.F.R. §240.14d-8).

2. Regulation 14E

The Williams Act does not, by its terms, set a minimum period during which a tender offer must remain open, but its requirements of a seven-day withdrawal right period[57] and proration for ten days in a partial offer[58] effectively prescribe a seven-day minimum in an offer for all of the outstanding securities of a class of a company and a ten-day minimum in a partial offer.[59] Under rule 14e-1,[60] however, a tender offer must be kept open for at least twenty business days from the date it is first disseminated. If the consideration offered or soliciting dealer's fee is increased during the course of a tender offer, the offer must remain open for at least ten business days from the date the notice of increase is disseminated.[61] Rule 14e-1 also requires that tendered securities be paid for or returned promptly after the termination or withdrawal of the offer.[62]

Under rule 14e-2,[63] the target company must inform its security-

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57 Exchange Act § 14(d)(5), 15 U.S.C. § 78m(d)(5) (1976). *See* note 41 and accompanying text *supra*.

58 Exchange Act § 14(d)(6), 15 U.S.C. § 78m(d)(6) (1976). *See* note 42 and accompanying text *supra*.

59 The New York Stock Exchange and the American Stock Exchange currently require a minimum offering period of ten and fourteen days, respectively. N.Y. STOCK EXCHANGE COMPANY MANUAL A-180 (1963); AMERICAN STOCK EXCHANGE COMPANY GUIDE § 904, at 222 (1973). State takeover laws also may provide for minimum offering periods and withdrawal periods which differ from those of the Williams Act. *See* notes 166 to 167 and accompanying text *infra*.

60 3 FED. SEC. L. REP. (CCH) ¶ 24,295 (1979) (to be codified in 17 C.F.R. § 240.14e-1).

61 The twenty- and ten-business-day periods are concurrent, not consecutive. A company's tender offer for its own securities is exempted from these minimum offer periods, provided it is not made in anticipation of, or in response to, another person's tender offer for securities of the same class. Rule 14e-1(a), 3 FED. SEC. L. REP. (CCH) ¶ 24,295 (1979). A minimum fifteen-business-day period is, however, applicable to self-tenders subject to rule 13e-4. 2 FED. SEC. L. REP. (CCH) ¶ 23,703B (1979). *See* note 230 *infra*.

62 The Commission recognizes that "the operation of this standard will be affected by the practices of the financial community and the following factors: current settlement, handling and delivery procedures relating to tenders made by guaranteed deliveries by appropriate institutions; procedures to cure technical defects in tenders; and the application of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 and the rules promulgated thereunder." SEC Rel. No. 34-16384, *supra* note 47, at 82,596 (footnote omitted).

Rule 14e-1 also regulates extensions of an offer. Extensions can be effected only by a notice given by press release or other public announcement. The notice must disclose the approximate number of securities tendered to date and must be issued no later than the earlier of 9:00 A.M., Eastern Time, on the next business day after the scheduled expiration date, or, if the class of securities is registered on one or more national securities exchanges, the first opening of any such exchange on the next business day after the scheduled expiration date.

63 3 FED. SEC. L. REP. (CCH) ¶ 24,296 (1979) (to be codified in 17 C.F.R. § 240.14e-2).

holders, within ten business days after dissemination of the offer, whether it recommends acceptance or rejection of the offer, is remaining neutral, or is unable to take position, and the reasons therefor.[64]

II. THE COMMISSION'S LEGISLATIVE PROPOSALS

The Commission's legislative proposals are broad and far-reaching. They would affect virtually every aspect of the planning and execution of any meaningful purchase of the securities of a publicly-held company. This section describes and analyzes the most significant provisions of the Commission's proposals and their effect on corporate acquisitions.

A. *Scope of the Williams Act*

Section 15(d) of the Exchange Act[65] requires a company the equity securities of which are not registered pursuant to section 12 of the Exchange Act[66] and that has made an offering of debt or equity securities registered under the Securities Act of 1933 (Securities Act), to file with the Commission the supplementary and periodic reports required under section 13 of the Exchange Act.[67] The securities of companies reporting under section 15(d) are not subject to the requirements of sections 13(d), 13(e) and 14(d). Purchases and sales of, or tender offers for such securities, however, are fully subject to the anti-fraud provisions of sections 10(b)[68] and 14(e).[69] Under the legislative proposals, purchases of

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64 The statement is subject to rule 14d-9, 3 FED. SEC. L. REP. (CCH) ¶ 24,288B (1979) (to be codified in 17 C.F.R. § 240.14d-9), which requires the target company to file a Schedule 14D-9 with the Commission as soon as practicable on the date the target company makes a recommendation with respect to a tender offer. The Schedule 14D-9, 3 FED. SEC. L. REP. (CCH) ¶ 24,284F (1979) (to be codified in 17 C.F.R. § 240.14d-101), must disclose: the identity and background of the person filing the statement, including any "conflicts of interest" (Item 3); the nature of and reasons for the solicitation or recommendation (Item 4); the identity of any persons retained, employed or to be compensated in connection with the solicitation or recommendation (Item 5); any recent transactions in the security or any intentions to tender to the offeror, sell or hold the securities held by the person(s) filing the schedule and by any executive officer, director, affiliate or subsidiary of such person(s) (Item 6); and certain negotiations and transactions by the target company (Item 7).

65 15 U.S.C. § 78o(d) (1976).

66 15 U.S.C. § 78*l* (1976).

67 15 U.S.C. § 78m (1976).

68 Exchange Act § 10(b), 15 U.S.C. § 78j(b)(1976) (prohibits fraudulent practices in connection with the purchase or sale of securities).

69 Exchange Act § 14(e), 15 U.S.C. § 78m(e) (1976) (prohibits fraudulent practices in connection with tender offers). *See* note 46 *supra*.

the equity securities of such section 15(d) companies, other than open-end investment companies registered under the Investment Company Act of 1940 (Investment Company Act),[70] would become subject to sections 13(d), 13(e), and 14(d) of the Exchange Act[71] when such equity securities have been the subject of a Securities Act registration statement and continue to be held of record by at least 300 persons.[72]

B. *Section 13(d) Requirements*

1. Sections 13(d) and 13(g) Combined

The legislative proposals would replace current sections 13(d) and 13(g) with a unified system of disclosure, and require any person who is or becomes a beneficial owner of more than five percent of a class of equity securities to file an information statement with the Commission, the company whose securities have been acquired, and any exchange on which the securities are traded.[73] Section 13(g) would be eliminated, but the Commission would retain the power to permit a short-form filing if it appears that an acquisition was in the ordinary course of business and not for the purpose nor having the effect of changing or influencing control of the company whose securities have been acquired.[74] The Commission anticipates that it would establish such a simplified system of disclosure similar to the one contained in current rule 13d-1(b)[75] for market professionals engaged in such acquisitions[76] who currently may file a Schedule 13G.[77]

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70 15 U.S.C. §§ 80a-1 to 80a-52 (1976 & Supp. 1978).

71 Such issuers are already subject to section 14(e) of the Exchange Act.

72 Thus, under the legislative proposals, the Williams Act would apply with respect to equity securities registered pursuant to section 12 of the Exchange Act; of an insurance company which otherwise would be required to be so registered except for the section 12(g)(2)(G) exemption, Exchange Act § 12(g)(2)(G), 15 U.S.C. § 78*l*(g)(2)(G) (1976); issued by a closed-end investment company registered under the Investment Company Act; or of a section 15(d) issuer, other than an open-end investment company registered under the Investment Company Act, if any security of such class has been the subject of a Securities Act registration statement and such class is held of record by at least 300 persons.

73 Proposed Bill § 13(d)(3), *supra* note 5, at 20. SEC Memorandum, *supra* note 5, at 14. The information statement required to be filed would be similar but not identical to present Schedule 13D, *see* note 25 *supra*.

74 *See* text accompanying note 29 *supra*.

75 17 C.F.R. § 240.13d-1(b) (1979). *See* notes 30 to 32 and accompanying text *supra*.

76 SEC Memorandum, *supra* note 5, at 14.

77 *But see* note 31 *supra* with respect to current availability of short-form filing to arbitrageurs.

2. Public Announcement and Filing Requirements

Under the legislative proposals, a person who acquires in the aggregate more than five percent of a class of equity securities would be required to make a public announcement, not later than one business day after reaching the five percent threshold, disclosing his identity, the amount of securities of the class beneficially owned by him, the identity of the company whose securities have been acquired, and the purpose of the acquisition.[78] An information statement would have to be filed within five business days after the acquisition.[79] Under current section 13(d) and the rules thereunder, no public announcement is required and a five-percent owner has ten days in which to file. Under the legislative proposals, amendments to an information statement disclosing any material change in the information previously filed would have to be filed within five business days of such change.[80] Current rule 13d-2 requires only "prompt" amendment.[81]

3. Limitations on Further Acquisitions

One of the most significant aspects of the legislative proposals is that further acquisitions by a person who must file an information statement or an amendment thereto would be prohibited from the time of the acquisition that creates the duty to file until two business days after the statement is filed.[82] Currently, acquisitions in the open market or in a series of negotiated purchases of substantial amounts of securities during the ten-day pre-filing period may be made without immediate public disclosure. Because such acquisitions are made without public disclosure, the Commission believes that they "deprive security holders of a fair opportunity to adjust their evaluation of the securities of a company with respect to potential change in control of that company."[83] Under the legislative proposals, such acquisitions would be precluded because a purchaser would be required to observe a waiting period between the purchase which causes him to exceed

78 Proposed Bill § 13(d)(3)(A), *supra* note 5, at 20.
79 Proposed Bill § 13(d)(3)(B), *supra* note 5, at 20.
80 Proposed Bill § 13(d)(5)(A), *supra* note 5, at 20.
81 17 C.F.R. § 240.13d-2 (1979). *See* note 27 and accompanying text *supra*.
82 Proposed Bill § 13(d)(5)(B), *supra* note 5, at 20.
83 SEC Memorandum, *supra* note 5, at 14.

the five percent threshold and each successive material purchase. Furthermore, the purchaser would have to cease all material purchases other than very limited private purchases upon reaching the ten-percent level and comply with the tender offer requirements of proposed section 14(d).[84]

While public disclosure and the observance of a waiting period after each successive material purchase may be appropriate where the purchaser's intent is to gain control of a company, such safeguards may be unnecessary in connection with other accumulations of securities. Where an acquisition is "for investment purposes only," the early disclosure and extended acquisition process required under the legislative proposals may be unduly burdensome and inappropriate. The fact that a Williams Act filing has been made, whatever its contents, may create investor anticipation and thereby lead to a run-up in the price of the security being acquired, to the detriment of the acquiror as well as the market for the security. In remedying this problem, it is necessary to reconsider the fundamental purpose of the beneficial ownership reporting requirements.

Section 13(d), as it presently is drafted, is not by its terms limited to situations in which there is an ongoing contest for control. Individuals who, as a result of an acquisition, beneficially own more than five percent of a class of securities must file a Schedule 13D, regardless of their intent with respect to that class.[85] However, the congressional purpose in enacting section 13(d) was to require immediate disclosure only of those acquisitions that have a substantial likelihood of culminating in contests for control.[86] Congress therefore formulated an objective test to determine whether an acquisition must be disclosed under section 13(d). Under the two-percent exemption of section 13(d)(6)(B),[87] a person is presumed not to have the requisite intent to affect control of a company if his acquisition, combined with all his acquisitions of the same class of securities in the preceding twelve months, does not exceed two percent of the class. Thus, increments of two percent or less in a

84 Proposed Bill § 14(d)(1)(B), *supra* note 5, at 21.
85 Exchange Act § 13(d)(1), 15 U.S.C. § 78m(d)(1) (1976).
86 *See* sources cited in notes 96 and 98 *infra*.
87 15 U.S.C. § 78m(d)(6)(B) (1976). *See* text accompanying note 28 *supra*.

single year by one person are considered too unlikely to culminate in a contest for control to require immediate disclosure under section 13(d). However, such increments are required to be reported annually on a Schedule 13G.[88]

Furthermore, the Williams Act grants authority to the Commission to permit short-form filing by investors whose purpose is not to obtain control.[89] On the basis of that authority, the Commission has allowed certain types of investors who do not qualify for the two-percent exemption to use a Schedule 13G rather than a Schedule 13D to disclose open market and privately negotiated accumulations of securities when such investors have no purpose to affect control.[90] The Commission has provided protection for investors against surprise takeovers by persons reporting on Schedule 13G by requiring that a Schedule 13D must be filed[91] as soon as a purpose to affect control is formulated. The Commission apparently believes that the annual Schedule 13G filing adequately protects investors until the adoption of a purpose to affect control. At that point, the likelihood of a contest for control increases significantly, and prompt disclosure of all activity in a company's securities is necessary to protect investors.

Under the present scheme, the Commission has limited the availability of Schedule 13G to those institutional investors that meet the requirements of rule 13d-1(b).[92] However, it would not be inconsistent with either the purposes of section 13(d) or the Commission's regulatory scheme under rule 13d-1 to permit all investors purchasing securities for investment purposes only to report such acquisitions on a periodic basis using an abbreviated information statement similar to Schedule 13G. The Commission's purpose in proposing its new section 13(d) scheme is to require disclosure only with respect to any "potential change in control" of a company.[93] The adoption of the purpose-to-affect-control test

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88 Exchange Act § 13(g)(1), 15 U.S.C. § 78m(g)(1) (Supp. 1978). *See* notes 30 to 32 and accompanying text *supra.*

89 15 U.S.C. § 78m(d)(5) (1976). *See* note 29 and accompanying text *supra.*

90 Rule 13d-1, 17 C.F.R. § 240.13d-1 (1979). *See* notes 30 to 32 and accompanying text *supra.*

91 Rule 13d-1(b)(3), 17 C.F.R. § 240.13d-1(b)(3) (1979).

92 17 C.F.R. § 240.13d-1(b) (1979). *See* notes 30 to 32 and accompanying text *supra.*

93 SEC Memorandum, *supra* note 5, at 14. On June 28, 1980, the Commission delivered

would achieve that aim directly. All securityholders without a purpose to affect control could use a Schedule 13G-type form and would not be subject to the announcement obligation. The more burdensome filing on a Schedule 13D and announcement obligation would be required only when investors need the protection of more prompt and more extensive disclosure, namely, when a contest for control is imminent.

C. *Proposed Definition of a Tender Offer*

The Commission's legislative proposals include a new approach to acquisitions of securities which would make the formal tender offer provisions of the Williams Act applicable to all acquisitions of ten percent or more of a company's equity securities and to most acquisitions by persons (including officers and directors) who have previously acquired a ten percent position. By enlarging the "tender offer" concept and requiring virtually all major acquisitions to be effected by formal tender offer, the Commission's proposed bill represents a clear departure from the scheme of regulation envisioned by Congress when it enacted the Williams Act.

Under existing law, a purchaser is required to make a post-acquisition public filing upon its acquisition of more than five percent of any class of equity securities.[94] Pre-acquisition filing is required only in connection with "tender offers" for such securities.[95] At the time of its enactment, the Commission and

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a report to Congress in which it concluded that the five percent threshold of the Williams Act should not be reduced. The Commission noted in the report that requiring disclosure below the five percent level "may mislead public investors, because they may attach significance to an acquisition beyond the real or stated intention of the reporting person." The Commission also noted that "the loss of financial privacy occasioned by a lowered reporting threshold also could be an important factor which would dissuade investors, especially foreign investors." Report of the Securities and Exchange Commission on Beneficial Ownership Reporting Requirements Pursuant to Section 13(h) of the Securities Exchange Act of 1934, [CURRENT] Fed. Sec. L. Rep. (CCH) ¶ 82,616, at 83,317-18 (June 28, 1980). These conclusions are addressed to the question of whether the five percent reporting threshold should be reduced, and the Commission stated that they are inapplicable with respect to greater-than-five-percent positions "which have the potential to change or influence control of the issuer." Nevertheless, the Commission's reasoning is equally applicable to greater-than-five-percent positions acquired solely for investment, and provides support for the position taken in the text.

94 *See* Exchange Act § 13(d), 15 U.S.C. § 78m(d) (1976), and the Commission's rules promulgated thereunder, 17 C.F.R. §§ 240.13d-1 to 240.13d-100 (1979).

95 *See* Exchange Act §§ 14(d), (e), 15 U.S.C. §§ 78n(d), (e) (1976), and the

Congress were in agreement that section 13(d) would regulate rapid and substantial non-tender offer acquisitions of securities such as large open market and privately negotiated accumulations, and Congress' determination *not* to require pre-transaction filing in the case of section 13(d) acquisitions, as distinguished from section 14(d) tender offers, was deliberate and carefully considered.[96]

Commission's rules promulgated thereunder, 3 FED. SEC. L. REP. (CCH) ¶¶ 24,281A to 24,296 (1979).

96 Senator Williams' original bill, introduced in 1965, provided for pre-transaction filing for all types of acquisitions:

> [I]t shall be unlawful for any person . . .
>
> (A) to acquire the beneficial ownership of, or increase his beneficial ownership to, more than 5 per centum of any class of any equity security which is registered pursuant to section 12 of [the Exchange Act,] or
>
> (B) to make a cash tender offer for, or a request or invitation for tenders for cash of, such a security which, if consummated, would result in such person owning beneficially more than 5 per centum of such security,
>
> until the expiration of twenty days after such person has sent to the issuer of the security at its principal executive office, by registered mail, a notice, and has filed [a statement] with the Commission.

S. 2731, 89th Cong., 1st Sess. (1965). In a 1966 memorandum, however, the Commission expressed the view that pre-transaction filing should not be required for any types of acquisitions other than tender offers and accordingly it proposed the section 13(d)-section 14(d) dichotomy which ultimately was enacted. *See* 112 CONG. REC. 19,003-06 (1966). *See generally* Swanson, *S. 510 and the Regulation of Cash Tender Offers: Distinguishing St. George from the Dragon,* 5 HARV. J. LEGIS. 431, 483-84 (1968); Comment, *supra* note 33, at 860-61 (1971). Senator Williams was apparently converted to the Commission's view by the time he introduced the final bill in 1967. *See* 113 CONG. REC. 856 (1967):

> [T]his bill provides that anyone acquiring the beneficial ownership of more than 10 percent [now 5 percent] of a class of equity security registered under the Securities Exchange Act file with the SEC substantially the same information as that required with respect to a cash tender offer; *however, such a filing would not be required until 7 days* [10 days, as enacted] *after the acquisition.* This statement would have to be sent to each exchange on which the security is listed and to the principal executive offices of the issuer of the security.
>
> Substantial open market or privately negotiated purchases of shares may precede or accompany a tender offer or may otherwise relate to shifts in control of which investors should be aware. *While some people might say that this information should be filed before the securities are acquired, disclosure after the transaction avoids upsetting the free and open auction market where buyer and seller normally do not disclose the extent of their interest and avoids prematurely disclosing the terms of privately negotiated transactions.*

(Emphasis added). *See generally* S. REP. NO. 550, *supra* note 33, at 7 ("The purpose of section 13(d) is to require disclosure of information by persons who have acquired a substantial interest or increased their interest in the equity securities of a company by a substantial amount, within a relatively short period of time.").

That section 13(d) was intended to regulate acquisitions involving the potential for rapid shifts in control is also in accord with the statutory language providing that section 13(d) is not triggered unless the purchaser owns, after his purchase, more than five percent of a class of a company's securities and exempting, in section 13(d)(6)(B), acquisitions of less

While both the courts[97] and the Commission[98] have continued to recognize that section 13(d) plays a crucial role in the Williams Act regulatory scheme, uncertainty has arisen as to whether large accumulations of securities involving open market or privately negotiated purchases (or both) should be regulated under section 14(d) as "tender offers."[99] The uncertainty in this regard is com-

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than two percent within any twelve-month period. *See* notes 85 to 88 and accompanying text *supra*. Apparently, Congress was of the view that such accumulations would not constitute a rapid enough acquisition or a large enough position to require reporting.

97 *See, e.g.*, Kennecott Copper Corp. v. Curtiss-Wright Corp., 584 F.2d 1195, 1206 (2d Cir. 1978) (section 13(d) comes into play whenever "ownership of more than five percent [of a class of equity securities] is obtained" through any of the "modes of stock acquisition" which are "more customary" than a tender offer); GAF Corp.v Milstein, 453 F.2d 709, 717 (2d Cir. 1971) ("the purpose of Section 13(d) is to alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of the technique employed, which might represent a potential shift in corporate control"), *cert. denied*, 406 U.S. 910 (1972).

98 *See, e.g.*, SEC Rel. No. 34-15348, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,762, at 81,063 (Nov. 22, 1978) ("[Section 13(d)'s] legislative history reveals that it was intended to provide information to the public and the affected issuer about rapid accumulations of its equity securities in the hands of persons who would then have the potential to change or influence control of the issuer."); SEC Rel. No. 34-15317, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,758, at 81,046 (Nov. 9, 1978).

99 Virtually every case that has addressed the "tender offer" issue has recognized the distinction between a widespread public solicitation to the general body of securityholders governed by section 14(d), and direct private purchases governed by section 13(d). *E.g.*, Kennecott Copper Corp. v. Curtiss-Wright Corp., 584 F.2d 1195, 1206 (2d Cir. 1978); Stromfeld v. Great Atl. & Pac. Tea Co., [CURRENT] FED. SEC. L. REP. (CCH) ¶ 97,287, at 97,011 (S.D.N.Y. Feb. 22, 1980) ("The complaint thus alleges a privately — indeed secretly — negotiated sale which excluded all but seven shareholders of the corporation. The complaint does not allege a public bid to buy stock or a widespread solicitation of stock."); Financial General Bankshares, Inc. v. Lance, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,403, at 93,429 (D.D.C. Apr. 27, 1978) ("Plaintiff . . . failed to show the widespread solicitation that is characteristic of a tender offer."). In Brascan Ltd. v. Edper Equities Ltd., 477 F. Supp. 773, 789 (S.D.N.Y. 1979), the court stated:

> [The offeror's] conduct had very little similarity to what is commonly understood as a tender offer and what was described as a tender offer in the context of the hearings leading to the passage of the Williams Act. [The offeror] did not engage in a widespread solicitation of stockholders. . . . [T]o acquire a large amount of stock in open market purchases, bidding cautiously so as to avoid bidding up the price of the stock to excessive levels unless there was large volume available at such prices . . . is not a tender offer, even if a large volume of stock is accumulated in such fashion.

(Citations ommitted). The court in S-G Securities, Inc. v. Fuqua Investment Co., 466 F. Supp. 1114, 1125-27 (D. Mass. 1978), expressed a similar view:

> The legislative history [of the Williams Act] indicates that the defendants' open market purchases *per se* do not come within the ambit of the statute. . . .
>
> Defendants' purchases, in the case at bar, were preceded by two and, in part, by three widely publicized press releases issued by defendants that outlined with some

pounded by the facts that the term "tender offer" is not defined in the Exchange Act and that until very recently the Commission had declined to propose or promulgate such a definition.[100]

In the years since the passage of the Williams Act, several courts have addressed the issue of whether purchases which do not involve a normal or conventional tender offer[101] constitute a Williams Act tender offer and many have held that, absent publici-

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specificity the details of the proposed buying program. . . .

I conclude that where there is:

1) a publicly announced intention by the purchaser to acquire a substantial block of the stock of the target company for purposes of acquiring control thereof, and
2) a subsequent rapid acquisition by the purchaser of large blocks of stock through open market and privately negotiated purchases,

such actions constitute a tender offer for purposes of § 14(d) of the statute.

(Footnotes omitted). *But see* Wellman v. Dickinson, 475 F. Supp. 783 (S.D.N.Y. 1979).

100 *See, e.g.,* SEC Rel. No. 34-15548, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,935, at 81,213 (Feb. 5, 1979) ("In recognition of the dynamic nature of tender offers and the need for the Williams Act to be interpreted flexibly in a manner consistent with its purposes, the Commission affirms its position that a definition of the term 'tender offer' is neither appropriate nor necessary at this time."); SEC Rel. No. 34-12676, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,659 (Aug. 2, 1976).

101 In conventional usage, a "tender offer" is "a publicly made invitation addressed to all shareholders of a corporation to tender their shares for sale at a specified price." Note, *The Developing Meaning of "Tender Offer" under the Securities Exchange Act of 1934,* 86 HARV. L. REV. 1250, 1251 (1973). *Accord,* Aranow & Einhorn, *Essential Ingredients of the Cash Tender Invitation,* 27 BUS. LAW. 415 (1972); Comment, *Regulation of Contested Cash Tenders Offers,* 46 TEX. L. REV. 915 (1968); Comment, *Senate Bill 510 and the Cash Tender Offer,* 14 WAYNE L. REV. 568, 569 (1968). *See also* Einhorn & Blackburn, *The Developing Concept of "Tender Offer": An Analysis of the Judicial and Administrative Interpretations of the Term,* 23 N.Y.L. SCH. L. REV. 379 (1978).

Although the term "tender offer" is not defined in the Williams Act, its characteristics were described in the House Report of the Committee on Interstate and Foreign Commerce, which held hearings on the Act, as follows:

> The offer normally consists of a bid by an individual or group to buy shares of a company — usually at a price above the current market price. Those accepting the offer are said to tender their stock for purchase. The person making the offer obligates himself to purchase all or a specified portion of the tendered shares if certain specified conditions are met.

H.R. REP. No. 1711, 90th Cong., 2d Sess., *reprinted in* [1968] U.S. CODE CONG. & AD. NEWS 2811. *See also* Kennecott Copper Corp. v. Curtiss-Wright Corp., 584 F.2d 1195 (2d Cir. 1978).

The Commission has described the conventional tender offer as

> an offer [which] is published by a person requesting that all or a portion of a class of a company's securities be deposited during a fixed time so that such person may purchase such securities at a specified price (whether cash and/or securities) and subject to specified conditions.

SEC Rel. No. 34-12676, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,659 (Aug. 2, 1976).

ty, they are not tender offers.[102] In one such case,[103] the Commission appeared as *amicus curiae* and argued to the court that an "eight factors" test should be used to determine whether a particular transaction or series of transactions constitutes a tender offer.[104] The court rejected these factors as "vague" and "not desirable."[105] In *Wellman v. Dickinson,*[106] however, the court accepted the Commission's "eight factors" test in an enforcement action brought by the Commission, and held that a series of purchases of about thirty-four percent of a class of a company's securities involving the solicitation of approximately thirty-three holders of those securities was a tender offer, notwithstanding the absence of publicity.[107] Prior to the *Wellman* case, the Second

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102 *See, e.g.,* Kennecott Copper Corp. v. Curtiss-Wright Corp., 584 F.2d 1195, 1206-07 (2d Cir. 1978) (solicitations through brokers off the floor of the New York Stock Exchange of fifty securityholders and an additional "approximately a dozen" institutional securityholders, in addition to substantial open market purchases, did not constitute a tender offer); Stromfeld v. Great Atl. & Pac. Tea Co., [CURRENT] FED. SEC. L. REP. (CCH) ¶ 97,287, at 97,010-12 (S.D.N.Y. Feb. 22, 1980) (purchase of forty-two percent of a class of a company's securities from seven securityholders (individuals and foundations) was not a tender offer); Brascan Ltd. v. Edper Equities Ltd., 477 F. Supp. 773, 789 (S.D.N.Y. 1979) (purchase of in excess of three million shares on the American Stock Exchange was not a tender offer); Financial General Bankshares, Inc. v. Lance, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,403, at 93,429 (D.D.C. Apr. 27, 1978). *But see* Wellman v. Dickinson, 475 F. Supp. 783 (S.D.N.Y. 1979).

103 Brascan Ltd. v. Edper Equities Ltd., 477 F. Supp. 773 (S.D.N.Y. 1979).

104 The eight factors, which are recited in Brascan Ltd. v. Edper Equities Ltd., 477 F. Supp. at 791 n.13, are: (1) active and widespread solicitation; (2) the solicitation is made for a large percentage of the company's stock; (3) a premium over the prevailing market price; (4) the terms of the offer are firm rather than negotiable; (5) whether the offer is contingent on the tender of a fixed amount of securities; (6) whether the offer is open only for a limited period of time; (7) whether the offerees are subjected to pressure to sell their securities; and (8) whether public announcements of a purchasing program precede or accompany a rapid accumulation.

105 477 F. Supp. at 791. Specifically, the court said:

> I have doubts as to whether [the Commission's] view constitutes either a permissible or a desirable interpretation of the statute. As to permissibility, I have some question whether it expands the scope of the statute beyond what Congress can reasonably be understood to have intended, depending how many and which factors are deemed necessary. I believe it is not desirable because the application of so vague a test would introduce a crippling uncertainty in an area in which practitioners should be entitled to be guided by reasonably clear rules of the road. The consequences of having purchased on the open market where a court would later determine on the basis of so unpredictable a test that the provisions of Section 14(d) should have been respected could well be catastrophic beyond reason.

Id.

106 475 F. Supp. 783 (S.D.N.Y. 1979).

107 The defendants contended that their purchases were privately negotiated and hence could not be deemed a tender offer. The court agreed that a "privately negotiated transaction . . . is outside the scope of Section 14 of the Williams Act," *id.* at 818, but held that

Circuit Court of Appeals, in *Kennecott Copper Corp. v. Curtiss-Wright Corp.*,[108] had indicated that, while several courts and commentators had taken the position that certain methods of acquiring securities other than conventional tender offers should be treated as tender offers for purposes of the Williams Act, the Second Circuit "has not yet moved that far."[109] In concluding that the open market and private purchase program before it was not a tender offer, the court stated that a contrary holding would have meant that the purchaser would have been subject to the pro rata, best price and withdrawal provisions[110] of the Exchange Act.[111] The court expressed its view that "it seems unlikely that Congress intended 'tender offer' to be so broadly interpreted as to make these provisions unworkable."[112]

On November 29, 1979, the Commission proposed to amend rule 14d-1 to provide a two-tier definition of the term "tender

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the purchases constituted a "public solicitation" and could be within the ambit of the pre-acquisition filing requirements. While recognizing that "a private or a public offering of an issuer concerns matters not relevant to considerations which would inform the boundaries separating a tender offer from a privately negotiated transaction," *id.* at 819, the court reached its conclusion by analogy to the private offering exemption from registration under the Securities Act. The court equated the phrase "privately negotiated purchase" to the Securities Act phrase "private offering," a term used to refer to certain offerings which are exempt from the registration requirements for newly issued securities under the Securities Act. The central premise of the Securities Act private offering exemption is that the person solicited in a private offering will have "access to the kind of information" which the Securities Act otherwise requires be disclosed. *See* SEC v. Ralston Purina Co., 346 U.S. 119, 127 (1953).

The distinction between sections 13(d) and 14(d), as presently drafted, however, does not turn on whether the purchaser affords the seller access to information, but rather on which types of transaction should require prior, and which types subsequent, disclosure. Under an "access" approach, every acquisition leaving the purchaser in excess of five percent would be treated as a section 14(d) tender offer if the solicited securityholders did not have access to the information required by section 14(d). Congress clearly intended to permit many acquisitions to be made without prior disclosure. *See* notes 94 to 96 and accompanying text *supra*. *Cf.* Chiarella v. United States, 100 S. Ct. 1108, 1117 (Mar. 18, 1980) (finding, in connection with section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) (1976), that "neither the Congress nor the Commission ever has adopted a parity-of-information rule"). To determine whether a transaction is a "privately negotiated" purchase, a court should consider the number of shareholders solicited, *cf.* note 126 *infra*, the manner in which they are located, the publicity or lack thereof before the purchases are consummated and the procedures by which the sales terms are agreed upon and executed, factors the court refused to consider in *Wellman*. *See* 475 F. Supp. at 820.

108 584 F.2d 1195 (2d Cir. 1978).

109 *Id.* at 1207.

110 Exchange Act §§ 14(d)(5)-(7), 15 U.S.C. §§ 78n(d)(5)-(7) (1976). *See* notes 41 to 43 and accompanying text *supra*.

111 584 F.2d at 1207.

112 *Id.*

offer."[113] The first tier would include offers to purchase securities which during any forty-five-day period are directed to more than ten persons and seek the acquisition of more than five percent of a class of equity securities.[114] The second tier of the proposed definition would include offers which are disseminated in a widespread manner, provide for a price in excess of the greater of five percent over or two dollars above the current market price, and do not provide for a meaningful opportunity to negotiate the price and terms. One problem posed by the first tier of the definition is that, assuming more than five percent of the security was involved in a transaction or a series of transactions, the definition would regulate certain block transactions (since such transactions often involve more than ten sellers) and require that they be effected by formal tender offer, thus effectively prohibiting them. Another problem is that the ten-person offeree limitation may be unduly restrictive.[115] The second tier similarly presents at least two problems. First, it does not require that the acquiror own more than five percent of the class of securities after the tender offer has been consummated, thereby bringing within the scope of the Williams Act acquisitions which previously were outside the scope of not only section 14(d), but also section 13(d).[116] Second, the terms "widespread" and "meaningful opportunity to negotiate" are not defined, thus posing opportunities for interpretive uncertainty.[117]

In its release proposing the tender offer definition, the Commis-

113 Proposed rule 14d-1(b), SEC Rel. No. 34-16385, [CURRENT] FED. SEC. L. REP. (CCH) ¶ 82,374 (Nov. 29, 1979).

114 Open market purchases at the current market price (defined as the higher of the last sale price or the highest current independent bid) by or through brokers or dealers, without solicitation, where the broker or dealer performs only its customary function and receives no more than its customary remuneration would be exempted.

115 *See* note 132 and accompanying text *infra*.

116 *See* Exchange Act § 13(d)(1), 15 U.S.C. § 78m(d)(1) (1976) (requirements of section 13(d) apply to acquisitions of securities by "any person who, [after such acquisition], is . . . the beneficial owner of more than 5 per centum of such class [of equity securities]"); Exchange Act § 14(d)(1), 15 U.S.C. § 78n(d)(1) (1976) (requirements of section 14(d) apply to tender offers "if, after the consummation thereof, [the offeror] would . . . be the beneficial owner of more than 5 per centum of [the] class [of target company securities]"). The Commission expressly recognized this problem in footnote 15 of its release. SEC Rel. No. 34-16385, *supra* note 113, at 82,604 n.15. The Commission noted, however, that section 14(d)(8)(A) of the Exchange Act, 15 U.S.C. § 78n(8)(A) (1976), which exempts the purchase of not more than two percent of a class of securities in a 12-month period from section 14(d), would be applicable.

117 In its release proposing the definition of the term "tender offer," the Commission observed that it "expects that the term 'widespread' would be interpreted in a manner consistent with the case law." SEC Rel. No. 34-16385, *supra* note 113, at 82,605 (citing

sion also proposed to adopt rule 14e-4(b), which would require a tender offer to be open to all holders of the securities subject to the offer, with two limited exceptions.[118] The adoption of proposed rule 14e-4(b), in combination with the proposed definition of tender offer, would effectively require many securities acquisition programs (in addition to block transactions) to be effected by formal tender offer.[119] As one court has accurately observed, this would seem to be an area which is more appropriately addressed by Congress.[120]

The Commission's proposed legislation suggests that the Commission may finally be prepared to acknowledge that the policy issues raised by the definition of the term "tender offer" are mat-

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Wellman and Hoover v. Fuqua Indus., Inc., [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,107 (N.D. Ohio June 11, 1979)). In finding that there was "widespread solicitation" in the *Wellman* case, the court took into account the size of the holdings solicited, the geographic dimensions of the effort and the number of solicitees approached. 497 F. Supp. at 824. Although the second tier of the definition of tender offer does not, as indicated in the text, expressly set forth a minimum percentage-of-securities-to-be-purchased requirement, a court could consider (although it is not required to do so) the percentage of securities solicited as part of its determination of whether an offer was disseminated in a "widespread" manner. However, a court could also decide that the size of the holdings solicited has absolutely no bearing on whether the offer was disseminated in a "widespread" manner.

The Commission asked for general comment on the appropriateness of the three definitional criteria, *i.e.*, "widespread manner," premium price and no opportunity to negotiate, and whether additional standards should be included in the definition. SEC Rel. No. 34-16385, *supra* note 113, at 82,605.

Recently, the Commission has indicated that it is "having second thoughts about" its proposed definition of the term "tender offer" because it may be "too restrictive." Schoor, *SEC Reconsiders Proposed Rules on Tender Offers*, Wall St. J., July 17, 1980, at 4, col. 1.

118 The proposed rule excludes tender offers limited to holders of less than 100 shares and those not made to officers, directors or affiliates of the target company. 3 FED. SEC. L. REP. (CCH) ¶ 24,298 (1979). *See* SEC Rel. No. 34-16385, *supra* note 113, at 82,611.

119 This result would ensue because open market purchases would in many cases be denominated tender offers under the proposed definition; however, proposed rule 14e-4, which would require that such an offer be made to all securityholders, would by its terms preclude open market purchases.

120 Brascan Ltd. v. Edper Equities Ltd., 477 F. Supp. 773, 790-92 (S.D.N.Y. 1979):

> The consequence of bringing . . . large scale open market and privately negotiated purchases within the scope of the Williams Act would be to rule, in effect, that no large scale acquisition program may be lawfully accomplished except in the manner of a conventional tender offer. While this may be a sensible legislative provision . . . there is nothing in the legislative history or the text of the Williams Act which suggests that it intended to bring about such consequences.
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> . . . .
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> While one might have no disagreement with legislation which imposed pre-acquisition disclosure requirements, comparable to those required by § 13(d), whenever a purchaser intended to acquire by any means a large specified percentage of publicly held stock, that is not what the Williams Act now requires. It is not in my view within the power of a court to so rewrite its provisions.

ters more appropriately addressed by Congress than by the Commission. Under the proposals, any acquisition that "represents the ability to exert or influence control of a company"[121] would have to be effected by formal tender offer, thus effectively vitiating the distinction between the section 13(d) post-purchase filing requirement and section 14(d) pre-purchase filing requirement[122] in cases where "control" would be deemed at issue. Under the proposed legislation, "control" would be presumed to be at issue in acquisitions involving more than ten percent of a class of a target company's equity securities, and any such acquisition would be viewed as a "statutory offer" and would have to be effected by a formal tender offer.[123]

A "statutory offer" would include all offers to acquire beneficial ownership of equity securities by a person who is or could thereby become the owner of more than ten percent of a class of such securities.[124] Excepted from the definition of a statutory offer would be offers made pursuant to a statutory merger or consolidation; solicitations of proxies; acquisitions of two percent or less in any twelve-month period; acquisitions from the target company; and privately negotiated acquisitions from no more than ten persons in any twelve months.[125] For purposes of the ten-person exemption, each member of a group would be counted individually.[126] According to the Commission, "[t]his approach is designed to be both more comprehensive and simpler to apply"[127]

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121 SEC Memorandum, *supra* note 5, at 15.

122 Congress recognized this distinction when it passed the Williams Act. *See* notes 94 to 96 and accompanying text *supra.* As the Second Circuit observed in *Kennecott,* 584 F.2d at 1207: "Kennecott's contention . . . that whenever a purchaser of stock intends through its purchases to obtain and exercise control of a company, it should immediately file a Schedule 13D . . . would render the five percent filing provisions of section 78m(d)(1) [13(d)(1)] meaningless except in cases where the purchaser did not intend to obtain a controlling interest."

123 SEC Memorandum, *supra* note 5, at 15.

124 Proposed Bill § 14(d)(1)(B), *supra* note 5, at 21.

125 *Id.*

126 The SEC Memorandum, *supra* note 5, does not deal with the issue of whether the term "person" should include discretionary accounts administered by fiduciaries. However, in its release proposing a definition of the term "tender offer," the Commission specifically requested comments with respect to this issue, and presumably it is reserving final judgment on the question until it has reviewed those comments. *See* SEC Rel. No. 34-16385, *supra* note 113, at 82,603-04. Since under the Williams Act voting and disposition powers are the hallmarks of beneficial ownership, *see* note 23 *supra,* for the purpose of counting the number of persons solicited, an investment adviser with discretionary power over several accounts should be considered a single person.

127 SEC Memorandum, *supra* note 5, at 15.

than proposed rule 14d-1(b) as well as the present statute, which does not define the term "tender offer."

The proposed approach represents a simple, but highly restrictive, attempt to bring unconventional tender offers and pre-takeover open market purchase programs within the ambit of tender offer regulation. The Commission states that the proposed definition "would require that a person seeking *rapidly* to gain [a substantial stock] interest (defined as more than ten percent of a class of equity securities) in a public corporation do so by means of a 'statutory offer.' "[128] It is clear, however, that the ten percent test would require all acquisitions beyond the ten percent level to be made by formal tender offer, regardless of the speed with which the initial ten percent position was obtained. Further, under the Commission's proposals, it may be virtually impossible for a person to acquire a more-than-ten-percent position in a target company, although that person may be seeking only to establish an investment position, or less than absolute or effective control. Since partial tender offers may very well lead to competitive 100 percent offers,[129] a potential acquiror seeking only a minority position may be unwilling to undertake a formal tender offer on the theory that success is unlikely. When one considers that the Commission's new tender offer rules[130] and the proposed legislation[131] appear to

128 Section Analysis, *supra* note 5, at 25. *But cf.* note 33 and accompanying text *supra* (Commission's statement in 1978 that purpose of section 13(d) was to require disclosure of rapid accumulations of securities).

129 *Cf. A Friendly Takeover,* Bus. Week, Oct. 29, 1979, at 54, col. 2 (Tappan Co., which became a prime takeover target after a broker bought ten percent of its stock, found a white knight, Aktiebolaget Electrolux, to acquire Tappan through a 100 percent cash tender offer).

130 Formal tender offers now must remain open for at least twenty business days. *See* text accompanying note 60 *supra.* The requirements that an offer remain open for ten business days after an increase in the consideration being offered, *see* text accompanying note 61 *supra,* and that withdrawal rights be extended for ten business days after the commencement of a competing bid, *see* text accompanying note 54 *supra,* may force delays in an offer that develops into a competitive situation. These rules, as well as the rule requiring the target company to react to an offer within ten business days, *see* text accompanying notes 63 to 64 *supra,* and disclose whether it is seeking a "white knight," *see* note 64 *supra* (Item 7 of Schedule 14D-9 — negotiations and transactions), *see also* note 160 *infra* (definition of the term "white knight"), have the effect of making it easier for a potential competitor to enter into a bidding contest with the original offeror. It will have more time to analyze the situation and more readily will be able to determine the attitude of the target toward a potential second offer. *See* Fogelson, *New SEC Rules, Recession Spell Slowdown in Mergers,* N.Y.L.J., June 2, 1980, at 21, col. 5.

131 The Commission's proposals would codify virtually all of the pro-competitive rules discussed in note 130 *supra. See, e.g.,* text accompanying notes 140 to 142 & 156 to 158 *infra.*

encourage competitive bids, this result is magnified. Finally, serious questions may be raised as to the advisability or desirability of discouraging or possibly preventing the acquisition, presumably at premium prices, of large minority positions in a company's securities, since such acquisitions permit securityholders either to sell at a premium or to continue as securityholders along with their new co-owners.

The ten-person private transaction exemption may also be unduly restrictive and may regulate transactions which should not be regulated as tender offers.[132] Treating members of a group as individuals for the purpose of this exemption compounds the problem.[133] Moreover, no provision is made in the definition of "person" to allow for normal block trading activities, which often involve more than ten sellers.

Even assuming that a percentage test were the appropriate means of regulating tender offers,[134] a ten percent threshold seems unduly low. The ten percent threshold might be viewed as analogous to the ten percent beneficial ownership provisions of section 16 of the Exchange Act.[135] That section, however, is intended

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132 The proposed ALI Federal Securities Code's definition of tender offer is somewhat narrower in that it excludes offers directed to thirty-five or fewer persons. ALI FED. SEC. CODE § 202(166) (Official Draft, 1980). It is worth noting, however, that the ten-person exemption in the proposed bill refers to ten sellers, while the thirty-five-person exception in the proposed Federal Securities Code refers to thirty-five offerees. *Compare* Proposed Bill § 14(d)(1)(B)(v), *supra* note 5, at 21 *with* ALI FED. SEC. CODE § 202(166) (Official Draft, 1980).

133 *Cf.* note 117 *supra.*

134 Percentage tests have been used in other jurisdictions to regulate tender offers. For example, in England, the City Code on Take-overs and Mergers Rule 34 (1976), *reprinted in* M.A. WEINBERG & M.V. BLANK, TAKE-OVERS AND MERGERS app. A (1979), requires any person who alone or in concert with other persons acquires securities carrying thirty percent or more of the voting rights of the target company to extend an offer to all other securityholders in the target company at the highest price it has paid in the past twelve months. According to Blank, "[t]he 30 percent level is fixed by the Code as the level at which an offeror will acquire effective control of the target company, being regarded as the level at which a person will generally be able to secure that ordinary resolutions of shareholders are passed in accordance with its wishes." Blank, *Defenses to Takeovers — The United Kingdom,* 7 INT'L BUS. LAW. 287, 288 (1979).

135 15 U.S.C. § 78p (1976). Section 16(a), 15 U.S.C. § 78p(a) (1976), requires that each officer, director and greater-than-ten-percent securityholder of a company file monthly reports with the Commission disclosing his beneficial ownership of securities of the company. Section 16(b), 15 U.S.C. § 78p(b) (1976), provides for the recapture by a company of any profit realized from any purchase and sale, or any sale and purchase, of securities of the company within a period of less than six months by its officers, directors or greater-than-ten-percent securityholders.

to prevent the misuse of inside information,[136] and the concepts of "equity security" and "beneficial ownership" for Williams Act purposes are different from those for section 16 purposes.[137] Further, access to inside information (assuming that such access exists at the ten percent level) is not tantamount to control. For example, even in the highly regulated investment company area, control is frequently presumed to exist at a level much higher than the ten percent level suggested in the Commission's proposals. Section 2(a)(9) of the Investment Company Act[138] creates a rebuttable presumption of control at the twenty-five percent level for the purposes of that Act.[139] Moreover, the Commission's proposed section 14(d) would be triggered by the acquisition of ten percent of a class of a target company's securities without regard to whether larger blocks are held by others; thus the tender offer provisions would apply even in cases where no possibility of acquiring control exists, *e.g.*, where fifty-one percent of a class of a company's securities is held by another person and a more-than-ten-percent securityholder decides to increase his position. In sum, a threshold substantially above ten percent that reflects a true ability to influence or exert control would seem more appropriate in the con-

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136 *See, e.g.*, SEC Rel. No. 34-15348, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,762, at 81,066 (Nov. 22, 1978) (quoted in note 137 *infra*).

137 The Commission has consistently stated its belief that, since the objectives of section 16(a) and sections 13(d) and (g) differ, the rules for determining beneficial ownership under the two sections must also differ. *See, e.g.*, SEC Rel. No. 34-15348, *supra* note 136, at 81,066; SEC Rel. No. 34-13291, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,980, at 87,576 (Feb. 1977) ("[T]he [1977 beneficial ownership disclosure] rules are not intended to affect interpretations of the provisions of Section 16 of the Exchange Act, or the rules and regulations thereunder, since the purposes of Section 16 are different from those of Section 13(d).").

According to the Commission, section 16(a) is a "prophylactic provision designed to prevent the use of inside information" to obtain windfall profits through short-term insider trading. SEC Rel. No. 34-15348, *supra* note 136, at 81,066. The overriding concern in defining beneficial ownership under section 16(a) is with the "economic incidents" of ownership. *Id.* Sections 13(d) and (g), on the other hand, focus on voting power and power to dispose of securities, and beneficial ownership is defined accordingly, without regard to rights to receive dividends and other economic benefits. SEC Rel. No. 34-14692, *supra* note 23, at 80,308-09. *See also* SEC Rel. No. 34-13291, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,980 (Feb. 24, 1977) (specifically rejecting a proposed receipt of income test for determining beneficial ownership).

138 15 U.S.C. § 80a-2(a)(9) (1976).

139 *Cf.* Savings & Loan Ins. Act, 12 U.S.C. § 1730a(a)(2)(A) & (B) (1976) *and* Bank Holding Companies Act, 12 U.S.C. § 1841(a)(2)(a) (1976), which contain irrebuttable presumptions of control at the twenty-five percent level.

text of tender offer regulation, even assuming the Commission's concept of a threshold is appropriate.

D. *Tender Offer Regulation*

The legislative proposals contain an entirely new section 14(d) regulating tender offers, which includes new and revised substantive provisions and, in certain areas, incorporates provisions of existing and proposed tender offer rules into the statute itself.

1. Minimum Period of Statutory Offer

Under the Commission's proposals, an offer would have to remain open for at least twenty business days; it would also have to remain open for at least ten business days after a change in the consideration, method of payment or amount of securities sought, or the filing of a competing offer.[140] This provision would codify current rule 14e-1.[141]

2. Withdrawal Rights

A tendering securityholder would have withdrawal rights until the second business day prior to the expiration of the offer and any extensions thereof, unless his securities were already purchased.[142] This proposed withdrawal period would be longer than either the existing seven-day minimum provision of the statute[143] or the fifteen-business-day period (and concurrent ten-business-day period after the commencement of a competing offer) prescribed by the Commission's rules.[144]

3. Proration

In an offer for less than all the outstanding securities of a class of a company, all securities tendered pursuant to a statutory offer

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140 Proposed Bill § 14(d)(3)(C), *supra* note 5, at 22.
141 3 FED. SEC. L. REP. (CCH) ¶ 24,295 (1979). *See* text accompanying notes 60 to 61 *supra*.
142 Proposed Bill § 14(d)(3)(D), *supra* note 5, at 22.
143 Exchange Act § 14(d)(5), 15 U.S.C. § 78n(d)(5) (1976).
144 Rule 14d-7, 3 FED. SEC. L. REP. (CCH) ¶ 24,287A (1979). *See* text accompanying note 54 *supra*.

would have to be purchased on a pro rata basis.[145] Currently, the Williams Act requires proration of securities tendered during the initial ten days of an offer and for ten days after any increase in the consideration offered;[146] the Commission's rules permit extensions of the statutory proration periods.[147]

4. Equality of Treatment

The Williams Act currently requires that when an offeror increases the amount of consideration offered in a tender offer, the higher consideration be paid to all securityholders who tendered their securities before the increase.[148] The Commission has proposed a rule which would require that all tendering securityholders receive the highest consideration offered and that the offer be made to all securityholders, regardless of residence.[149] Under the Commission's legislative proposals, all securityholders who tender their securities in response to a statutory offer similarly would have to receive the highest consideration offered to any of them pursuant to the offer.[150] All-cash offers would have to be made to all securityholders residing in the United States.[151] By using the term "offered" rather than "paid," the legislative proposals would effectively prevent an offeror from lowering its initial offer. Chairman Williams' letter to the Senate Banking Committee notes that Congress could use "paid" instead of "offered" to allow an offeror to lower its offer.[152]

5. Purchase of Deposited Securities

Under the legislative proposals, tendered securities could be purchased only on or after the offer's expiration date, or on any date on which the offer is extended if the minimum offer period has expired.[153] Thus, the new withdrawal rights would attach to secur-

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145 Proposed Bill § 14(d)(3)(E), *supra* note 5, at 22.
146 Exchange Act § 14(d)(6), 15 U.S.C. § 78n(d)(6) (1976).
147 Rule 14d-8, 3 FED. SEC. L. REP. (CCH) ¶ 24,288A (1979). *See* text accompanying notes 55 to 56 *supra*.
148 Exchange Act § 14(d)(7), 15 U.S.C. § 78n(d)(7) (1976). *See* note 3 *supra*.
149 Proposed rule 14e-4, 3 FED. SEC. L. REP. (CCH) ¶ 24,298 (1979).
150 Proposed Bill § 14(d)(3)(B)(ii), *supra* note 5, at 23.
151 Proposed Bill § 14(d)(3)(B)(i), *supra* note 5, at 23.
152 Williams Letter, *supra* note 4, at 3.
153 Proposed Bill § 14(d)(3)(F), *supra* note 5, at 22. In the event that there are one or more extensions of an offer, the "expiration date" is the latest expiration date. *Id.*

ities tendered during, but not purchased at the expiration of, the initial offer period of an offer that is extended. The Commission's tender offer rules currently require prompt payment or return after termination or withdrawal of an offer.[154] Under the existing tender offer rules, tendered securities may be purchased at any time after the expiration of any applicable withdrawal periods.[155]

6. Target Company's Position

The target company's position with respect to a tender offer would have to be announced and a filing made within ten business days after the offeror's Schedule 14D-1[156] is filed.[157] This provision would codify current rule 14e-2.[158]

E. *Preemption of State Laws Governing Tender Offers*

The Commission's proposals contain an express preemption of all state laws regulating tender offers and acquisitions of beneficial ownership of securities.[159] The significance of federal preemption in the tender offer area can be best understood in light of the origins and development of state regulation of takeovers and the history of the efforts to obtain a judicial determination of whether the Williams Act preempts such state regulation.

Before the proliferation of the state takeover statutes, starting in 1974, the cash tender offer had evolved into a ten-day transaction, with the offer being consummated ten days after announcement. The target company thus had ten days to find a "white knight"[160] or to obtain sufficient judicial delay to search for one. If neither judicial delay was achieved nor a white knight found within ten

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154 Rule 14e-1, 3 FED. SEC. L. REP. (CCH) ¶ 24,295 (1979).

155 Although there is no specific provision in the Williams Act or the Commission's tender offer rules regarding when securities may be purchased, the withdrawal right period effectively establishes the rule set forth in the text.

156 3 FED. SEC. L. REP. (CCH) ¶ 24,284C (1979).

157 Proposed Bill § 14(d)(4), *supra* note 5, at 22.

158 3 FED. SEC. L. REP. (CCH) ¶ 24,296 (1979). *See* text accompanying notes 63 to 64 *supra*.

159 Proposed Bill § 28(a), *supra* note 5, at 23.

160 A "white knight" is a competing offeror friendly to the target company which attempts to "save" the target from being acquired by an offeror whose offer is considered undesirable by the target company's board of directors. *See generally* 1 M. LIPTON & E. STEINBERGER, TAKEOVERS AND FREEZEOUTS vii-viii (1978).

days, the initial offeror generally was successful. Time was on the side of the offeror.

State takeover statutes were designed to remedy this situation.[161] Of the thirty-five states[162] which have takeover statutes currently in force, all but a few have enacted exemptions from those statutes for offers that are approved by the target company's directors, or "friendly" offers.[163] The state statutes altered the acquisition landscape through their requirements of notice — ranging from ten to sixty days — before the commencement of an offer, and, in most cases, approval by a state securities commissioner[164] which could result in substantial delays. In some cases, state takeover statutes have resulted in an order prohibiting a proposed offer.[165]

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161 The jurisdictional bases for the application of a state takeover statute vary, and it is possible for a takeover bid to be subject to several state statutes. The most common criteria are incorporation of the target company in the state or location of the target company's principal office or principal place of business and/or substantial assets there. Other criteria include specified numbers of employees or securityholders in the state. Several statutes have been amended to narrow the class of potential companies subject to their provisions in order to reduce the vulnerability of those statutes to challenges of incompatibility with the United States Constitution. *See, e.g.,* Ark. Investor Protection Take-Over Act, § 67-1264(6)(b) (1979); La. Business Take-Over Offers, § 51:1500.1(13) (1979). *See generally* text accompanying notes 168 to 170 *infra.*

The mode of regulation of covered tender offers falls into three general categories: (i) requiring notice to the target company a specified period prior to commencement of the offer (*e.g.,* the Delaware statute); (ii) requiring both notice to the target and a pre-offer informational filing with the state's securities regulatory agency, which has the power (and, under certain statutes, the obligation, if so requested by the target) to hold hearings into alleged disclosure violations (*e.g.,* the N.Y. Security Takeover Disclosure Law and the Ga. Corporate Takeovers Law); and (iii) requiring not only pre-offer notice and filing but, also, compliance with substantive fairness standards, fulfillment of which may also be the subject of hearings (*e.g.,* the N. J. Corporation Takeover Bid Disclosure Law). *See generally* Bartell, *State Take-Over Laws: A Survey,* 1 NINTH ANNUAL INSTITUTE ON SECURITIES REGULATION 339 (1977); 1 M. LIPTON & E. STEINBERGER, *supra* note 160, at chap. 5.

162 Alaska, Arkansas, Colorado, Connecticut, Delaware, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, South Carolina, South Dakota, Texas (takeover provisions under its blue sky regulations), Utah, Virginia, and Wisconsin.

163 *See, e.g.,* Ga. Corporate Takeovers Law § 22-1901 (1977); Ky. Takeover Bids Law § 292.560 (1978); N.J. Corporation Takeover Bid Disclosure Law § 2 (1977); N.Y. Security Takeover Act § 1601 (1979). However, the Delaware statute, which is a principal takeover law in terms of the number of potential target companies subject to it, is among those statutes which apply to friendly as well as hostile offers. *See* DEL. GEN. CORP. LAW § 203 (1977).

164 *E.g.,* Ga. Corporate Takeovers Law § 22-1902 (1977); Me. Takeover Bid Disclosure Law § 804 (1979); OHIO REV. CODE ANN. § 1707.041 (1980); Va. Takeover-Bid Disclosure Act § 13.1-531 (1980).

165 *See, e.g.,* In the Matter of Pabst Brewing Company and APL Corporation, 3 BLUE SKY L. REP. (CCH) ¶ 71,415, at 68,369 (Wis. Comm'r Sec. 1978); In the Matter of Elkhart

Many statutes also contain requirements that an offer be kept open for more than the minimum periods required by the Williams Act[166] or that the securityholders' federal withdrawal rights be extended,[167] thereby further delaying consummation of the offer. Thus, prior to the adoption of the new tender offer rules, state takeover statutes, when enforceable, had proven to be significant weapons in the takeover defense arsenal.

In shifting the time advantage from the offeror to the target company, however, the state statutes may have created the basis for their demise. Compliance with one of the state takeover statutes may prevent the offeror from commencing its offer in all states. Further, each of the state takeover statutes varies in some respect from the scheme of tender offer regulation adopted in the Williams Act, which is designed to ensure full disclosure of material facts without favoring target companies against prospective offerors[168] and has nationwide applicability. As a result, the validity of the state statutes has been challenged on the ground of preemption by the Williams Act under the supremacy clause of the Federal Constitution[169] and as an undue burden on interstate commerce in violation of the commerce clause.[170]

The first significant test of the constitutionality of state takeover statutes came in *Great Western United Corp. v. Kidwell,*[171] in which both the United States District Court for the Northern District of Texas and the Fifth Circuit Court of Appeals held that

Lake's Road America, Inc. and Robert W. Winter, 3 BLUE SKY L. REP. (CCH) ¶ 71,410, at 68,341-42 (Wis. Comm'r Sec. 1977).

166 *E.g.,* Mass. Regulation of Take-Over Bids in the Acquisition of Corporations Law § 7 (1976) (sixty days); Mich. Take-Over Offer Act § 451.905 (1978) (sixty days); Mo. Take-Over Bid Disclosure Act § 3 (1979) (not less than twenty-one days, nor more than thirty-five days); Neb. Corporation Take-Over Law § 21-2409 (1978) (thirty days). For a discussion of the Williams Act's minimum offering periods, *see* notes 57 to 59 and accompanying text *supra.*

167 *E.g.,* Col. Investor Protection Act § 11-51.5-103 (1975) (within fifteen days of the offer, or after thirty-five days); DEL. GEN. CORP. LAW § 203 (1977) (within twenty days of the offer); Ill. Business Take-Over Act § 9 (1978) (during the first seventeen days of the offer, and after sixty days from the first date of the offer); Mo. Take-Over Bid Disclosure Act § 3 (1979) (within twenty-one days of the first date of the offer). For a discussion of securityholders' withdrawal rights under the Williams Act, *see* notes 41 and 54 and accompanying text *supra.*

168 *See* 113 CONG. REC. 854-55 (1967).

169 U.S. Const. art. VI, cl. 2.

170 U.S. Const. art. I, § 8, cl. 3.

171 439 F. Supp. 420 (N.D. Tex 1977), *aff'd,* 577 F.2d 1256 (5th Cir. 1978), *rev'd on venue grounds sub nom.* Leroy v. Great Western United Corp., 443 U.S. 173 (June 26, 1979).

the Idaho takeover statute was unconstitutional. While technically only applicable to the Idaho law, the Fifth Circuit decision was a sweeping condemnation of all the state takeover statutes. The Fifth Circuit held that the Williams Act preempts any state takeover law that is inconsistent as to time, disclosure or other material aspects of a tender offer.[172] Under this analysis, no state takeover law would be constitutional. The Fifth Circuit also held that the Idaho takeover law violated the commerce clause in that it unduly burdened interstate commerce.[173] The Supreme Court set

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172 577 F.2d at 1279-81. The Fifth Circuit stated:

> There is no real dispute that the Idaho statute — like most of the state takeover laws — increases a target company's ability to defeat a tender offer. The Idaho law helps target companies primarily through provisions not found in the Williams Act that give them advance notice of a tender offer and the ability to delay the commencement of an offer, by means such as insisting on a hearing. . . . The Idaho statute favors the target in other ways, as well. Idaho's regulation of defensive efforts by a target is significantly weaker than Idaho's regulation of an offeror's activities. . . . Finally, the Idaho statute gives the target corporation board the power to exclude an offer from state regulation by approving the offer. . . .
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> Idaho chose to protect investors differently from the way Congress protected investors. Instead of relying upon *investors'* decisions after full disclosure, Idaho relies upon the business judgment or corporate directors with a fiduciary duty to their shareholders. Idaho's "fiduciary approach" to investor protection may be one way to protect shareholders, but it is an approach Congress rejected.
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> Idaho's statute is preempted, because the market approach to investor protection adopted by Congress and the fiduciary approach adopted by Idaho are incompatible. The Senator for whom the Williams Act is named has written, "[a]dvance notice provisions, and requirements concerning the duration of offers, the pro rata purchases of shares, and the withdrawal rights of shareholders either explicitly conflict with federal provisions on the same subjects or are obstacles to the accomplishment of objectives implicit in the federal statutes". . . : Congress intended for the investor to evaluate a tender offer; Idaho asks the target company management to make that decision on behalf of the shareholders. . . . That Congress rejected provisions very similar to some of those in the Idaho takeover statute does not mean the state law is automatically preempted. . . . In this situation, however, Congress rejected those provisions to preserve the neutral regulatory stance that gives each side of a tender offer an equal opportunity to persuade the investor. When Idaho enacted those rejected provisions it hampered an offeror's ability to express and explain its position directly to investors. In doing so, Idaho disrupted the neutrality indispensable for the proper operation of the federal market approach to tender offers regulation. The Idaho takeover statute "stands as an obstacle to the accomplishment and execution of the full purposes and objectives" of the Williams Act.

577 F.2d at 1278-80 (footnotes and citations omitted).

173 The court reasoned that the sole legitimate local purposes which the Idaho law was designed to further, *i.e.*, encouraging civic responsibility on the part of the management of local corporations and protecting target company securityholders, were outweighed by the burdens the law imposed upon interstate commerce, *i.e.*, delaying or prohibiting the consummation of tender offers. 577 F.2d at 1281-86.

aside the Fifth Circuit's decision, stating that it was not reaching the merits of the issue of the constitutionality of state takeover laws and that the basis for its decision was that "venue did not lie in the Northern District of Texas."[174] Certain language contained in the Supreme Court's venue discussion may, however, be read to indicate that the Court generally views the scope of the federal securities laws as being somewhat narrower than did the Fifth Circuit.[175]

Various state statutes were successfully challenged and the enforcement of such statutes enjoined after the Fifth Circuit decision in *Kidwell* and prior to the Supreme Court's decision.[176] In several

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174 Leroy v. Great Western United Corp., 443 U.S. 173, 180 (June 26, 1979).

175 Section 28(e) of the Exchange Act, 15 U.S.C. § 78bb(e), provides: "Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder." The Fifth Circuit had read the language of section 28(e) as "impliedly prohibit[ing] a state official from enforcing a statute that conflicts with the [Exchange] Act." 577 F.2d at 1271. The Supreme Court put a different cast on section 28:

> The reference in § 27 [which provides that federal district courts have exclusive jurisdiction over all actions brought under the Exchange Act and rules promulgated thereunder, and sets forth venue rules for such actions] to the 'liabilit[ies] or dut[ies] created by this chapter' clearly corresponds to the various provisions in the [Exchange] Act that explicitly establish duties for certain participants in the securities market or that subject such persons to possible actions brought by the Government, the Securities and Exchange Commission, or private litigants. Section 28 is not such a provision. There is nothing in its text or its legislative history to suggest that it imposes any duty on the States or that indicates who might enforce any such duty. *The Section was plainly intended to protect, rather than to limit, state authority.* Because § 28 imposed no duty on petitioner, the argument that § 27 establishes venue in the District Court is unsupportable.

443 U.S. at 181-82 (emphasis added). Moreover, the Court wrote:

> The merits of Great Western's claims [or unconstitutionality] may well depend on a proper interpretation of the State's statute, and federal judges sitting in Idaho are better qualified to construe Idaho law, and to assess the character of Idaho's probable enforcement of that law, than are judges sitting elsewhere.

Id. at 186. Indeed, several lower courts have attempted to read *Kidwell* in a light favorable to a finding of constitutionality of state takeover statutes. *See, e.g.*, Strode v. Esmark, No. 79-CI-1950 (Franklin Cty. Cir. Ct. May 13, 1980) ("Section 28 of the [Exchange] Act . . . specifically precludes preemption unless actual conflict can be shown between the state and federal regulations. This section was designed to protect the authority of the states in securities regulation and not to limit it. Leroy v. Great Western Corporation [sic]. . . ."); GM Sub Corp. v. Liggett Group Inc., [CURRENT] FED. SEC. L. REP. (CCH) ¶ 97,389, at 97,546 (Del. Apr. 30, 1980) ("[O]n the accommodation between the Federal Rule and the Delaware Statute . . . see Leroy v. Great Western United Corp. . . ., in which the Supreme Court of the United States said that Section 28(e) 'was plainly intended to protect, rather than limit, state authority.' ").

176 *See, e.g.*, Dart Indus. Inc. v. Conrad, 462 F. Supp. 1 (S.D. Ind. 1978), *application*

other cases prior to the Supreme Court decision, the courts expressed reservations as to constitutionality, without deciding the issue.[177] Since the Supreme Court ultimately decided *Kidwell* on venue grounds, the constitutionality issue has remained open. Decisions handed down since *Kidwell* have suggested that lower courts might have become reluctant to hold state takeover statutes unconstitutional.[178]

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for stay of temporary restraining order denied (7th Cir. Nov. 13, 1978) (Delaware statute); Brascan Ltd. v. Lassiter, Civ. Action No. 79-1253 (E.D. La. May 3, 1979) (Louisiana statute); Mite Corp. v. Dixon, No. 79 C 200 (N.D. Ill. Feb. 9, 1979), *appeal pending*, No. 79-1267 (7th Cir.) (Illinois statute).

177 *See, e.g.*, UARCO, Inc. v. Daylin, Inc., Civ. No. 78-C-4246 (N.D. Ill. Nov. 27, 1978) (the Delaware and Illinois statutes); Occidental Petroleum Corp. v. Hurd, C-3-78-1100 (S.D. Ohio 1978) (the Ohio statute); S-G Securities, Inc. v. Fuqua Investment Co., 466 F. Supp. 1114 (D. Mass. 1978) (the Massachusetts statute); Sharon Steel Corp. v. Durham, Civ. 79-181 (Sup. Ct. Me. Mar. 26, 1979) (the Maine statute); Telco Marketing Services, Inc. v. Hospital Financial Corp., No. 79 C 2343 (N.D. Ill. June 11, 1979) (the Illinois and Delaware statutes). *See also* UV Indus. Inc. v. Posner, 466 F. Supp. 1251 (D. Me. 1979) (the Maine statute).

178 *See, e.g.*, Strode v. Esmark, Inc., No. 79-CI-1950 (Franklin Cty. Cir. Ct. May 13, 1980) (holding the Kentucky statute constitutional against challenges on preemption and commerce clause grounds); AMCA Int'l Corp. v. Krouse, [CURRENT] FED. SEC. L. REP. (CCH) ¶ 97,249 (S.D. Ohio Dec. 21, 1979) (holding the Ohio statute constitutional against challenges on preemption and commerce clause grounds); City Investing Co. v. Simcox, 476 F. Supp. 112 (S.D. Ind. July 27, 1979) (holding the Indiana statute constitutional against challenges on preemption and commerce clause grounds; appeal pending). *But see* Eure v. NVF Co., No. 79 CVS 4093 (N.C. Super. Ct. May 15, 1980) (holding those provisions of the North Carolina statute requiring prepurchase disclosure in connection with certain open market stock purchases unconstitutional on preemption and commerce clause grounds; but holding the withdrawal, proration and best-price provisions of the same statute constitutional). *See also* Eure v. Grand Metropolitan Limited 80 CVS 1685 (N.C. Super. Ct. Apr. 1, 1980) (open market purchases preliminarily enjoined on ground of noncompliance with tender offer disclosure provisions of North Carolina takeover statute), *motion for stay pending appeal granted*, Eure v. Grand Metropolitan Limited, No. 80 SC 210PS-TS (N.C. Ct. App. Apr. 30, 1980); Chromalloy American Corp. v. Sun Chemical Corp., 474 F. Supp. 1341 (E.D. Mo. Aug. 20, 1979) (denying a preliminary injunction against the enforcement of the Delaware and Missouri statutes), *aff'd*, 611 F.2d 240 (8th Cir. Dec. 14, 1979); Eure v. Consolidated Foods Corp., 78 CVS 4358 (N.C. Super. Ct. Sept. 7, 1978) (temporary restraining order granted against making further open market purchases on grounds that the disclosure provisions of the North Carolina statute were violated). *Compare* Wylain, Inc. v. TRE Corp., [CURRENT] FED. SEC. L. REP. (CCH) ¶ 97,270 (Del. Ch. Jan. 30, 1980) (holding Delaware Act constitutional and not preempted) *with* TRE Corp. v. Wylain, Inc., Civ. No. CA 3-79-1450-F (N.D. Tex. Nov. 27, 1979) (temporary restraining order granted against enforcement of Delaware Tender Offer Act on grounds of preemption), *motion for stay pending appeal granted*, No. 79-3814 (5th Cir. Nov. 30, 1979), *and* TRE Corp. v. Dixon, 79 C 5284 (N.D. Ill. Dec. 21, 1979) (motion for preliminary injunction) (holding Illinois statute to have been preempted).

More recently, in Telvest, Inc. v. Bradshaw, [CURRENT] FED. SEC. L. REP. (CCH) ¶ 97,329 (4th Cir. Mar. 26, 1980), the Fourth Circuit Court of Appeals reversed a preliminary injunction granted by the District Court against enforcement of the Virginia takeover statute as applied to open market purchases in excess of ten percent of a class of a target

Just as the tide of judicial opinion may have begun to shift in favor of the constitutional validity of state takeover statutes, the new tender offer rules, which were designed to invalidate many of

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company's securities. While the court did not specifically rule on the constitutionality of the statute, but rather based its decision on the standards for granting preliminary injunctions, the opinion nevertheless places strong emphasis on the presumed validity of state statutes, and its analysis suggests that it would be likely to uphold the statute if the ultimate question of constitutionality were before it. It should be noted that the court did not consider the effect of rule 14d-2 on the question of preemption of the Virginia statute, since the rule was not in effect when the case was argued.

On April 3, 1980, Telvest petitioned the Fourth Circuit for a rehearing on the ground that on March 19, 1980, one week prior to the court's decision, the Virginia statute was amended to eliminate the provision which had been before the court. In its place, an exemption from the statute was enacted for open market purchases, except by a person who intends "to change the control of the offeree company." Virginia Take-Over-Bid Disclosure Act § 13.1-529(a) (iii) (1980). Such persons will be exempt if they file an information statement with the Virginia State Corporation Commission which discloses, among other information, the purpose of the prospective change in control and the method of carrying it out. *Id.* There is a presumption in the statute that a ten-percent securityholder who has purchased more than one percent of a class of the company's securities in the preceding twelve-month period has a control intention. *Id.* Telvest has also requested leave to amend its complaint to challenge the statute, as amended.

A separate preemption issue under state takeover laws has been the extent to which acquisitions other than tender offers are covered by the provisions of those laws. Some state statutes generally define a "tender offer" as any offer for more than a specified percentage (usually five percent) of any class of equity securities of a company, *e.g.*, Me. Takeover Bid Disclosure Law § 802(16) (1979) (five percent); Utah Take-Over Offer Disclosure Act § 61-4-3(7) (1979) (five percent), while others define the term by reference to the term "tender offer" itself, *e.g.*, Kan. Take-over Bids Law § 17-1276(a) (1976) (twenty percent) Ky. Take-Over Bid Disclosure Act § 292.560(1) (1978) (five percent); N.Y. Security Takeover Disclosure Act § 1601(a) (1979) (five percent); N.C. Tender Offer Disclosure Act § 78B-2(14) (1980) (five percent); OHIO REV. CODE ANN. § 1707.041 (A)(1) (1980) (ten percent). A few of these statutes also have provisions specifically aimed at preventing accumulations of securities through privately negotiated or open market purchases as a prelude to a tender offer. These provisions prohibit an offeror from making a tender offer if the offeror beneficially owns a specified percentage (either two percent or five percent) or more of any class of the target company's equity securities, any of which were purchased within the twelve-month period preceding the proposed tender offer, unless, prior to making any such purchases, the offeror publicly announced its intention to gain control of the target company or otherwise disclosed such intention to the persons who sold the offeror their securities. *E.g.*, Ga. Corporate Takeovers Law § 22-1904 (1977) (five percent); Kan. Take-over Bids Law § 17-1277(b) (1976) (two percent); Ky. Take-over Bid Disclosure Act § 292.570(2) (1978) (five percent); OHIO REV. CODE ANN. § 1707.041(B)(2) (1980) (five percent). The courts have been relatively consistent in holding that state "tender offer" provisions, as they apply to open market purchases, were not preempted by Congress' enactment of the Williams Act. *See, e.g.*, Strode v. Esmark, Inc., No. 79-CI-1950 (Franklin Cty. Cir. Ct. May 13, 1980) (holding the application of Kentucky statute to open market purchases constitutional against challenges on preemption and commerce clause grounds); Eure v. Grand Metropolitan Limited, 80 CVS 1685 (N.C. Super. Ct. Apr. 1, 1980) (open market purchases preliminarily enjoined on ground of noncompliance with tender offer disclosure provisions of North Carolina takeover statute), *motion for stay pending appeal granted*, Eure v. Grand Metropolitan Limited, No. 80 SC 210PS-TS (N.C. Ct. App. Apr. 30, 1980); UV Indus., Inc. v. Posner, 466 F. Supp. 1251 (D. Me. 1979) (Maine statute held applicable

their provisions, were adopted.[179] Under new rule 14d-2, unless an offer is abandoned within five business days of an announcement of the amount of target securities sought and the price to be paid, the offeror must disseminate to securityholders the disclosure required by the Williams Act.[180] The Commission regards a state takeover statute filing as a public announcement for this purpose.[181] Because the five-business-day period will invariably elapse before the offer can be commenced under a state statute's minimum notice or filing period, the offeror may be forced to violate state takeover statutes in order to comply with rule 14d-2. On this basis, the Commission has commented that there exists a direct and substantial conflict between the new rules and state takeover statutes and that such statutes "frustrate the operation and purposes of the Williams Act."[182]

The potential conflict between the federal and state requirements is apparently being resolved by courts[183] and state ad-

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to large open market block purchase); Eure v. Consolidated Foods Corp., 78 CVS 4358 (N.C. Super. Ct. Sept. 7, 1978) (temporary restraining order granted against making further open market purchases on grounds that the disclosure provisions of the North Carolina statute were violated). *But see* Eure v. NVF Co., No. 79 CVS 4093 (N.C. Super. Ct. May 15, 1980) (holding those provisions of the North Carolina statute requiring prepurchase disclosure in connection with certain open market purchases of securities unconstitutional on preemption and commerce clause grounds; but holding the withdrawal, proration and best-price provisions of the same statute constitutional); UV Indus., Inc. v. Sharon Steel Corp., 3 BLUE SKY L. REP. (CCH) ¶ 71,466 (N.Y. Cty. Sup. Ct. 1979) (large open market block purchase held not subject to New York statute defining takeover bid in terms of tender offer for more than five percent of a class of a target company's securities). *See also* Telvest, Inc. v. Bradshaw, discussed *supra.*

179 *See* SEC Rel. No. 34-16384, note 47 *supra.*

180 Rule 14d-2, 3 FED. SEC. L. REP. (CCH) ¶ 24,282A (1979).

181 *See* SEC Rel. No. 34-16384, *supra* note 47, at 82,583-84. *See also* SEC Rel. No. 34-16623, [CURRENT] FED. SEC. L. REP. (CCH) ¶ 24,2841, at 17,721-7A (Mar. 5, 1980) (stating, in response to a question concerning filings with state and federal agencies, that "[a]ny announcement of . . . the identity of the parties and the price and amount of securities sought which would make that information available to the public . . . would commence the five business day period").

182 SEC Rel. No. 34-16384, *supra* note 47, at 82,584, citing the Commission's Supreme Court *amicus curiae* brief in Leroy v. Great Western United Corp., 443 U.S. 173 (June 26, 1979).

183 *See* Sun Life Group, Inc. v. Standard Life Insurance Co., [CURRENT] FED. SEC. L. REP. (CCH) ¶ 97,314 (S.D. Ind. Mar. 12, 1980) (Indiana insurance holding company statute construed not to prohibit the making of a tender offer prior to Indiana Insurance Commissioner approval if final consummation of the offer is conditioned on obtaining such approval); Offer to Purchase, dated June 10, 1980, for ERC Corporation by a subsidiary of Getty Oil Company (Missouri and Kansas Insurance Acts interpreted by those states' insurance commissioners to permit the making of a tender offer prior to their respective approvals if purchase of shares conditioned upon obtaining such approvals); GM Sub Corp. v. Liggett Group Inc., [CURRENT] FED. SEC. L. REP. (CCH) ¶ 97,389 (Del. Apr. 30, 1980)

ministrators[184] by accommodating the state statutes to the federal rule in order to permit offers to go forward as required by the Williams Act, subject to applicable post-filing hearing procedures.[185] However, the issue of the constitutionality of state statutes under the new tender offer rules is likely to remain a mat-

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(permitting the offeror to proceed with its offer in compliance with rule 14d-2 by vacating a lower court decision which had granted a temporary restraining order against the offer until the expiration of the Delaware statute's twenty-day pre-offer waiting period); Eure v. Grand Metropolitan Limited, [CURRENT] FED. SEC. L. REP. (CCH) ¶ 97,383 (N.C. Super. Ct. Apr. 18, 1980) (holding that the Commission's rule 14d-2 is "overriding and preemptive" with respect to the North Carolina takeover law, which provides for a thirty-day post-filing waiting period); *In re:* Registration of Tender Offer by GM Sub and Grand Metropolitan Limited (S.C. Sec. Comm'r Apr. 18, 1980) (South Carolina Commissioner, after determining that the offeror had made the necessary filings, that the filings gave full and fair disclosure of the terms of the offer, and that the terms of the offer were fair, exercised his statutory authority to permit the immediate commencement of the offer, thereby avoiding a direct conflict between the South Carolina statute's twenty-day pre-offer waiting period and the Commission rules). *See also* H.B. Holdings, Inc. v. Rosario Resources Corp., 80 Civ. 201 (CLB) (S.D.N.Y. filed Jan. 10, 1980) (New York Attorney General entered into a stipulation which permitted the bidder to commence its tender offer within five days of its public announcement, as required by rule 14d-2, notwithstanding New York statute's twenty-day pre-offer waiting period; litigation rendered moot when the offer was terminated); AMCA Int'l Corp. v. Krouse, [CURRENT] FED. SEC. L. REP. (CCH) ¶ 97,249, at 96,753 n.4 (S.D. Ohio Dec. 21, 1979) (in case antedating the effective date of the new tender offer rules, the court stated its view that, given the conflict between the federal and state rules, state statutes "will indisputably be preempted when the new federal regulation becomes effective").

184 Several states have taken legislative or administrative measures, *see, e.g.*, 3 BLUE SKY L. REP. (CCH) ¶¶ 65,001; 65,021; 65,065 (Feb. 15, 1980) (Wisc. Disclosure Regulations amendments); 1A BLUE SKY L. REP. (CCH) ¶ 71,641 (Feb. 19, 1980) (Indiana policy statement); 1A BLUE SKY L. REP. (CCH) ¶¶ 23,422; 23,633 (Apr. 8, 1980) (Md. Corporate Take-Over Law § 11-902(d) amendment and policy statement); 2 BLUE SKY L. REP. (CCH) ¶ 33,776A (Apr. 1980) (N.J. Corporate Takeover Bid Disclosure Law Regulations amendment); 2 BLUE SKY L. REP. (CCH) ¶¶ 42,302; 42,303; 42,305; 42,306; 42,315 (June 30, 1980) (New York Security Takeover Disclosure Act Amendments), in order to protect the enforceability of their state takeover statutes and, at the same time, allow compliance with new rule 14d-2. *But see* the Complaint in Ohio ex rel. Krouse v. SEC, Civ. Act No. C-2-80-111 (S.D. Ohio filed Feb. 14, 1980), [CURRENT] FED. SEC. L. REP. (CCH) ¶ 97,286 (suit brought by the Ohio Commissioner of Securities against the Commission seeking a declaratory judgment that the Commission's rules are invalid and that they do not invalidate the Ohio tender offer law).

185 Since open market purchases as a general rule do not constitute "tender offers" under the Williams Act, *see* note 99 *supra*, and rule 14d-2 applies only to "tender offers" covered by the Williams Act, it seems fairly safe to say that rule 14d-2 will probably have no effect on the line of cases holding that state takeover statutes as applied to open market purchases are not preempted, *see* note 178 *supra*. It is worth noting that, in the event that one of the Commission's proposed definitions of the term "tender offer," *see* text accompanying notes 113 to 117 & 121 to 127 *supra*, were to be adopted, certain open market purchases and purchase programs would in fact be regulated as "tender offers" under the Williams Act. In that case, courts faced with the constitutionality issue might very well determine that state regulation of open market purchases has been preempted by the Williams Act. The breadth of the term "tender offer" under the federal statute, then, might determine to a large extent the area in which state regulation could validly operate. *See* notes 198 to 201 and accompanying text *infra*.

ter of dispute.[186] Thus, for example, if one accepts the rationale that, in enacting the Williams Act, Congress did not intend to preempt state regulation of tender offers,[187] it could be argued that the Commission's endeavor by technical rule to preempt the field exceeds its regulatory authority under the Exchange Act.[188]

In its legislative proposals, the Commission has proposed to amend section 28(a) of the Exchange Act[189] expressly to preempt all state laws that regulate "tender offers or acquisitions of beneficial ownership" of securities "as such."[190] According to the Commission, "[t]ender offers are uniquely national in character," and therefore the regulation of tender offers should be effected by means of a uniform national law rather than by the laws of various states, many of which purport to regulate tender offers on a nationwide basis.[191] State regulation of tender offers for local companies, defined as companies having their principal place of business in the state and more than half of their equity securityholders holding more than half of their outstanding equity securities residing in the state, would not be preempted (at least to the extent that it is not in conflict with sections 13(d) and 14(d) of the Exchange Act),[192] since, in the opinion of the Commission, the

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186 While those state statutes that have been amended may no longer be in direct conflict with the new rules, their constitutionality is, as before, uncertain. *See, e.g.*, SEC Rel. No. 34-16384, *supra* note 47, at 82,596:

> The problems engendered by tender offers of excessively short duration also may have provided part of the stimulus for some of the 36 states which have enacted antitakeover statutes since 1968. To the extent this was a purpose of such legislation, the attempt to alleviate the problem was laudable, but has resulted in an inconsistent, overlapping and often counterproductive pattern of regulation and in many instances may have tipped the carefully constructed balance between bidder and subject company envisioned by the Williams Act in favor of subject company. Accordingly, the Commission believes that a uniformly applied federal regulation will better serve the purposes and policies of the Williams Act, including the interests of investors.

187 *See* AMCA Int'l Corp. v. Krouse, [CURRENT] FED. SEC. L. REP. (CCH) ¶ 97,249, at 96,754 (S.D. Ohio Dec. 21, 1979).

188 Of course, to the extent that courts and state administrators have accommodated the state statutes to the federal rule, the issue may not, as a practical matter, be a burning one. However, in view of the Commission's recent spate of proposals to amend the statute and the rules, the issue of the scope of the Commission's authority is important and should not be ignored.

189 15 U.S.C. § 78bb(a) (1976).

190 Proposed Bill § 28(a), *supra* note 5, at 23.

191 SEC Memorandum, *supra* note 5, at 18.

192 Proposed Bill § 28(a), *supra* note 5, at 23. The ALI's Proposed Federal Securities Code contains a similar exemption. ALI FED. SEC. CODE § 1904(c) (Official Draft, 1980).

predominantly local character of the transaction would warrant local rather than national regulation. Other state blue sky laws (*e.g.*, those regulating fraud in intrastate securities transactions) would not be affected by the proposed amendment.[193] State laws relating to transfers of ownership or control which do not regulate tender offers or acquisitions of beneficial ownership "as such" (*e.g.*, certain insurance holding company statutes), and those governing the conduct of the internal affairs of state-chartered corporations (*e.g.*, going private transactions) would not automatically be preempted under the legislative proposals. Rather, such provisions would be preempted only if it were determined that they frustrate the purposes of the federal securities laws.

Because the proposed amendment employs the "as such" concept, it fails adequately to clear up an ambiguity present in the new tender offer rules with respect to whether the federal securities laws preempt various state regulatory statutes which prevent the making or the consummation of an offer.[194] Under the proposed amendment, preemption would be achieved directly rather than indirectly through rule 14d-2, but it is still not entirely clear which state regulatory provisions would be preempted. For example, some insurance holding company statutes forbid the "making of a tender offer" without prior approval,[195] while others merely prohibit the acquisition of control of an insurance company without

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193 Section Analysis, *supra* note 5, at 29.

194 Filings pursuant to various state regulatory statutes, *e.g.*, insurance holding company and bank holding company statutes, as well as state takeover laws, may constitute "public announcements" of the material terms of an offer within the meaning of rule 14d-2, which requires that an offer be commenced within five days of such announcements. *See* note 180 and accompanying text *supra; cf.* text accompanying note 181 *supra* (Commission regards state takeover statute filing as public announcement for rule 14d-2 purposes). Thus, according to the Commission, such statutes are preempted by rule 14d-2. *See* text accompanying note 182 *supra.* However, it is not clear that the Commission intended that rule 14d-2 would preempt all non-takeover law regulatory requirements. *See, e.g., Amicus* Brief of the Commission at 5 n.5, Sun Life Group, Inc. v. Standard Life Insurance Co., [CURRENT] FED. SEC. L. REP. (CCH) ¶ 97,314 (S.D. Ind. Mar. 30, 1980):

> In view of the provisions of the Indiana statute which require the Insurance Commission to consider the effects of the tender offer on policyholders and other aspects of the business of insurance, the Commission does not believe that the 30 day period [the minimum notice period for hearing under the Indiana Act] would have a severe, adverse impact on the operation of the Williams Act, assuming an expeditious hearing and resolution of the relevant issues. In this respect, the Indiana statute may be different from many state takeover statutes that impose waiting periods and other restrictions which may be inherently inconsistent with the recently adopted tender offer rules.

195 *See, e.g.*, IND. INS. CODE § 27-1-23-2 (1971); MASS. INS. LAWS CH. 175 § 193M (1970).

prior approval.[196] The former type of provision arguably regulates tender offers "as such" and would be preempted under the specific language of the proposed amendment that would preempt all state takeover laws; the latter type of provision would more likely be among those statutes that would be preempted only if, in the words of the Commission, they "stand as an obstacle to the accomplishment of the purposes of the federal law."[197]

Although the proposed amendment to section 28(a) is the shortest section of the proposed bill,[198] it is, with the possible exception of the concept of "statutory offer," the single most significant provision of the legislative proposals. First, the proposed amendment would preempt all state takeover laws which purport to regulate "tender offers" as that term is interpreted for purposes of federal law. Second, it would preempt all state takeover laws designed to regulate open market purchases and other acquisitions of beneficial ownership, thus precluding the states from having even a limited role in regulating takeovers and other accumulations of securities. The legislative proposals would thus represent a complete federalization of these areas of regulation.[199] While the wisdom of taking such a drastic step might be open to question, it seems clear that it would be more appropriate for Congress to consider amending the Williams Act expressly to preempt state regulation than it is for the Commission to adopt a rule, such as rule 14d-2, which indirectly preempts such regulation without a specific congressional mandate to do so.

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196 *See, e.g.*, N.Y. INS. LAW § 69-f (1969).

197 Section Analysis, *supra* note 5, at 29. The Commission has indicated that it would take the position set forth in the text. *See Amicus* Brief of the Commission at 4-5, Sun Life Group, Inc. v. Standard Life Insurance Co., [CURRENT] FED. SEC. L. REP. (CCH) ¶ 97,314 (S.D. Ind. Mar. 12, 1980) (quoted in note 194 *supra*).

198 The proposed amendment would add the following proviso to section 28(a) of the Exchange Act, 15 U.S.C. § 78bb(a) (1976):

> *provided, however,* that Sections 13(d) and 14(d) shall be plenary and exclusive with respect to any state law that purports to regulate as such tender offers or acquisitions of beneficial ownership subject to these Sections, except for any such state law that is not in conflict with Sections 13(d) and 14(d) to the extent that such state law applies to a tender offer for, or an acquisition of, equity securities of a company (1) that has its principal place of business in that state, and (2) more than fifty percent of the beneficial holders, as defined by the Commission, of whose outstanding voting securities, who in the aggregate hold fifty percent or more of those securities, are residents of that state.

199 *Compare* ALI FED. SEC. CODE § 1904(c) (Official Draft, 1980), which would preempt only those state laws regulating transactions which are "tender offers" under the Code.

F. *Role of Commercial Banks and Investment Bankers in Tender Offers; Arbitrageurs*

The Commission's separate report to the Senate Banking Committee on the role of banks in tender offers[200] expresses the Commission's view that it should be granted specific authority to regulate the activities of banks and other financial institutions in connection with tender offers. Although the proposals would not change current practice significantly, they would greatly increase the Commission's express statutory authority in the area and therefore deserve careful scrutiny.

The very large tender offers of recent years have almost always required some degree of external financing. Accordingly, as one court has observed, banks play a "critical role in determining whether tender offers will go forward and as a result exert [a] significant influence in determining [whether] management [of the target company] survives."[201] The number of financial institutions willing and able to extend credit in the required amounts is limited[202] and, therefore, tender offer financing has become, in significant part, the preserve of the major commercial banks. Those same banks also tend to have banking relationships with companies that become the targets of tender offers. This set of circumstances can result in situations in which a bank financing a tender offer has also, at some stage, had a banking relationship with the target company.

Just as few commercial banks are active in the area of tender offer financing, so too, only a limited number of investment banking firms have the experience and expertise sought by companies embarking upon acquisitions of other major public companies.

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200 Bank Memorandum, note 5 *supra*.

201 Humana, Inc. v. American Medicorp, Inc., [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,286, at 92,829 (S.D.N.Y. Jan. 5, 1978).

202 Recently, financing was particularly limited due to the Federal Reserve Board's policy against loans to finance corporate takeovers. *See* Federal Reserve Board Release, FED. BANKING L. REP. (CCH) ¶ 9521A, at 5412 (Mar. 14, 1980) ("[B]anks are encouraged particularly . . . [t]o discourage financing of corporate takeovers or mergers and the retirement of corporate stock, except in those limited instances in which there is a clear justification in terms of production or economic efficiency commensurate with the size of the loan.") *But see* Metz, *Takeover Lending Ban Isn't So Stringent Today, It Seems, Despite Volcker's Letter,* Wall St. J., May 29, 1980, at 4, col. 2; *Volcker Vows to Keep Stiff Money Policy, But Says Credit Restraints May End Soon,* Wall St. J., May 15, 1980, at 3, col. 2. The Board's policy was suspended in July, 1980.

Again, these same firms tend to be prominent in other areas of investment banking,[203] and this set of circumstances can result in situations in which an investment banking firm advising an offeror has also, at some time, had a relationship of some kind with the target company.

Because they are aware that these situations may occur and that such situations furnish a potential target company with the opportunity for making embarrassing and reputation-damaging charges of breach of fiduciary duty, conflict of interest and misuse of confidential information, both commercial banks and investment banking firms have implemented internal control systems designed to ensure that their mergers and acquisitions departments and, in the case of commercial banks, members of their loan departments involved in acquisition financing, do not receive from other departments or even other members of the same department any non-public information about companies with which those other departments or members have contacts. These systems, which have come to be known by the generic label "Chinese Wall," are designed to permit those other departments and members to conduct their regular business while ensuring that if any company with which such business is being conducted should at some point become the target of a takeover bid by a client of the mergers and acquisitions department or a customer of another member of the loan department, such department or member can demonstrate that in fact confidential information about the target company was not received and that the target company therefore suffered no harm.[204] An effective "Chinese Wall" can enable offerors to resist injunction motions based on claims of conflict of interest or breach of fiduciary duty.[205]

Concurrently with adopting its new tender offer rules, the Com-

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203 *E.g.*, securities underwriting, private placements, brokerage, arbitrage.

204 *See generally* Colling, *The Chinese Wall and Conflict of Interest in Banks*, 34 BUS. LAW. 73 (1978); Lipton & Mazur, *The Chinese Wall Solution to the Conflict Problems of Securities Firms*, 50 N.Y.U.L. REV. 459 (1975); Chazen, *Reinforcing The Chinese Wall: A Response*, 51 N.Y.U.L. REV. 552 (1976); Lipton & Mazur, *The Chinese Wall: A Reply to Chazen*, 51 N.Y.U.L. REV. 579 (1976).

205 *See, e.g.*, Washington Steel Corp. v. TW Corp., 602 F.2d 594 (3d Cir. 1979); Harnischfeger Corp. v. Paccar, Inc., 474 F. Supp. 1151 (E.D. Wis. July 10, 1979). *Cf.* In re Registration of Tender Offer by Brascan U.S.A. Inc. for the Common Stock of F.W. Woolworth Co. (S.C. Sec. Comm'r May 14, 1979).

mission proposed rule 14e-3(a)[206] which would impose a disclose-or-abstain-from-trading obligation on certain "tippees"[207] in possession of material non-public information. Proposed rule 14e-3(a) would impose an obligation to disclose or abstain from purchasing or selling, or arranging for the purchase or sale of, a target company's securities or options thereon, on any person (other than the prospective offeror) who is in possession of information relating to a tender offer that the prospective offeror has determined to make or is making and knows or has reason to believe that such information was received[208] from the prospective offeror.[209] The obligation would apply to any tippee who knows or has reason to believe that the non-public information, including knowledge of the prospective offeror's intention to make the offer[210] and information about price and price increases, commencement, receipt of regulatory approvals and possible cancellation of

206 Proposed rule 14e-3(a), 3 FED. SEC. L. REP. (CCH) ¶ 24,297 (1979). *See* SEC Rel. No. 34-16385, note 113 *supra*. [As this Article went to press, the Commission adopted proposed rule 14e-3, with certain revisions. SEC Rel. No. 34-17120 (Sept. 4, 1980).].

207 Implicitly drawing support from the Court of Appeals decision in United States v. Chiarella, 558 F.2d 1358 (2d Cir. 1978) (upholding the conviction of a printer who, upon learning of impending takeover attempts from confidential documents belonging to the prospective bidders, purchased securities of the target companies without disclosing his knowledge of the impending takeovers to the sellers of those securities), *rev'd*, 100 S. Ct. 1108 (Mar.18, 1980), the Commission considers the term "tippee" to include "persons involved in the planning, financing, preparation or execution" of a tender offer with the offeror even though such persons are not insiders of the company whose securities are being bought or sold on the basis of the tipped information. However, subsequent to the proposal of the rule, the Supreme Court reversed Chiarella's conviction, holding that nondisclosure is actionable only if the defendant has a duty of disclosure arising out of corporate insider status or some prior relationship with the party on the opposite side of the securities transaction. 100 S. Ct. at 1108. The Commission staff has indicated that it intends to pursue the adoption of a rule such as proposed rule 14e-3 not withstanding the Supreme Court's decision in *Chiarella*. Representatives of the staff have stated their view that *Chiarella* was a section 10(b) case and that the Court indicated that the Commission has the ability under section 14(e) to adopt anti-fraud rules relating to tender offers, such as proposed rule 14e-3. Remarks of Theodore E. Levine, Associate Director of the Division of Enforcement of the Commission, and Stephen Lamb, Special Counsel to the Commission, at the Second Annual Securities Update-1980 Seminar presented by Law Journal Seminars-Press (May 23, 1980).

208 The proposed rule would apply whether the information is received directly or indirectly.

209 The proposed rule would also apply to information received from a person acting on behalf of the prospective offeror.

210 According to the Commission, several factors are indicative of an offeror's determination to make a tender offer, including board of directors consideration of making an offer and the occurrence of activities which facilitate the making of an offer, such as arranging financing or authorizing preparation of tender offer materials or negotiation of a dealer-manager agreement. SEC Rel. No. 34-16385, *supra* note 113, at 82,607 n.33.

the offer,[211] is factually correct, rather than speculative or merely rumored.[212]

In addition to grafting onto section 14(e) a rule that tippees should disclose or abstain from trading even if they are not insiders of the offeror, proposed rule 14e-3(c) would impose liability on an offeror who communicates material non-public information when the offeror knows or has reason to believe that the tippee will trade rather than abstain.[213] At the same time, the Commission proposed in rule 14e-3(b) to codify the "Chinese Wall" concept by providing that a person (*e.g.*, an investment banking firm) may purchase or sell securities as to which the person possesses undisclosed information, provided that the individual making the investment decision on behalf of such person (*e.g.*, its arbitrage department) does not know or have access to the non-public information.[214]

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211 Proposed rule 14e-2(a), which the Commission proposed in February 1979, would have prohibited only trading on the basis of non-public information regarding a "determination to make a tender offer in the future." *See* SEC Rel. No. 34-15548, *supra* note 100, at 81,239-40. The proposed rule was not adopted, due to the Commission's concern that "the scope of [the proposed rule] was not sufficiently broad to reach other aspects of the misuse of material, non-public information relating to a tender offer." SEC Rel. No. 34-16385, *supra* note 113, at 82,607. According to the release, material information in regard to a prospective tender offer includes "the amount and class of securities being sought, the price or range of prices being offered therefor, and the date of commencement." *Id.* Information material to investors in the context of an ongoing tender offer include "price increases, the receipt of regulatory approval, or the withdrawal of the offer." *Id.*

212 *Cf.* SEC v. Monarch Fund, 608 F.2d 938 (2d Cir. Oct. 23, 1979) (investment adviser who took action on the basis of rumors which turned out to be true was not acting on material inside information).

213 Proposed rule 14e-3(c), 3 FED. SEC. L. REP. (CCH) ¶ 24,297 (1979). In the case of a tippee who is an officer, director, employee or partner of the offeror or a person involved in the planning of the tender offer, the offeror must have evidence that the tippee will trade rather than abstain.

214 Proposed rule 14e-3(b), 3 FED. SEC. L. REP. (CCH) ¶ 24,297 (1979). The proposing release makes clear, however, that the rule proposal contemplates more than the mere existence of a Chinese Wall. There must be evidence that the Wall works and that the person making the investment decision in fact did not have access to and did not know of the information. *See* SEC Rel. No. 34-16385, *supra* note 113, at 82,608.

While the proposed rule is limited to a Chinese Wall, the proposing release states that this is merely one method of achieving the desired result and should not be viewed as the Commission's preferred choice. As an alternative to the Chinese Wall, the release discusses the use of the restricted list procedure either alone or in combination with a Chinese Wall. *See id.* at 82,608-09. Under the restricted list approach, the institution would be prohibited from investing in a security for its own account or recommending the security. The Commission also acknowledges the existing variations in this procedure, *e.g.*, placing a security on a list at the time information is obtained or at the time a relationship is entered into that is likely to lead to the receipt of material, non-public information. *Id.* at 82,609. *See generally* Lipton & Mazur, note 204 *supra*.

The Commission's legislative proposals would require that the identity of the bank financing a tender offer or other substantial acquisition of securities be disclosed in the acquiror's Schedules 13D and 14D-1 if "any prior or present commercial relationship exists between such bank and the issuer of the class of securities to be acquired."[215] The term "prior or present commercial relationship" is not defined in the proposals, and presumably such a definition would be promulgated by the Commission. The Commission suggests that "present commercial relationship" would be defined as a business relationship between a bank and a target company that may involve communication of material, non-public information about the company to the bank, and that "prior commercial relationship" would be defined as a business relationship between a bank and a target company which existed within the two years before the acquiror approached the bank for financing and pursuant to which material, non-public information about the company may have been communicated to the bank.[216]

The proposals would prohibit a bank financing a statutory offer or other offer for more than five percent of a class of a company's securities from disclosing to the offeror material, non-public information obtained from the target company, unless that company expressly authorizes such disclosure.[217] The Commission also would add a new section to "clarify the Commission's authority to promulgate rules governing the use by banks and other financial intermediaries [investment bankers, financial advisers and securities analysts] of material, non-public information concerning a [target] company in connection with planning, financing or otherwise participating in, or rendering advice in connection with a tender offer."[218] According to the Commission, such a provision would provide the Commission with the flexibility necessary to establish a regulatory framework (if and when it is needed) to prevent abusive practices in connection with conflicts of interests involving banks, investment bankers, financial advisers and

215 Bank Memorandum, *supra* note 5, at 10. If this provision is adopted, the Commission will consider amending Schedule 14D-1 to require disclosure of the nature and extent of such a commercial relationship. *Id.*

216 *Id.*

217 Proposed Bill § 14(d)(5), *supra* note 5, at 22; Bank Memorandum, *supra* note 5, at 10-11.

218 *Id.* at 12; *see* Proposed Bill § 14(g), *supra* note 5, at 23.

securities analysts in tender offers.[219] Finally, under the Commission's legislative proposals, the Commission would be given express authority to regulate the activities of arbitrageurs.[220]

G. *Issuer Repurchases and Tender Offers*

Section 13(e) of the Exchange Act[221] grants the Commission broad rulemaking authority in connection with repurchases of a company's securities by the company itself or by a controlling person of the company. Pursuant to section 13(e), the Commission adopted rule 13e-3[222] and Schedule 13E-3,[223] effective September 7, 1979, relating to "going-private" transactions by public companies or their affiliates.[224] Rule 13e-3 prescribes filing, disclosure

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219 *See* Bank Memorandum, *supra* note 5, at 10-11; Section Analysis, *supra* note 5, at 27-28.

220 Proposed Bill § 14(f)(2), *supra* note 5, at 23. It is worth noting that the arbitrageur provision appears in the Proposed Bill and in the Section Analysis, *supra* note 5, at 27, but is not otherwise mentioned in the Commission's submission to Congress. Members of the staff of the Commission's Enforcement Division have in the past expressed concern with respect to the activities of arbitrageurs and whether they have access to material, non-public information. In this connection, proposed rule 14e-3 would prohibit all persons, including arbitrageurs, from trading on material, non-public information relating to a tender offer. *See* notes 206 to 214 and accompanying text *supra.*

221 15 U.S.C. § 78m(e) (1976).

222 2 FED. SEC. L. REP. (CCH) ¶ 23,703A (1976) (to be codified in 17 C.F.R. § 240.13e-3).

223 2 FED. SEC. L. REP. (CCH) ¶ 23,706 (1979) (to be codified in 17 C.F.R. § 240.13e-100). Schedule 13E-3 contains many of the disclosures required in connection with tender offers and proxy solicitations subject to section 14 of the Exchange Act, as well as disclosures which are not customary in those contexts. For example, in the item calling for a description of the purpose of the transaction, the person filing must describe alternative means considered to accomplish that purpose, reasons for the structure of the transaction and for undertaking the transaction at the time, benefits and detriments (quantified to the extent practicable) of the transaction to the company, its affiliates and unaffiliated securityholders; a statement as to whether the person filing reasonably believes the transaction is fair or unfair to unaffiliated securityholders and of the material factors upon which the belief as to fairness is based and, to the extent practicable, the weight assigned to each factor; a statement of whether the company or affiliate has received any report, opinion or appraisal which is materially related to the going private transaction (*e.g.*, a fairness opinion), and a summary of any such report, opinion or appraisal. In addition, certain financial information is required and, if material, pro forma financials showing the effect of the transaction on the company's balance sheet, statement of income, ratio of earnings to fixed charges and book value must be provided.

224 SEC Rel. No. 34-16075, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,166 (Aug. 2, 1979). An "affiliate" is defined in rule 13e-3 as "a person that directly or indirectly through one or more intermediaries controls, is controlled by, or is under common control with such issuer." Rule 13e-3(a)(1), 2 FED. SEC. L. REP. (CCH) ¶ 23,703A (1979) (to be codified in 17 C.F.R. § 240.13e-3).

The transactions enumerated in Rule 13e-3 are: (i) a tender offer by the company or an

and dissemination requirements and, in most cases, includes antifraud provisions relating to going private transactions. Unlike a rule proposed by the Commission in 1977,[225] the rule does not regulate the substantive fairness of going private transactions. However, the person filing the required disclosure statement must state whether he reasonably believes the proposed going private transaction is fair or unfair or unaffiliated securityholders, must include a reasonably detailed statement of the material factors upon which such belief is based and, to the extent practicable, of the weight assigned to each factor, and must discuss whether certain specified procedural safeguards for the benefit of unaffiliated securityholders are being utilized.

Although section 14(d)(8)(B) of the Exchange Act[226] exempts tender offers by a company for its own securities from the tender offer provisions of the Williams Act, section 13(e) empowers the Commission to promulgate rules relating to issuer repurchases generally. Thus, shortly after adopting its new going private rule, the Commission adopted rule 13e-4[227] and Schedule 13E-4[228] to regulate offers for a company's securities by the company itself or its affiliates.[229] Rule 13e-4 prescribes filing, disclosure, and dissemination requirements and includes specific antifraud provi-

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affiliate for its own equity securities; (ii) solicitation pursuant to the Exchange Act of proxies or consents from (or distribution of information statements to) the company's equity securityholders in connection with a merger, consolidation, reclassification, recapitalization, reorganization or similar corporate transaction of the company or between the company and its affiliate, or in connection with a sale of substantially all the company's assets to an affiliate or a reverse stock split involving the purchase of fractional interests; and (iii) the purchase by the company or its affiliate, irrespective of whether an Exchange Act proxy solicitation (or distribution of information statements) is involved, of the issuer's equity securities in connection with a merger (*e.g.*, a short-form merger), the dissolution of the company subsequent to the disposition of substantially all of the company's assets to an affiliate, the acquisition of fractional interests in connection with a reverse stock split or any acquisition, *e.g.*, open market purchases, subject to the control of the company or its affiliates.

225 SEC Rel. No. 34-14185, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,366 (Nov. 17, 1977).

226 15 U.S.C. § 78n(d)(8)(B) (1976).

227 2 FED. SEC. L. REP. (CCH) ¶ 23,703B (1979) (to be codified in 17 C.F.R. § 240.13e-4).

228 2 FED. SEC. L. REP. (CCH) ¶¶ 23,707 (1979) (to be codified in 17 C.F.R. § 240.13e-101).

229 SEC Rel. No. 34-16112, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,182 (Aug. 16, 1979). Rule 13e-4 applies to companies with a class of equity securities registered pursuant to section 12 or subject to the reporting requirements of section 15(d) of the Exchange Act, and to closed-end investment companies registered under the Investment Company Act.

sions.[230] Issuer tender offers which involve going private transactions are subject to the requirements of both rules 13e-3 and 13e-4.

In its legislative proposals, the Commission would maintain the present regulatory framework and continue to exempt issuer tender offers from section 14(d) of the Exchange Act,[231] because it feels that such transactions are adequately regulated under rule 13e-4. Similarly, the Commission contends that the abuses formerly associated with "going private" transactions have been addressed by rule 13e-3, and that no additional regulation in this area is necessary at the present time.[232] While questions have been raised as to the authority of the Commission to promulgate the new rules,[233] the Commission reiterates its belief that it has adequate authority under sections 13(e) and 14(e) of the Exchange Act to support the promulgation of rules 13e-3 and 13e-4.[234]

H. *Enforcement Issues and Civil Liability*

The Commission proposes not to change the procedures or bases for Commission criminal or civil enforcement actions under sections 21(d) and 21(e) of the Exchange Act,[235] which it finds adequate for obtaining injunctive and remedial relief.[236] However, the

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230 The rule provides for a minimum offering period of fifteen business days, withdrawal rights during the first ten business days, after forty business days, and during the seven business days following a competing offer, proration of all securities deposited during the first ten business days or within the first ten business days after notice of an increase in the consideration being offered, with special exceptions for odd-lots and securityholders who elect "all or none" or "part or none," and equality of treatment for tendering securityholders in that if the consideration being offered is increased during the offer, securityholders who previously tendered their shares must receive the increase.

231 It should be noted, however, that although the SEC Memorandum, *supra* note 5, at 17-21, states that the exemption for issuer tender offers in current section 14(d)(8) should be continued, the Proposed Bill does not contain such an exemption.

232 SEC Memorandum, *supra* note 5, at 16-17.

233 *See, e.g.*, Comment, *An Appraisal of Authority for the Fairness Standard Contained in the SEC's Proposed "Going-Private" Regulations*, 28 EMORY L.J. 111 (1979); Comment Letter on Proposed Rule 13e-3 submitted by the Association of the Bar of the City of New York, Committee on Securities Regulation 2-24 (Feb. 27, 1978); Comment Letter on Proposed Rule 13e-4 Submitted by American Bar Association 3-6 (Mar. 3, 1978). These comment letters expressed the view that the legislative history of section 13(e) and the Supreme Court's decision in Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (breach of fiduciary duty, absent a disclosure violation, does not constitute a federal cause of action under section 10(b)) indicate that the Commission cannot promulgate substantive (as opposed to disclosure) requirements in the issuer tender offer and going private areas. *See generally* SEC Memorandum, *supra* note 5, at 17.

234 *Id.* at 17.

235 15 U.S.C. § 78u(d), (e) (1976).

236 SEC Memorandum, *supra* note 5, at 19.

Commission proposes a new provision which would confer broad private rights of action for violations of the Williams Act and impose liability on directors who do not exercise reasonable care in tender offer situations.[237]

In accordance with the Commission's belief that the parties to a takeover bid (*i.e.*, the offeror or offerors, the target company and its securityholders) are often in a better position to bring suit and that such private actions are often the only practical means of compensating persons who have suffered financial losses as a result of Williams Act violations, the legislative proposals would confer a private right of action for damages or equitable relief on a target company's securityholders, a target company itself, and a defeated offeror.[238] Recognizing that such private rights of action should not result in damage recoveries which are disproportionate in relation to the risks assumed in entering a takeover contest or unfair to the securityholders of a target company subject to damage liability, the legislative proposals grant courts discretion to modify an award to a target company or offeror (but not to a securityholder or a class of securityholders), if such an award would otherwise be unjust or inequitable.[239] Defendants in a damage suit would have an affirmative defense of reasonable care.[240] The legislative proposals would also eliminate any requirement that a plaintiff show reliance on a misrepresentation or omission; instead, a cause of action would be stated if the misrepresentation or omission were shown to be material.[241] Finally, the legislative proposals would establish a statute of limitations for all actions brought under the Williams Act, requiring that an action be brought within one year after discovery of the facts constituting

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237 Proposed Bill § 14(i)(1), *supra* note 5, at 23.

238 *Id.; see* SEC Memorandum, *supra* note 5, at 19-20; Section Analysis, *supra* note 5, at 28. By granting a private right of action for damages to a defeated offeror, the legislative proposals would overrule Piper v. Chris-Craft Indus., Inc., 433 U.S. 1 (1976).

239 Proposed Bill § 14(i)(3), *supra* note 5, at 23; *see* SEC Memorandum, *supra* note 5, at 20; Section Analysis, *supra* note 5, at 28.

240 Proposed Bill § 14(i)(1), *supra* note 5, at 23; *see* SEC Memorandum, *supra* note 5, at 20; Section Analysis, *supra* note 5, at 28.

241 Proposed Bill § 14(i)(2), *supra* note 5, at 23; *see* SEC Memorandum, *supra* note 5, at 20; Section Analysis, *supra* note 5, at 28. This reliance formulation is identical to that used for section 10(b) under Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972). The materiality standard incorporated in the legislative proposals parallels that of TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

the violation and within three years after the occurrence of the last substantial element of the violation.[242]

With respect to the affirmative defense afforded defendants in damage actions, the analysis submitted with the proposed bill states that the "reasonable care standard is a contextual one" and "allows a court (or jury) to take into account such factors as the status of the defendant, his fiduciary or other obligations to the plaintiff or plaintiffs (including any duty of inquiry), his access to relevant information and other circumstances."[243] This standard is substantially similar to the "flexible duty" standard that has been used in rule 10b-5[244] cases. Although the viability of that standard[245] has been placed in serious doubt after the Supreme Court decision[246] that scienter is a necessary element of a 10b-5 civil action for damages,[247] the Commission apparently intends expressly to revive the flexible duty standard, at least in the context of civil suits for damages under the Williams Act. While the reasonable care standard appears to be designed to create a negligence standard rather than a scienter standard with respect to the duty of care

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242 Proposed Bill § 14(i)(4), *supra* note 5, at 23; *see* SEC Memorandum, *supra* note 5, at 20; Section Analysis, *supra* note 5, at 29. Currently, the Williams Act does not contain a statute of limitations. A cause of action therefore must be brought within the period permitted under the relevant state law. *See* UAW v. Hoosier Cardinal Corp., 383 U.S. 703,704 (1966) ("state statutes have repeatedly supplied the periods of limitations for federal causes of action when federal legislation has been silent on the question"). *See also* Robertson v. Seidman & Seidman, 609 F.2d 774 (2d Cir. Aug. 29, 1979); Arneil v. Ramsey, 550 F.2d 583 (2d Cir. 1977).

243 Section Analysis, *supra* note 5, at 28.

244 17 C.F.R. § 240.10b-5 (1979).

245 The standard was enunciated in White v. Abrams, 495 F.2d 724 (9th Cir. 1974) (quoted in note 247 *infra*).

246 Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

247 *See id.* at 193 n.12 (lists *White* as an example of the negligence standard the Supreme Court was repudiating); Spectrum Financial Cos. v. Marconsult, Inc., 608 F.2d 377, 382-85 (9th Cir. 1979) (Ferguson, D.J., concurring specially) (disagreeing with the majority as to the appropriateness of applying the flexible duty standard: "The Supreme Court inquired into scienter and made no separate duty inquiry, and we should do the same."), *cert. denied,* Docket No. 79-1351 (May 12, 1980). *But see* Pegasus Fund, Inc. v. Laraneta, [CURRENT] FED. SEC. L. REP. (CCH) ¶ 97,281 (9th Cir. Feb. 14, 1980) (reaffirming the flexible duty standard). As stated in *White,* 495 F.2d 724, 735, the flexible duty standard

> require[s] the jury to consider the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question.

(Footnotes omitted.)

required in tender offer situations,[248] it is unclear whether the Commission intends that this standard would vary in any material way from the "business judgment" rule which is generally applicable under state law to corporate decision-making.[249]

As discussed above,[250] one aspect of the Commission's proposals is an apparent move toward a federalized securities and corporate law. The Commission's proposals would codify the current requirement under the rules that a target company take a position with regard to a tender offer and disclose its reasons for the position taken.[251] This requirement, as well as the proposed expansion of the scope of private causes of action under the Williams Act, would have the effect of bringing within the federal system many actions which otherwise might be heard only in state courts. In addition, the reasonable care standard would effectively federalize the standard of care applicable to directors in tender offer situations.[252] Finally, the new statute of limitations for causes of action under the Williams Act would create a uniform federal rule as to the time limits for bringing such actions.[253]

The desirability of effectively creating a federal law of director responsibility is open to debate. Although corporations traditionally have been "creatures of the states,"[254] there has been a movement to federalize certain aspects of corporate life[255] and the proposed legislation is merely one manifestation of that movement. One can hope that the principal effect of the pressure to

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248 Section Analysis, *supra* note 5, at 28.

249 *See, e.g.*, Panter v. Marshall Field & Co., [CURRENT] FED. SEC. L. REP. (CCH) ¶ 97,299 (N.D. Ill. Feb. 25, 1980); Treadway Cos., Inc. v. Care Corp., [CURRENT] FED. SEC. L. REP. (CCH) ¶ 97,603 (Aug. 12, 1980); Johnson v. Trueblood, No. 79-1892 (3d Cir. July 31, 1980). *See generally* Tender Offers and Corporate Directors, (speech before the Seventh Annual Securities Regulation Institute, San Diego, Cal., Jan. 17, 1980), *reprinted in* [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,445, at 82,881; Lipton, *Takeover Bids in the Target's Boardroom,* 35 BUS. LAW. 101 (1979).

250 *See* notes 198 to 201 and accompanying text *supra.*

251 *See* notes 158 to 160 and accompanying text *supra.*

252 In this respect, the Commission's proposed bill is just one of several recent proposals to create a federal corporate law. *See, e.g.*, S. 2567, 96th Cong., 2d Sess., 126 CONG. REC. S3754-57 (Apr. 16, 1980) ("Protection of Shareholders' Rights Act of 1980"); H.R. 7010, 96th Cong., 2d Sess. ("The Corporate Democracy Act") (introduced at 126 CONG. REC. H2490 (Apr. 2, 1980)). *See also* Nader & Green, *Corporate Democracy,* N.Y. Times, Dec. 28, 1979, at A27, col. 1.

253 *See* note 242 and accompanying text *supra.*

254 Sante Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977) (quoting Cort v. Ash, 422 U.S. 66, 84 (1975)).

255 *See, e.g.*, sources cited in note 252 *supra.*

federalize director's responsibilities in takeover situations will be to make state courts[256] and legislatures, as well as others,[257] even more sensitive to the issues in this area.

Conclusion

The Commission's legislative proposals seem to be drafted to accomplish two aims. First, the Commission is seeking to replace the current section 13(d)-section 14(d) regulatory scheme with a system which would require virtually all meaningful acquisitions to be effected with pre-acquisition notice. Second, the Commission seems to be seeking exclusive federal jurisdiction in the acquisition area through the preemption of state takeover laws, the expansion of private rights of action under the Williams Act, and the adoption of a reasonable care standard as a defense to liability.

The proposed legislation raises extremely important policy issues. They deserve in-depth consideration and analysis, and decisions with respect to them should not be taken precipitously.

256 For example, following the Supreme Court decision in Sante Fe Indus., Inc. v. Green, 430 U.S. 462 (1977), that in the context of a Delaware short-form merger transaction, claims of fraud or breach of fiduciary duty are state claims unless the conduct complained of also constitutes a federal disclosure violation or other manipulative or deceptive practice, the Delaware Supreme Court responded by adopting an "entire fairness" concept in certain merger cases. *See, e.g.,* Singer v. Magnavox Co., 380 A.2d 969, 976 (Del. 1977) (long-form merger); Tanzer v. International General Indus., Inc., 379 A.2d 1121 (Del. 1977) (long-form merger); Roland Int'l Corp. v. Najjar, 407 A.2d 1032 (Del. Aug. 6, 1979) (short-form merger).

257 *See, e.g.,* New York Stock Exchange Audit Committee Policy, N.Y. STOCK EXCHANGE COMPANY MANUAL A-29 (1978); AMERICAN STOCK EXCHANGE COMPANY GUIDE § 122, at 10 (1973) (policy regarding independent, or outside, directors).

ENERGY TAX CREDITS IN THE ENERGY TAX ACT OF 1978 AND THE CRUDE OIL WINDFALL PROFITS TAX ACT OF 1980

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In 1978, Congress enacted and President Carter signed the Energy Tax Act of 1978. It was designed to encourage energy conservation and utilization of new energy technologies by individuals and businesses. Individuals became entitled for the first time to conservation energy tax credits up to $300, plus tax credits for solar, wind, and geothermal equipment up to $2,200. Businesses became eligible for a 10 percent energy tax credit for investments in these energy sources. In 1980, Congress again acted on the energy problem facing the United States and, among other things, expanded property for which credits were allowed in residences and businesses.

In this Article, the authors analyze and compare the residential and business energy tax credits under the 1978 Act and related provisions of the 1980 Act. They concentrate on technical and policy problems solved by the 1980 Act as well as those it failed to address. The authors conclude that the 1980 Act represents a desirable move towards U.S. energy self-sufficiency.

The United States is currently faced with a serious energy shortage stemming from its failure to satisfy domestic demands with its own resources and technology.[1] Congress has perceived the nation's resulting dependence on oil imports as a threat to the

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1 For a timely, in-depth analysis of America's current and future energy situtation, *see* ENERGY FUTURE (R. Stobaugh & D. Yergin eds. 1979) [hereinafter cited as ENERGY FUTURE]; H. LANDSBERG, ENERGY: THE NEXT TWENTY YEARS (1979) [hereinafter cited as ENERGY: THE NEXT TWENTY YEARS]; S. SCHURR, ENERGY IN AMERICA'S FUTURE (1979) [hereinafter cited as ENERGY IN AMERICA'S FUTURE]. ENERGY FUTURE, *supra*, the report of the Energy Project at Harvard Business School, contributed substantially to the energy policy debate within Congress during 1979. Members of the Senate noted the influence of this project upon introduction of two pieces of legislation: S. 1760, 96th Cong., 1st Sess., 125 CONG. REC. S12784-85 (daily ed. Sept. 17, 1979) (remarks of Sen. Packwood); S. 1308, 96th Cong., 1st Sess., 125 CONG. REC. S11506-07, S11509 (daily ed. Aug. 2, 1979) (remarks of Sen. Kennedy and Sen. Durkin).

nation's well-being, national security, and ability to conduct an independent foreign policy.[2] Consequently, it has responded by enacting, or at least considering, legislation designed to decrease energy consumption and to increase the energy contribution of virtually every domestic resource. These measures include import quotas, price regulation, penalties, federal research and development, loan guarantees and subsidized loans, outright monetary grants, and tax incentives.

Congress has recently focused upon energy conservation[3] and utilization of power derived from renewable resources — including solar,[4] wind, ocean thermal, geothermal, wood, hydroelectrical, and biomass — as one approach to reducing United States dependence on foreign oil. As a consequence, Congress provided energy tax credits in the Energy Tax Act of 1978 (the 1978 Act) to encourage conservation and investment in some of those resources.[5] Two years later, with United States dependence on foreign oil still a deep concern, Congress acted on legislation introduced by Senator Bob Packwood and expanded and increased energy tax credits to provide a more effective stimulus in the Crude Oil Windfall Profits Tax Act of 1980 (the 1980 Act).[6]

This Article describes and analyzes the renewable energy source and conservation tax credits enacted in 1978 and 1980. The first

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2 *See* S. REP. No. 529, 95th Cong., 1st Sess. 3, 6, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 7945.

3 Conservation may be defined as the protection from loss and waste. Congress has used this term to group various equipment and technologies, including insulation, heat pumps, weather stripping, storm windows for residences, and cogeneration and heat pumps for business. *See id.* at 32.

4 The term "solar energy" has two meanings. In its broader use, it refers to any renewable energy source, including sunlight, biomass (fuels from plant matter ranging from wood to seaweed), wind, hydropower, and ocean thermal energy. In its more narrow sense, solar energy refers to use of the light or heat from the sun to heat a building or water, or to produce electricity. For an analysis of the prospects for solar technologies, *see* U.S. DEPT. OF ENERGY, DOMESTIC POLICY REVIEW OF SOLAR ENERGY (1979). For the purpose of this Article, the term "solar energy" will be used in its more narrow sense.

5 Energy Tax Act of 1978, Pub. L. No. 95-618, 92 Stat. 3174 (codified at 26 U.S.C. §§ 39-48 (1979)) [The Energy Tax Act of 1978, as incorporated into the Internal Revenue Code, as amended, is hereinafter cited as I.R.C.].

6 Crude Oil Windfall Profit Tax of 1980, Pub. L. No. 96-223, 94 Stat. 229 (codified at 26 U.S.C. §§ 39-48) [hereinafter cited as the 1980 Act]. Legislation leading to the 1980 Act included H.R. 3919, 96th Cong., 1st Sess., 125 CONG. REC. S18364 (daily ed. Dec. 17, 1979); *see* Alternative Energy Source and Conservation Tax Incentive Act of 1979, S. 1571, 96th Cong., 1st Sess., 125 CONG. REC. S10543-45 (daily ed. July 25, 1979); Alternative Energy Source and Conservation Tax Incentive Act of 1979, S. 1760, 96th Cong., 1st Sess., 125 CONG. REC. S12788-90 (daily ed. Sept. 17, 1979).

section briefly discusses the recent history of the nation's energy problems and some of the possible solutions considered by Congress, including the use of energy tax credits. Section two summarizes the applicable portions of the 1978 Act. Section three examines the related provisions of the 1980 Act, concentrating on the technical provisions of this Act as well as some of the policy reasons for its enactment. Finally, section four reaches conclusions about both Acts.

I. THE NATURE OF THE PROBLEM AND CONGRESSIONAL RESPONSE

The 1973 Arab oil embargo impressed upon Congress the fact that the United States had shifted from a position of energy self-reliance to one of dependence on Middle Eastern oil.[7] Such dependence, however, did not suddenly develop in the last decade. In 1947, energy consumption in the United States had already exceeded domestic production and resulted in importation of foreign oil.[8] Over the years, oil had served as the primary fuel in both the industrial and transportation fields, and by 1970, United States production of petroleum had peaked and begun to decline. The gap in domestic demand for energy was filled with imported oil from the Middle East, a plentiful and inexpensive alternative to exploring for and producing coal and oil in Europe and in the United States.[9]

Despite attempts to increase domestic energy production, the gap between demand for energy in the United States and total domestic supply has continued to grow steadily. Over the next decade, the present supply deficiency of 10.7 million barrels of oil per day is predicted to rise to 13.1 million barrels of oil per day.[10] Even with deregulation of natural gas, domestic production has

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7 *See* R. VERNON, "AN INTERPRETATION": THE OIL CRISIS (1976); M. CONANT, GEOPOLITICS OF ENERGY (1977); R. ENGLER, THE POLITICS OF OIL (1961).

8 H. GORDON AND R. MEADER, PERSPECTIVES ON THE ENERGY CRISES 7 (1977).

9 R. VERNON, *supra* note 7, at 3.

10 CONGRESSIONAL RESEARCH SERVICE, PROJECT INDEPENDENCE: U.S. AND WORLD ENERGY OUTLOOK THROUGH 1990, at 5 (June 1977) (U.S. Sen. Comm. on Energy and Natural Resources).

not increased.[11] On paper, coal reserves, the centerpiece of President Carter's National Energy Plan, would appear to provide the means to United States energy self-sufficiency. However, exploitation of abundant coal resources, including synthetic fuel production, may be impeded by environmental concerns about the deleterious effects of air pollution and strip mining.[12] Similarly, President Nixon's "Project Independence," calling for atomic energy to provide 30 to 40 percent of United States electricity by the end of the 1980's,[13] will probably not be realized since strong opposition has forced a serious re-evaluation of the nuclear energy option. Social, political, and legal restrictions on coal, natural gas, and nuclear energy development have thus exacerbated the already serious dependence of the United States on foreign oil.

Since energy produced from conventional domestic sources has not displaced the need for imported oil, Congress has focused its attention on increasing both conservation efforts and investment in renewable resources.[14] Among other measures intended to encourage energy investment, Congress has provided for tax credits.

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11 COMM. ON NUCLEAR AND ALTERNATIVE ENERGY SYSTEMS, NAT'L ACADEMY OF SCIENCES, ENERGY IN TRANSITION 1985-2010, at 21 (1979) [hereinafter cited as CONAES REPORT]. The Conference Committee Report on the Natural Gas Policy Act of 1978, Pub. L. No. 95-621, shows that deregulation provisions of the Act are not expected to reverse production declines in the long run. Bupp & Schuller, *Natural Gas: How to Slice a Shrinking Pie,* in ENERGY FUTURE, *supra* note 1, at 56.

12 *See* ENERGY: THE NEXT TWENTY YEARS, *supra* note 1; CONAES REPORT, *supra* note 11.

13 L. LINDBERG, THE ENERGY SYNDROME 297 (1977); L. GRAYSON, ECONOMICS OF ENERGY 3 (1975); FED. ENERGY AD., PROJECT INDEPENDENCE REPORT 427 (Nov. 1974).

14 Senator Packwood stated in a floor statement on Sept. 17, 1979, that

> These technologies [solar, wind, geothermal, hydroelectrical, and biomass energy; industrial cogeneration; residential conservation; alcohol fuel; and van pooling] can have an important impact on our efforts to reduce our . . . high use of imported oil. The technologies affected are generally currently available for wide scale use. However, tax incentives can importantly increase the rate at which our society makes these energy investments.

125 CONG. REC. S12784 (daily ed. Sept. 17, 1979).

Supporters of this approach include those who oppose nuclear and fossil fuels on environmental grounds as well as those who merely advocate the pursuit of all possible solutions to the energy problem. *See* ENERGY: THE NEXT TWENTY YEARS, *supra* note 1, at chs. 9-11.

By comparison, the CONAES REPORT, *supra* note 11, advocated nuclear and coal as the most valuable long-term energy alternatives, and supported conservation as the most viable economic alternative for the short term.

Any analysis of the philosophy behind the renewable energy source and conservation options must begin with the pioneering article by Amory B. Lovins. Lovins, *Energy Strategy: The Road Not Taken?,* 55 FOREIGN AFFAIRS 65 (1976). *See also* D. HAYES, RAYS OF HOPE: THE TRANSITION TO A POST-PETROLEUM WORLD (1977).

In the energy area, a tax credit permits a taxpayer to deduct from taxes owed an amount equal to a given percentage of the taxpayer's expenditures on qualifying energy investments.[15]

Tax credits have certain advantages over more direct federal development programs. They are favored by congressmen who wish to avoid the creation of additional federal bureaucracies necessitated by direct government development.[16] As incentives, tax credits offer a more palatable alternative to legislative directives and penalties. Tax credits also provide a superior incentive to deductions since they would be taken advantage of by a larger number of taxpayers; anyone who owes taxes can claim a credit, whereas generally only taxpayers who itemize their expenses may claim a deduction. Thus, tax credits provide a more equitable tax incentive, particularly as between taxpayers with sufficient liability to absorb the full amount of the credit.[17]

Yet, the tax credit is not without its faults. Although more equitable than tax deductions, nonrefundable energy tax credits, such as those enacted in both the 1978 and 1980 Acts, are more likely to be claimed by middle- and upper-income taxpayers than by lower-income taxpayers. Individuals with low income generally lack both the funds to make the improvements which would qualify them for the credit as well as tax liabilities large enough to absorb the maximum credit.[18] Tax credits are also criticized because they are not included in the federal budget. Since credits are not subject to the ongoing congressional budgetary and appropriations process, they often are not carefully supervised after enactment.[19]

Notwithstanding these deficiencies in the tax credit approach, Congress was convinced of its advantages and in 1978 enacted five

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15 *See generally* sources cited *infra* note 17.

16 Statement of Sen. Packwood, 125 CONG. REC. S10543 (daily ed. July 25, 1979); *see also* statement of James Harding, *Solar Energy Hearings Before House Comm. on Government Operations,* 95th Cong., 2d Sess. 81, 85 (May 12, 1978).

17 *See generally* 5 MERTENS LAW OF FEDERAL INCOME TAXATION §§ 32.01 *et seq.* (personal credits); 32.09(d); 32A.01 *et seq.* (business credits); (J. Doheny, ed. 1980).

18 1978 Statistics of Income, Individual Income Tax Returns, I.R.S. Pub. No. 198 (4-80), Table 8. *See also* Calif. Energy Comm., Staff Report: California's Solar Energy Tax Credit — An Analysis of Tax Returns for 1977, at 14 (Sept. 1979).

19 The Department of the Treasury now compiles and publishes a tax expenditure budget which estimates dollar values of the various tax breaks and incentives provided by law, including deductions and credits. This budget, however, has not been formally incorporated into the congressional budget process.

separate pieces of legislation which became known as the National Energy Act. One piece, the Energy Tax Act of 1978 was the first federal law to provide for comprehensive energy tax credits for investments in conservation and renewable energy source property.[20]

After a year of evaluating the effectiveness of the 1978 Act, monitoring the deepening energy crisis, and weighing further the comparative merits of tax incentives versus other legislative solutions, Congress considered additional legislation aimed at improving and expanding business and residential energy tax credits. The product of these efforts was the enactment in the Crude Oil Windfall Profits Tax Act of 1980, of many new conservation and renewable energy incentives tailored after comparable provisions in the 1978 Act.[21] Among other provisions, the 1980 Act creates a windfall profits tax designed in large part to finance development of diverse renewable energy sources.

II. The Energy Tax Act of 1978: How Residential and Business Energy Tax Credits Operate

A. *Residential Energy Tax Credits*

The 1978 Act provides energy tax credits for both residential and business energy expenditures. The residential provisions cover two types of expenditures: (1) conservation expenditures called qualified "energy conservation expenditure[s]"[22] in the Internal Revenue Code (the Code), for items such as insulation, weather-stripping, and energy-conserving equipment; and (2) expenditures, referred to as "renewable energy source expenditures" in the Code, for machinery and equipment that produce energy from renewable sources, namely, solar, wind, and geothermal installations.

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20 I.R.C. §§ 39-48; the other four acts include: the Public Utility Regulatory Policies Act of 1978, Pub. L. No. 95-617, 92 Stat. 3117-3174 (codified at 16 U.S.C. § 2601 (1979)); the National Energy Conservation Policy Act of 1978, Pub. L. No. 95-619, 92 Stat. 3206-3288 (codified at scattered sections of 12, 15, 23, and 42 U.S.C.); the Powerplant and Industrial Fuel Use Act of 1978, Pub. L. No. 95-620, 92 Stat. 3289-3349 (codified at scattered sections of 15, 42, 45, and 49 U.S.C.); and the Natural Gas Policy Act of 1978, Pub. L. No. 95-621 (codified at 15 U.S.C. §§ 330-332 (1979), 42 U.S.C. § 7255 (1979)).

21 I.R.C. §§ 39-48; 1980 Act; H.R. Rep. No. 817, 96th Cong., 2d Sess. 119-52 (1980); S. Rep. No. 394, 96th Cong., 1st Sess. 80 (1979).

22 *See generally* Hyatt, *Thermal Efficiency and Taxes: The Residential Energy Conservation Tax Credit,* 14 Harv. J. Legis. 281, 302 (1977).

1. Energy-Conserving Components

The 1978 Act provides a nonrefundable income tax credit[23] of $300, or 15 percent of qualified expenditures up to $2,000, for insulation[24] and "other energy-conserving component[s]," installed in or on principal residences located in the United States.[25] These items must be new and their original use must begin with the taxpayer.[26] An individual taxpayer becomes entitled to the credit for energy conservation expenditures when original installation of the property or component is completed.[27] All energy-conserving components and insulation must comply with quality standards to be established by the Internal Revenue Service (I.R.S.) and must be expected to remain in operation for at least three years.[28]

The residences must have been fully constructed or substantially completed prior to April 20, 1977. Expenditures qualify for energy tax credits only if made on or after April 20, 1977, and before December 31, 1985.[29] Energy tax credits which exceed tax liability

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23 I.R.C. § 44C(b)(5).

24 Insulation is defined as any item which is specifically or primarily designed to reduce heat loss or gain from a water heater or dwelling. Attic, floor, and wall insulation made of fiberglass, rock-wool, cellulose, and styrofoam are examples of insulating materials. To qualify as insulation, the item must be installed between a conditioned area (one that is heated or cooled by conventional or renewable energy source means) and a nonconditioned area, except when installed on a water heater, water pipe or heating and cooling duct. Thus, for example, awnings do not qualify as insulation. Items whose function is primarily decorative, structural, or safety-related, even though designed partially to have an insulating effect, are also excluded. I.R.C. § 44C(c)(3); Treas. Reg. § 1.44C-2 (1980) [hereinafter cited as Reg. § __]; S. REP. NO. 529, 95th Cong., 1st Sess. 11 (1979). Examples of such items are carpeting, drapes (including linings), shades, wood paneling, fireplace screens, and new or replacement walls (except qualifying insulation therein). *Id.*

25 I.R.C. § 44C(1).

26 I.R.C. § 44C(c)(4)(B).

27 I.R.C. § 44C(c)(7)(A).

28 I.R.C. § 44C(c)(4); Prop. Reg. § 1.44C-5; Reg. § 1.44C-4.

29 I.R.C. § 44C(c)(1). The regulations provide:

> Construction of a dwelling is substantially completed when construction has progressed to the point where the unit could be put to use as a personal residence, even though comparatively minor items remain to be finished or performed in order to conform with the plans and specifications of the completed building.

Reg. § 1.44C-3(f).

Construction, for purposes of energy conservation expenditures, encompasses reconstruction. *Id.* Reconstruction means replacement of most of the major structural components in a dwelling, such as walls, floors and ceilings. Reg. § 1.44C-3(a)(2).

The regulations offer the following example of nonqualifying energy conservation expenditures:

> *Example.* On January 1, 1979, A purchases a dwelling that is to become A's principal residence. The dwelling unit was originally constructed in 1950. A

may be carried forward and added to tax credits during the following year. The carryover extends until the end of 1987, two years longer than the period permitted for the residential energy tax credit.[30]

Energy-conserving components eligible for tax credits include such items as: (1) furnace replacement burners;[31] (2) devices for modifying flue openings;[32] (3) electrical or mechanical furnace ignition systems;[33] (4) storm or thermal windows or doors;[34] (5)

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spends $50,000 to reconstruct the dwelling by replacing most of the dwelling's major structural components such as floors, walls and ceilings. Included in the cost is $3,000 attributable to energy-conserving components. Reconstruction is substantially completed on April 1, 1979, and A moves into the reconstructed residence on May 1, 1979. Since construction includes reconstruction, A's reconstructed residence is not considered substantially completed before 1979. Thus, amounts spent with respect to A's reconstructed residence for energy-conserving components do not qualify as energy conservation expenditures.

Reg. § 1.44C-3(f). *See also* I.R.C. § 44C(c)(8); Reg. § 1.44C-3(e) (principal residence rule).

30 Reg. § 1.44C-1(e) explains the carryover as follows:

(e) *Carryover of unused credit.* If the credit allowable by this section exceeds the tax liability limitation imposed by section 44C(b)(5) and paragraph (d)(3) of this section, the excess credit shall be carried over to the succeeding taxable year and added to the credit allowable under this section for the succeeding taxable year. A carryover that is not used in the succeeding year because it exceeds the tax liability limitation shall be carried over to later taxable years until used, except that no excess credit may be carried over to any taxable year beginning after December 31, 1987. I.R.C. § 44C(b)(6).

31 The burner must replace an existing burner. It does not qualify if it is acquired as a component of, or for use in, a new furnace or boiler. Reg. § 1.44C-2(d)(4)(i).

32 The regulations provide:

(ii) *A device for modifying flue openings.* The term "device for modifying flue openings" means an automatically operated damper that

(A) Is designed for installation in the flue, between the barometric damper or draft hood and the chimney, of a furnace; and

(B) Conserves energy by substantially reducing the flow of conditioned air through the chimney when the furnace is not in operation. Conditioned air is air that has been heated or cooled by conventional or renewable energy source means.

Reg. § 1.44C-2(d)(4)(ii).

33 The term "furnace ignition system" means an electrical or mechanical device installed in a gas-fired boiler that automatically ignites the gas burner and replaces a pilot light. Reg. § 1.44C-2(d)(4)(iii).

34 These are:

(A)(1) A window placed outside or inside an ordinary prime window, creating an insulating air space.

(2) A window with enhanced resistance to heat flow through the glazed area by multi-glazing.

(3) A window that consists of glass or other glazing materials that have exceptional heat-absorbing or heat-reflecting properties. For purposes of this subdivision (iv), the term "glazing material" does not include films and coatings applied on the surface of a window.

(B)(1) A second door, installed outside or inside a prime exterior door, creating an insulating air space.

(2) A door with enhanced resistance to heat flow through the glazed area by multi-glazing.

automatic energy-saving setback thermostats;[35] (6) caulking or weatherstripping for doors or windows;[36] and (7) energy usage display meters.[37]

While the 1978 Act and the related regulations define several categories of energy-conserving components, these categories are by no means exhaustive. Receptiveness of the Secretary of the Treasury (Treasury) to new energy equipment is central to implementation of the congressional goal of encouraging private innovation. Consequently, the Treasury may specify other equipment which is eligible for residential energy tax credits at any time.[38] Unfortunately, the 1978 Act provides little guidance as to what new equipment may be added to the list of qualifying "in-

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> (3) A prime exterior door that has an R-value (a measurement of the ability of insulation to resist the flow of heat) of at least 2 throughout.
>
> For the purpose of this subdivision, "multi-glazing" is an arrangement in which two or more sheets of glazing material are affixed in a window door frame to create one or more insulating air spaces. Multi-glazing can be achieved by installing a preassembled, sealed insulating glass unit or by affixing one or more additional sheets of glazing onto an existing window (or sash) or door. For purposes of this subdivision, a storm or thermal window or door does not include any film applied on or over a surface of a window or door.

Reg. § 1.44C-2(d)(iv).

35 The regulations define this component as follows:

> The term "automatic energy-saving setback thermostat" means a device that is designed to reduce energy consumption by regulating the demand on the heating or cooling system in which it is installed, and uses —
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> (A) A temperature control device for interior spaces incorporating more than one temperature control level, and
>
> (B) A clock or other automatic mechanism for switching from one control level to another.

Reg. § 1.44C-2(d)(v).

36 "Caulking and weatherstripping" means:

> [P]liable materials used to fill small gaps at fixed joints on buildings to reduce the passage of air and moisture. Caulking includes, but is not limited to, materials commonly known as "sealants", "putty", and "glazing compounds". The term "weatherstripping" means narrow strips of material placed over or in movable joints of windows and doors to reduce the passage of air and moisture.

Reg. § 1.44C-2(d)(vi).

37 The formal term "energy usage display meter," is defined as:

> [A] device the sole purpose of which is to display the cost (in money) of energy usage in the dwelling. It may show cost information for electricity usage, gas usage, oil usage or any combination thereof. The device may measure energy usage of the whole dwelling, or individual appliances or systems on an instantaneous or cumulative basis.

Reg. § 1.44C-2(d)(vii).

38 Reg. §§ 1.44C-2(viii), 1.44C-6 (procedures and criteria for additions to the approved list of energy-conserving components or renewable energy source property, yet to be specified). The Department of the Treasury has been granted similar authority with respect to renewable energy sources for heating and cooling residences, and providing hot water for use inside residences, I.R.C. § 44C(c)(5)(A)(i) ("specially defined energy property") and I.R.C. § 48(1)(5) (energy conserving items in business).

sulation" or "other energy-conserving components." Although the Treasury may not be the ideal arbiter of which technologies deserve tax subsidies,[39] its authority to expand the list of eligible equipment is still preferable to freezing incentives for development of conservation technology to items enumerated by Congress in the 1978 Act.

2. Renewable Energy Source Property

The second prong of the 1978 Act concerning residential energy tax credits is directed to expenditures for "renewable energy source property," defined in the Code as: (1) property which transmits or uses solar energy;[40] (2) energy derived from geothermal deposits;[41] (3) or wind energy for nonbusiness residential purposes.[42]

The term renewable energy source property does not include swimming pools, even if used as an energy storage medium, or any

39 Moore, *A Critique of Insulation and Solar Energy Tax Credit Proposals,* TAX NOTES, April 18, 1977, at 15-20; *Energy Tax Act of 1977, Hearings Before the U.S. Sen. Comm. on Finance,* Part III, 997-98 (Sept. 12, 1977) (statement of Mechanical Contractors Association of America).

40 The term "solar energy property" means equipment and materials of a solar energy system as defined in this paragraph (and parts solely related to the functioning of such equipment) which, when installed in connection with a dwelling, transmits or uses solar energy to heat or cool the dwelling or to provide hot water for use within the dwelling. For this purpose, solar energy is energy derived directly from sunlight (solar radiation). Property which uses, as an energy source, fuel or energy which is indirectly derived from sunlight (solar radiation), such as fossil fuel or wood or heated underground water is not considered solar energy property. Materials and components of "passive solar systems" as well as "active solar systems", or a combination of both types of systems may qualify as solar energy property. Reg. § 1.44C-2(f)(1).

41. "Geothermal deposits" is defined in I.R.C. § 613(e)(3). Geothermal energy property is defined in the regulations as follows:

> *Geothermal energy property.* The term "geothermal energy property" includes equipment (and parts solely related to the functioning of such equipment) necessary to transmit or use energy from a geothermal deposit to heat or cool a dwelling or provide hot water for use within the dwelling.

Reg. § 1.44C-2(h).

42 Wind energy property is defined in the regulations as follows:

> *Wind energy property.* The term "wind energy property" includes equipment (and parts solely related to the functioning of such equipment) which, when installed in connection with a dwelling, transmits or uses wind energy to produce energy in any form for personal residential purposes. Examples of equipment using wind energy in a useful form are windmills, wind-driven generators, power conditioning and storage devices that use wind to generate electricity or mechanical forms of energy. Devices that use wind merely to ventilate do not qualify as wind energy property.

Reg. § 1.44C-2(g).

other energy storage medium whose primary function is other than storage of energy. It also does not include maintenance costs or the cost of leasing renewable energy source property.[43]

Under the 1978 Act, a taxpayer is entitled to a nonrefundable energy tax credit of 30 percent of the first $2,000, and 20 percent of the next $8,000 of qualifying renewable energy source expenditures, including labor costs, allowing for a maximum credit of approximately $2,200.[44] This credit is available for expenditures made from April 20, 1977, until December 31, 1985, with unused credits carried over until the end of 1987.[45]

Renewable energy source property need only be installed in connection with a United States[46] principal residence,[47] and the property need not be located in or on a principal residence of the taxpayer, as required for energy conservation property. For example, a free-standing windmill located on a taxpayer's property which transfers electricity to the residence would qualify.

Similarly, eligibility for renewable energy source tax credits does not depend on the date of construction of the dwelling unit, as it does with energy conservation expenditures. Expenditures are considered made when the installation of the property is completed or, in the case of construction or reconstruction of a dwelling, when the taxpayer commences use of the dwelling as a principal residence. This rule is designed to determine the timeliness of the renewable energy source expenditure.[48] The original use of the equipment must begin with the taxpayer and be reasonably expected to last five years, in contrast to the three year requirement for conservation equipment. Like conservation equipment, however, renewable energy source equipment must comply with performance and quality regulations to be promulgated by the I.R.S.[49]

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43 I.R.C. § 44C(2)(C); Reg. § 1.44C-2(b)(2). However, costs of on-site preparation, assembly, and original installation are included as renewable energy source expenditures. I.R.C. § 44C(c)(2)(B).

44 *Id.;* I.R.C. § 44C(b)(2). The minimum credit that can be filed is $10. I.R.C. § 44C(b)(4).

45 I.R.C. §§ 44C(b)(6), 44C(f).

46 I.R.C. § 7701(a)(9), which defines "United States," is linked to the Energy Tax Act of 1978 by Reg. § 1.44C-2(b)(2).

47 I.R.C. § 44C(2)(A)(ii).

48 Reg. § 1.44C-3(a)(2).

49 I.R.C. §§ 44C(c)(4)(B)-(D).

One of the most controversial aspects of the 1978 Act is its treatment of passive solar systems. Passive solar systems are structural modifications, such as thick thermal walls to retain heat and window space designed to capture the sun's heat and light. Congress stated that "the [renewable energy source] credit would apply to 'passive' as well as 'active' solar systems."[50] Yet it rendered the credit ineffective with respect to passive systems by excluding credits for expenditures for energy-related structures, under the so-called "structures rule."[51] Thus, any component which serves a dual purpose (structural and energy-related) is not eligible for the energy tax credit. This eliminates these credits for most passive solar applications. The I.R.S. has concluded that one of the few

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50 S. REP. NO. 1324, 95th Cong., 2d Sess. 44 (1978). Active and passive solar systems are defined in the regulations as follows:

> (2) *Active solar system.* An active solar system is based on the use of mechanically forced energy transfer, such as the use of fans or pumps to circulate solar generated energy, or thermal energy transfer, such as systems utilizing thermal siphon principles. Generally, this is accomplished through the use of equipment such as collectors (to absorb sunlight and create hot liquids or air), storage tanks (to store hot liquids), rockbeds (to store hot air), thermostats (to activate pumps or fans which circulate the hot liquids or air), and heat exchangers (to utilize hot liquids or air to heat air or water).

Reg. § 1.44C-2(f)(2).

> (3) *Passive solar system.* A passive solar system is based on the use of conductive, convective, or radiant energy transfer. In order to qualify as a passive solar system, a solar system used for heating purposes must contain all of the following: a solar collection area, an absorber, a storage mass, a heat distribution method, and heat regulation devices. The term "solar collection area" means an expanse of transparent or translucent material, such as glass which is positioned in such a manner that the rays of sun directly strike an absorber. The term "absorber" means a surface, such as a floor, that is exposed to the rays of the sun admitted through the solar collection area, which converts solar radiation into heat, and then transfers the heat to a storage mass. The term "storage mass" means material, such as masonry, that receives and holds heat from the absorber and later releases the heat to the interior of the dwelling. The storage mass must be of sufficient volume, depth, and thermal energy capacity to store and deliver adequate amounts of solar heat for the relative size of the dwelling. In addition, the storage mass must be located so that it is capable of distributing the stored heat directly to the habitable areas of the dwelling through a heat distribution method. The term "heat distribution method" means the release of radiant heating from the storage mass within the habitable areas of the dwelling, or convective heating from the storage mass through airflow paths provided by openings or by ducts in the storage mass, to habitable areas of the dwelling. The term "heat regulations (sic) devices" means shading or venting mechanisms (such as awnings or insulated drapes) to control the amount of solar heat admitted through the solar collection areas and nighttime insulation or its equivalent to control the amount of heat permitted to escape from the interior of the dwelling.

Reg. § 1.44C-2(f)(3).

51 *Id.*

passive solar applications qualifying for the energy tax credit would be a roof pond, provided that the container holding the water is placed on an existing roof.[52]

In a similarly restrictive approach, the 1978 Act provides an energy tax credit only for solar energy used to heat or cool a dwelling or provide hot water[53] and not for equipment which generates electricity, such as photovoltaic cells.[54]

3. General Provisions

Within certain limits, taxpayers may claim energy tax credits for both energy conservation and renewable energy source expenditures. They must, however, comply with restrictive regulations of the I.R.S. which, among other things, require taxpayers to maintain records for all qualifying expenditures and be able to substantiate all labor costs.[55] In addition, the regulations require manufacturers of energy-conserving components and renewable energy source property to comply with certification procedures for qualifying property.[56] Manufacturers may apply for approval of an

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52 Conversation with Attorney Advisor, Legislation and Regulations Division, Office of Chief Counsel, I.R.S., Washington, D.C. (Dec. 15, 1979). The "structures rule" in the residential sector is defined in the regulations as follows:

> (4) *Components with dual function.* To the extent that a passive or active solar system utilizes portions of the structure of a residence, only the materials and components whose sole purpose is to transmit or use solar radiation (and labor costs associated with installing such materials and components) are included within the term "solar energy property". Accordingly, materials and components that serve a dual purpose, *e.g.,* they have a significant structural function or are structural components of the dwelling (and labor costs associated with installing such materials and components) are not included within the term "solar energy property". For example, solar collectors and roof ponds that form part of a roof (including additional structural components to support the roof), windows (including clerestories and skylights), and greenhouses do not qualify as solar energy property. In the case of a trombe wall (a south facing wall composed of a mass wall and exterior glazing), the mass wall (and labor costs associated with installing the mass wall) will not qualify. However, the exterior (non-window) glazing will qualify. Any shading, venting and heating distribution mechanisms or storage systems that do not have a dual function will also qualify.

Reg. § 1.44C-2(f)(4).

53 I.R.C. § 44C(c)(5)(A)(i).

54 Photovoltaic cells were developed to provide an energy source for satellites. These flat plates convert sunlight directly to electricity. While the cost is currently uneconomical for business or residential use, recent advances in silicone production suggest continuing reduction in cost in the future. *See* S. SCHURR, *supra* note 1, at 308.

55 Reg. §§ 1.44C-3(1), (2).

56 Reg. § 1.44C-5; Rev. Proc. 80-36, 1980-38 I.R.B. 18.

item as an energy-conserving component or as renewable energy source property. However, quality and performance standards for such certification have not yet been promulgated in the regulations.[57]

The 1978 Act allows taxpayers to claim energy tax credits for expenditures only with respect to their principal residences;[58] a vacation or second home does not constitute a principal residence. In order for the entire conservation or renewable energy source expenditure to be eligible for the residential energy tax credit, at least 80 percent of the equipment's use must be for personal residential purposes,[59] with the entire amount of the qualified expenditures used to compute the residential energy tax credit. On the other hand, if less than 80 percent of the use of a component or item of property is for personal residential use, the taxpayer must make an allocation with respect to such expenditures. The expenditure taken into account for the residential credit is the amount that bears the same ratio to the expenditures as the personal residential use bears to the total use of the residence. Presumably, taxpayers would be entitled to business energy tax credits and/or investment tax credits for that portion of the energy investment allocable to business use of a residence.

Taxpayers eligible for energy tax credits under the 1978 Act are not limited to home owners and apartment renters, but include joint occupants of a dwelling,[60] tenant-stockholders in cooperative housing corporations,[61] and condominium owners.[62]

Renters of cooperatives or condominiums are usually not entitled to a proportionate residential energy tax credit. Since a renter is not a member of a condominium management association, he would not be assessed for expenditures made by that body. The 1978 Act, however, allows a credit if the renter makes the expenditures directly.[63]

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57 Reg. §§ 1.44C-4, -5(c).
58 I.R.C. § 44C(c)(8).
59 I.R.C. §§ 44C(c)(1)(B), (2)(B)(ii), (c)(7)(D); Reg. § 1.44C-3(g).
60 I.R.C. § 44C(d)(1); Reg. § 1.44C-3(h).
61 I.R.C. § 44C(d)(2); Reg. § 1.44C-3(I).
62 I.R.C. § 44C(d)(3); Reg. § 1.44C-3(I).
63 S. REP. No. 529, 95th Cong., 1st Sess. 32, 38, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 7970.

4. Conclusions

Although the residential energy tax credits in the 1978 Act certainly drew attention to conservation and renewable energy source technologies, it is not clear whether they induced substantial new energy-saving investments. According to the I.R.S., approximately 6.6 percent of all individual tax returns for 1978 included claims for conservation or renewable energy source tax credits.[64] It is not possible to determine what portion, if any, of the expenditures represented by these claims would have been made regardless of the availability of the credits.

The effectiveness of the 1978 energy tax credits was hampered, however, by the relatively low amount of energy tax credits provided (for example, a maximum of $300 per household for conservation expenditures) and the narrow interpretation of statutory language in the 1978 Act by the I.R.S. denying energy tax credits for all installations other than those made on the taxpayer's principal residence. The obvious defect of the so-called "principal residence" rule was its failure to encourage taxpayers to make energy investments in second or vacation homes.[65]

Compilations of federal income tax returns have also shown that under the 1978 provisions for renewable energy source expenditures, taxpayers will most likely claim credits only for investments in solar energy.[66] High utility bills and a suitable climate make solar equipment a wise investment in various parts of the country, and there is likely to be an increase in consumer demand for active solar systems.[67] Yet, in many areas, the payback period (or length of time needed for fuel saving to equal the initial investment) is too long to justify the approximately $7,000 to $15,000 expenditure required to install a residential solar space and water heating system. Nonetheless, those seeking to make a long-term personal contribu-

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64 1978 Statistics of Income, Individual Income Tax Returns, I.R.S. Pub. 198 (4-80), Tables 3 & 8.

65 For a discussion of attempts to build equity into energy conservation goals, and the "principal residence rule," *see Hearings Before the U.S. Sen. Finance Comm. on the Energy Tax Act of 1977,* 95th Cong., 1st Sess., Part I, 64-65 (Aug. 8, 1977).

66 1978 Statistics of Income, *supra* note 18, Table 8.

67 THE MITRE CORPORATION, SOLAR ENERGY: A COMPARATIVE ANALYSIS TO THE YEAR 2020 (1978). Solar energy systems to heat and cool buildings are closest to commercialization and are expected to account for the majority of solar energy savings before 1985.

tion to the nation's energy predicament may not be deterred by economic considerations.[68] Furthermore, several states already offer substantial tax credits in the solar area,[69] while some local governments require the use of solar installations in certain buildings. Two counties in Southern California, for example, require solar hot-water heating in new residential construction.[70] Active and passive solar energy systems are well suited for decentralized, small-scale, residential use.[71]

By contrast, the 1978 Act is unlikely to prompt much increased residential use of wind and geothermal energy equipment. Wind can be used to generate electricity on a residential basis or to pump water for drinking and irrigation. Moreover, geothermal heat is abundant and often inexpensive in Oregon, Hawaii, New Mexico and some other Western locations.[72] In some instances, homeowners can simply sink a geothermal well and pipe the heat or steam into their homes or surrounding buildings. Even so, as with windpower, geothermal may be best suited for commercial use and other activities capable of employing centralized collection and distribution installations. Because of the economics of scale associated with centralized, large-scale collection of geothermal heat and windpower, the residential energy tax credit for these resources cannot be expected to play a large role in reducing national consumption of oil and natural gas.

Finally, although product certification may provide some assurance that an item is energy-efficient within the intent of the 1978 Act, it may place such a burden on the Treasury, which is charged with reviewing new technologies, that energy-efficient items or equipment may not receive approval before expiration of the residential energy tax credits. Even if the Treasury acts quickly, deserving technologies developed by small businesses may never obtain certification because of the costs attendant in the approval

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68 ENERGY FUTURE, *supra* note 1, at 191.

69 Friedmann, *Solar and Wind Energy Tax Incentives: State Statutes*, ENERGY LAW SERVICE MONOGRAPH 7B (Jan., 1980); *Current Developments*, 1 SOLAR L. REP. 723 (1979); *see also* note 71 *infra*.

70 *Current Developments*, 1 SOLAR L. REP. 723 (1979).

71 OFFICE OF TECHNOLOGY ASSESSMENT, U.S. CONGRESS, APPLICATION OF SOLAR TECHNOLOGY TO TODAY'S ENERGY NEEDS (1978).

72 U.S. DEP'T OF INTERIOR, ASSESSMENT OF GEOTHERMAL RESOURCES OF THE UNITED STATES — 1978, at 154 (Geological Survey Circular 790) [hereinafter cited as ASSESSMENT OF THE U.S.].

process. It is, therefore, essential that the Treasury expeditiously approve new technologies at the least possible certification expense.

B. *Business Energy Tax Credits*

1. General Provisions

Congress believed that the urgency of the energy problem required enactment of specific energy tax incentives to reduce consumption by businesses of oil and natural gas.[73]

The 1978 Act provides a 10 percent energy tax credit[74] for investment in "energy property"[75] by those in trade, business, agriculture, or industry.[76] Public utilities are usually not eligible for energy tax credits,[77] although they are allowed limited investment tax credits.[78] In addition, state and local governments, most tax-exempt organizations, and holders of federal grants[79] are not eligible for energy tax credits.

Energy tax credits for trade and business, with some key differences, operate like investment tax credits. Important differences include the specific types of property eligible for the energy tax

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73 S. REP. NO. 529, 95th Cong., 1st Sess. 71, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 7942, 8003.

74 I.R.C. § 46(a)(2)(C).

75 I.R.C. § 46(a)(2)(A)(ii).

76 I.R.C. § 46(a). For purposes of energy credits, the term "industrial" includes "agricultural." Owners of farms, for example, are allowed energy tax credits for investments in qualifying property. I.R.C. § 48(l)(12).

77 I.R.C. § 48(l)(3)(B). This section precludes certain energy tax credits for public utility property (as defined in § 46(f)(5)).

78 Public utilities are entitled to regular tax credits under I.R.C. § 46(c)(3), including credits for exempt uses of boilers utilizing petroleum products. Exempt uses include the use of these boilers in the state of Hawaii and the use of certain boilers which produce less than 9,500 BTU's per kilowatt hour and are capable of converting to synthetic fuels. I.R.C. §§ 48(a)(10)(B)(iv),(v), and (vi). *See generally* S. REP. NO. 529, 95th Cong., 1st Sess. 73, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 8005-06 (relative to consideration of using credits as an incentive to phase down boilers). Other exempt uses include the use of petroleum burning boilers in apartments, hotels, motels, or other residential facilities or office buildings, wholesale or retail establishments, and any other facilities which are not integral parts of manufacturing, processing, mining, or recovering natural gas and oil. I.R.C. § 48(a)(10)(B). The intent of Congress in providing this exemption seems to be both to encourage utilities and manufacturers to use more energy-efficient boilers and to relieve lodging facilities of the burden of not receiving needed investment tax credits. *See generally* S. REP. NO. 529, 95th Cong., 1st Sess. 74, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 8006.

79 *See* S. REP. NO. 1324, 95th Cong., 2d Sess. 64; S. REP. NO. 529, 95th Cong., 1st Sess. 74, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 8006.

credit, the limited duration of the energy tax credit, and the refundability of the energy tax credit for business investments in solar and wind equipment.

Property eligible for the investment tax credit is technically described in the Code as "section 38 property."[80] Such property includes tangible personal property used in the taxpayer's trade or business, such as machinery and equipment. By comparison, a narrower range of property qualifies for the business energy tax credits, including solid waste recycling equipment, equipment which reduces energy consumption, and solar and wind energy property and equipment which facilitates the shift from oil and natural gas to other fuels called "alternative energy property" in the Code.[81]

The business energy tax credit is available for investments made after September 30, 1978, until December 31, 1982.[82] The credit is nonrefundable,[83] except for investments in solar and wind equipment,[84] but may be applied against a taxpayer's entire tax liability.[85]

Certain property is eligible both for the 10 percent investment tax credit and the 10 percent energy tax credits; other property is eligible only for the energy tax credit.[86] Under the 1978 Act, with the exception of certain farm structures, only two solar technologies were eligible to receive both the investment tax credit and the energy tax credit — process heat and electrical generation.

2. Analysis and Conclusions

Although solar and wind energy property is eligible for the energy tax credit, the "structures rule" precludes their eligibility for the investment tax credit for systems to heat and cool a

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80 I.R.C. § 48(l)(1).
81 I.R.C. §§ 48(l)(1)-(6).
82 I.R.C. § 46(a)(2)(C).
83 I.R.C. § 46(a)(10)(B).
84 I.R.C. § 46(a)(10)(C).
85 I.R.C. § 46(a)(10)(B)(i).
86 I.R.C. § 46(a)(2)(A). Only property which is considered section 38 property (as defined in I.R.C. § 38(a)) is allowed both the energy and regular investment tax credits. Energy property which is not considered section 38 property is nonetheless entitled to an energy credit. I.R.C. § 46(a)(2)(D). However, a solar system which heats a structure or enclosure built and used specifically for commercial livestock or horticultural production does qualify for both the energy and investment tax credits. I.R.C. § 48(a)(1)(D).

building which require structural modification of the building.[87] Thus, instead of receiving a 20 percent total tax credit, the investor only receives the 10 percent energy tax credit under the 1978 Act. This is an unfortunate situation. First, solar energy systems to heat and cool buildings are expected to account for a large proportion of solar energy savings in the near term.[88] Because of Congress' failure to provide a meaningful energy tax credit under the 1978 Act, this basic solar application did not receive the assistance it needed to surmount financial barriers in the open market.

Second, even though eligible for both investment and energy tax credits, solar process heat and solar electrical generation were still not sufficiently subsidized to induce wide-scale commercialization. Even with substantial research by major U.S. corporations, the cost of manufacturing photovoltaic cells used in solar electrical generation remains prohibitive for business use.

Similarly, although a number of commercial installations are now operative, the high initial cost of the systems dictates the need for a substantially higher tax subsidy if solar process heat is to compete with conventional energy systems. Under the 1978 Act, qualifying solar process heat installations must heat water for a specific commercial purpose, such as dishwashing, car washing, and laundry washing. Because no structural modification is required, solar process heat generally qualifies for both the energy and investment tax credits. Economic analysis based upon prevailing energy prices indicates, however, that process solar heat presently requires a 50 percent energy tax credit, accelerated depreciation schedules, and low-interest loans to gain economic parity with electric or gas systems in most parts of the country.[89] Obviously, the 20 percent credit does not approach this level of assistance.

Third, unlike the residential credits, the business energy credits contained in the 1978 Act were quite limited. Although many technologies were covered, few if any were given tax subsidies ade-

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87 S. REP. NO. 394, 96th Cong., 1st Sess. 79 (1979); I.R.C. §§ 48(a)(1)(A), (B).

88 THE MITRE CORPORATION, SOLAR ENERGY, A COMPARATIVE ANALYSIS TO THE YEAR 2020, at 5 (March, 1978), *reprinted in Hearings Before the Sen. Select Comm. on Small Business on S. 807 and S. 2733, The Energy Research Incentives Act and the Small Business Energy Loan Act,* 95th Cong., 2d Sess. 109, 115 (1978).

89 *Id.* at 202, 212. Presentation by Frank Kendall, Manager for Planning and Analysis, Exxon Enterprises, 1251 Avenue of the Americas, New York, N.Y. (Sept., 1979).

quate to spur commercialization. While energy tax credits serve as a "pump primer" to educate homeowners to the existence of conservation and renewable energy sources, business investors need no such introduction and will purchase energy equipment if and when it becomes cost-effective to do so. The concept underlying the various types of energy property is to encourage broad-based investment in energy technology and conservation. Larger credits are therefore necessary to make renewable and alternative energy investment and development attractive in purely economic terms.

Further, if energy tax credits are to be effective, regulations promulgated with respect to them must neither so greatly complicate procedures nor so narrowly construe the statutory language as to defeat this legislative intent. Otherwise, energy tax credits will not significantly contribute to the goal of energy independence.

In short, the business energy tax credits of the 1978 Act — like the residential ones — were too limited in scope and effect to overcome current economic barriers to renewable energy source investment. First, the 10 percent credit failed to provide an effective stimulus to new investment. Second, only expenditures for certain equipment or property (called "energy property") were covered, and a large number of possible conservation expenditures were ignored. The 10 percent energy tax credit was not available for the most common uses of solar power: heating or cooling a building. Third, public utilities, the primary suppliers of industrial energy, were specifically made ineligible for the tax incentives. The effect of precluding these bodies from receiving energy tax credits is to deny incentives to the entities capable of collecting and distributing energy from alternative sources to large numbers of energy consumers. These constraints on the business energy tax credits made investment in energy much less desirable than it otherwise could have been.

III. The Crude Oil Windfall Profit Tax Act of 1980

The 1980 Act improved on the 1978 Act by increasing the duration and rates of certain energy tax credits while expanding the list of qualifying technologies. In the process of creating the 1980 Act, Congress rejected numerous tax credit proposals designed to reduce oil or gas consumption. However, the more limited provi-

sions which were adopted, together with the rising cost of fuel, can be expected to stimulate investment in conservation and renewable energy source technology substantially beyond that induced by the 1978 Act.[90]

A. *Major Provisions*

The major residential provision of the 1980 Act is the increase in the solar, wind, and geothermal energy tax credit from a maximum of $2,200 to $4,000, or 40 percent of expenditures up to $10,000. Congress intended, by expanding this energy tax credit, to induce substantial new residential investment in renewable energy source technology. Photovoltaic solar cells and structural modifications such as a solar panel installed as a roof now qualify for the energy tax credit. Existing I.R.S. regulations allowing for joint ownership of qualified property are now formalized in the 1980 Act. Due to the growing list of available federal and state energy grants and subsidized loans, rules against "double-dipping" (taking the energy tax credit for expenditures made with subsidized funds) were enacted.

The 1980 Act, however, includes provisions which fail to induce investment in residential installations. For example, the requirement that equipment be installed in or on only the taxpayer's principal residence is retained and passive solar energy remains largely ineligible. Rejecting proposals to expand the list of technologies eligible for the existing 15 percent conservation energy tax credit, Congress enacted a complicated scheme by which the Treasury may add to the list of eligible conservation or renewable energy source equipment. Six items were specified for review under the new standards: heat pumps, airtight wood-burning stoves, replacement oil or gas furnaces, replacement coal furnaces and boilers, replacement wood-burning furnaces or boilers, and infrared radiant heating panels.[91]

In the area of business installations, Congress broadened the scope of technologies eligible for business energy tax credits to in-

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90 For a technical overview of certain provisions of the 1980 Act, *see* Bates, *New and Expanded Tax Incentives for Energy Development Offered by the Windfall Profits Tax Act*, 53 J. TAX. 12 (1980).

91 H.R. REP. NO. 817, 96th Cong., 2d Sess. 122 (1980).

clude cogeneration, ocean thermal energy conversion (commonly referred to as OTEC), and hydroelectric installations. Existing energy tax credits for biomass property are extended for three more years through 1985. The existing excise tax exemption for gasohol is also enhanced by a new energy tax credit designed to encourage higher alcohol content.

Public expenditures for solar, wind, geothermal, hydroelectric, and biomass energy production are made eligible for tax-exempt industrial development bonds (IDB's). Under "double dipping" rules, however, the level of energy tax credits allowed is reduced to the extent that subsidized financing such as IDB's and government grants is used to purchase the eligible equipment.

For business installations, the energy tax credit for solar, wind, and geothermal property has been increased from 10 to 15 percent through 1985. The conference committee rejected the Senate provision which would have allowed the 10 percent investment tax credit for all business renewable energy source technologies. Thus, the so-called "structures rule," which bars the investment tax credit for much space heating and cooling, will continue to impede solar utilization. Although commercialization can be expected to focus on solar process heat, which is now eligible for a combined 25 percent tax credit, the credit provided in the Senate proposal is still lower than that considered necessary to surmount economic barriers in the business sector.[92]

Similarly, with the exception of hydroelectric property, large potential energy savings by public utilities remain untapped because of continued express ineligibility of utilities for tax incentives.

B. *Residential Energy Tax Credits*

Congress considered three general aspects of residential energy tax credits prompted in large part by California's successful experience in the area:[93] first, whether the existing energy tax credits of the 1978 Act embraced a sufficiently broad number of technol-

92 H.R. CONF. REP. NO. 1773, 95th Cong., 2d Sess. 64, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 8069, 8092. *See also* ENERGY FUTURE, note 1 *supra.*

93 In 1977, California enacted sweeping legislation which provided both a high level of tax credit (55 percent) and broad eligibility. While the Energy Tax Act of 1978 may be more symbolic than effective, the California tax subsidies have won high praise for their results. *See* ENERGY FUTURE, *supra* note 1, at 196.

ogies; second, whether eligibility of various taxpayers and property was too limited; and third, whether the rate or amount and duration of the credits were adequate to achieve the goal of encouraging less reliance on oil and natural gas.

1. Credits For Conservation Expenditures

Congress decided that the 1978 Act did not provide energy tax credits for a broad enough range of energy-conserving components capable of reducing oil or gas consumption. Consequently, it adopted a set of standards that the Treasury, in consultation with other federal agencies, including the Department of Energy, is to use to determine whether new equipment should be added to the list of eligible conservation property.

Congress rejected the Senate proposal to extend the tax credit termination date by 15 years, through 1999, while increasing the credit amounts.[94] The longer credit period was intended to assure a stable market for new technology in order to convince businesses to make substantial capital investments in energy technology and to mount the marketing efforts necessary to induce desired energy spending by consumers. Congress retained the shorter period in order to induce prompt energy investments.

Two principal problems concerning energy tax credits for conservation equipment remain. First, the 1980 Act does not increase the rate or amount of tax credits for these expenditures. Taxpayers may still claim only 15 percent of the first $2,000 of their qualified expenditures or a maximum credit of $300. Second, the Senate rejected proposals to make the tax credits refundable. The failure to provide for a refundable conservation energy tax credit constitutes one of the major shortcomings of the 1980 bill. The potential additional energy savings to be realized by low-income households is enormous, since at least 43 percent of low-income households have no insulation.[95] Yet, lower-income households are generally less able to devote the funds to make energy-conserving improvements and may have insufficient taxable income to make use of energy tax credits. As a consequence, nonrefundable credits provide sub-

94 S. REP. No. 394, 96th Cong., 1st Sess. 76 (1979).

95 1 OFFICE OF TECHNOLOGY ASSESSMENT, U.S. CONGRESS, RESIDENTIAL ENERGY CONSERVATION 80 (1980).

sidies to many middle- and upper-income households which could have made energy conservation expenditures without the subsidy. To date, over 90 percent of the residential energy tax credits have been claimed by taxpayers with adjusted gross incomes of over $12,000 a year.[96] Thus, a refundable tax credit would have been more equitable and may have given lower-income households the money necessary to make conservation expenditures.

2. Credits for Qualified Renewable Energy Source Expenditures

The 1980 Act expanded the energy tax credits available for residential expenditures for renewable energy source equipment. The amount of credits available is substantially increased and a wider array of technologies is now eligible for the credit.

Congress increased the renewable energy source tax credit (relating to solar, wind, and geothermal equipment) to 40 percent of expenditures up to $10,000, for a maximum credit of $4,000,[97] a substantial increase from the rates and amounts provided under the 1978 Act. This higher tax credit will stimulate increased investment by reducing the period required to recover initial costs. In determining the sufficiency of the energy tax credit to induce new investment, a key variable is the payback period. The mobility of Americans requires short payback periods if significant capital investments are to be induced. For example, based on current costs, the new 40 percent credit will reduce the payback period of a residential, solar hot water system to three to four years in the northeastern states.[98] In many cases, this time is probably short enough to induce investment.

For residential wind applications, limiting the 40 percent credit to the first $10,000 of expenditures may well skew investment towards smaller-capacity wind-generating equipment capable only of satisfying household electrical needs other than heating. Wind machines which produce electricity for a single home currently cost approximately $10,000 (or $6,000 after the energy tax credit). Larger machines with the capacity to satisfy both electrical and

96 1978 Statistics of Income, Individual Income Tax Returns, I.R.S. Pub. 198 (4-80), Table 8.

97 1980 Act § 202(a)(2) (amending I.R.C. § 44C(b)(2)).

98 Presentation by Peter Colaianni, Director of Administration, Solar Energy Industries Ass'n, 1001 Connecticut Ave., N.W., Washington, D.C. (Sept. 25, 1980).

heating needs presently cost approximately $20,000. Since the energy tax credit applies only to the first $10,000 spent, no energy tax credit is available for the additional $10,000 cost necessary to equip a house with a wind installation having both electrical and heating capabilities. Thus, the incentive to make such installations is not enhanced by the 1980 Act.

Congress also expanded the renewable energy source equipment provisions under the 1980 Act to cover more technologies than the 1978 Act. In a needed amendment, the 1980 Act includes electrical generation as one of the qualifying uses of renewable energy source property. Photovoltaic technology is the primary beneficiary of this amendment, although even with a 40 percent energy tax credit,[98] substantial technical advances will be necessary before it is economically competitive with conventional energy sources in the residential sector or the business sector.[99]

Under the I.R.S. interpretation of the 1978 Act, solar and wind property were considered to be non-qualifying structural components whenever they served a dual function as part of the structure of a building and also as energy equipment. Solar collectors installed in and made part of a roof, for example, were not eligible for the energy tax credit.[100] Congress partially rectified this problem by specifically including solar panels installed as a part of the roof as qualifying renewable energy source property under the 1980 Act.[101] However, Congress followed the I.R.S. regulations by continuing to exclude other structural components, even where they were integral to the installation and functioning of qualifying property,[102] such as a heat absorbing storage wall incorporated in an advanced passive solar design.

3. General Provisions

a. *Joint Ownership*

Although regulations under the 1978 Act already provided that joint owners of qualified renewable energy source property and energy conservation property were eligible for energy credits equal

99 U.S. DEP'T OF ENERGY, DOMESTIC POLICY REVIEW OF SOLAR ENERGY 3 (1979).
100 Reg. § 1.44C-2(f)(4); *see* note 52 *supra*.
101 1980 Act § 202(d) (amending I.R.C. § 44C(c)(2)).
102 H.R. 817, 96th Cong., 2d Sess. 123 (1979).

to their prorated shares of the cost of jointly acquired equipment, the 1980 Act codifies this concept. Renewable energy source property is particularly well suited for joint utilization by several households. Windmills and solar panels can be positioned on common property (*e.g.*, roof tops) with the electricity or heat shared by owners residing in duplexes, townhouses, condominiums, cooperatives, or other communities. Under new provisions, the investment incentive is increased since each owner is entitled to claim the maximum energy tax credit for his share of the expenditures.[103]

b. *Standards for Review*

As was previously mentioned, the Treasury was granted the authority to add to the statutory list of insulation, energy-conserving components, and renewable energy source property eligible for energy tax credits.[104] Recognizing that elimination of this discretionary authority would discourage continued innovation, but wishing to limit revenue loss attributable to expanding energy tax credits, Congress instituted standards in the 1980 Act to guide the Secretary's determinations.[105] First, the Secretary must find that existing federal subsidies do not render an energy tax credit unnecessary or inappropriate.[106] Second, the proposed item must not be dangerous to public health, safety, or the environment.[107]

The most critical standard, because of the difficulty of proof entailed, provides that a proposed item must reduce total national consumption of oil and natural gas sufficiently to justify the resulting revenue loss.[108] Both the energy-savings and revenue-loss calculations are extremely difficult to make. The Treasury and the Department of Energy are required to answer the following questions regarding the proposed item: To what extent will availability of the energy tax credit increase demand for the item? Is there sufficient production capacity to meet this demand? How much oil or natural gas will be used to produce the item? What is its useful

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103 1980 Act § 201(a) (amending I.R.C. § 44C(d)); Reg. § 1.44C-3(h) (joint ownership).
104 I.R.C. §§ 44C(c)(4)(A)(viii), (5)(A)(i).
105 1980 Act § 201(b)(1) (amending I.R.C. § 44C(c)).
106 *Id.* (enacting I.R.C. § 44C(c)(9)(A)(iii)).
107 *Id.* (enacting I.R.C. § 44C(c)(9)(A)(ii)).
108 *Id.* (enacting I.R.C. § 44C(c)(9)(A)(i)).

life?[109] Does an energy tax credit compare favorably with other federal programs as a cost effective means of reducing oil and gas consumption?[110]

Based upon the detailed analysis required to make energy-saving and revenue-loss estimates, as well as the reluctance of the Treasury to expand eligibility for energy tax credits in the past, it appears unlikely that the list of qualified equipment will be significantly expanded without congressional mandate. Any future amendment should therefore attempt to delineate simpler standards to facilitate the certification of inventions in the energy field.

c. *Preventing "Double Dipping"*

With the recent proliferation of federal, state, and local programs designed to conserve and produce energy,[111] Congress was concerned that taxpayers might claim energy tax credits for expenditures of publicly subsidized funds. The 1980 Act forces the purchaser of conservation or renewable energy source equipment to choose between an energy tax credit or "subsidized energy financing."[112]

While existing law already renders one form of subsidized energy financing ineligible for residential energy tax credits, namely, property purchased with tax-exempt grants, Congress expanded the list of ineligible subsidized energy financing to include use of subsidized low-interest energy loans and direct or indirect proceeds from tax-exempt bonds.[113] Loan guarantees, however, are not considered subsidized energy financing, even though they generally result in lower-than-market interest rates. Similarly, taxable grants and state and local income tax credits are not included in the "double dipping" provisions.[114]

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109 *Id.* (enacting I.R.C. § 44C(c)(9)(C)).

110 *Id.* (enacting I.R.C. § 44C(c)(9)(B)(ii)).

111 For an example of a directly competing program providing low-interest loans, *see* S. 932, Title II, The Solar Energy Development Bank, Pub. L. No. 96-294, 94 Stat. 611 (to be codified at 12 U.S.C. § 3601 *et seq.* (1980)); S. REP. NO. 387, 96th Cong., 1st Sess. 42 (1979).

112 1980 Act § 203 (amending I.R.C. § 44C(c)).

113 *Id.*

114 According to the conference report, the rationale is that the taxation of grants serves as a partial off-set to their subsidized nature. Credits against state and local income taxes are not taken into account because the fact that those taxes are deductible from federal

4. Conclusions

While the 1978 Act increased the public's awareness of conservation and renewable energy source technology, the 1980 Act took the next step by eliminating some of the economic barriers to residential energy investment. The large initial cash outlay required to purchase and install a renewable energy source system has thus far thwarted wide-scale commercialization of residential solar and wind equipment. The new 40 percent energy tax credit is designed to reduce the payback period to an acceptably low number of years. The combination of rapidly escalating fuel costs and energy tax credits of up to $4,000 per dwelling should be sufficient to induce investment in renewable energy source equipment on purely economic grounds in many parts of the United States.

C. Business Energy Tax Credits

The business provisions of the 1980 Act include a coordinated package of energy tax credits designed to increase energy conservation, to encourage the development of additional energy sources other than oil and natural gas, and to promote increased utilization of energy sources for which incentives were provided in the 1978 Act. These incentives include new categories of eligible energy property, increased rates of energy tax credits, broadened availability of energy tax credits, and extension of the effective period for energy tax credits for certain new technologies and energy projects.

1. "Energy Property" Under the 1980 Act

Under the 1980 Act, several categories of "energy property" — property in which qualified investments can be made — in addition to those provided in the 1978 Act, are made eligible for tax benefits. To those under the 1978 Act, the 1980 Act adds the categories of: (1) cogeneration equipment; (2) small-scale hydroelectric generating property; and (3) ocean thermal energy conversion equipment.[115] The types of qualified investments as well as the

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taxes implies that the taxpayer has, as in the case of taxable grants, made some contribution of his own. H. REP. No. 817, 96th Cong., 2d Sess. 121 (1980).

115 1980 Act §§ 222(a) (enacting I.R.C. §§ 48(2)(A)(vii), (viii)), 222(b) (enacting I.R.C. § 48(1)(3)(A)(ix)); (redefining the term "energy property").

credit percentage in the categories of solar, wind, geothermal, and biomass property under the 1978 Act have also been modified in the 1980 Act.

a. *Cogeneration Equipment*

Under the 1980 Act, cogeneration property qualifies as energy property and is eligible for a 10 percent, nonrefundable energy tax credit through 1982, in addition to the existing 10 percent investment tax credit. Cogeneration is the simultaneous production of either electrical or mechanical energy and useful thermal energy such as heat, steam, or gas and can be produced in a conventional industrial system. Although cogeneration equipment is currently available,[116] it is still expensive and rarely used in this country.[117]

Even though a substantial incentive is probably necessary to encourage use of cogeneration equipment, the cogeneration tax credits in the 1980 Act are severely limited. First, the equipment must be installed in a commercial or industrial facility which existed on January 1, 1980, and must expand or initiate the facility's cogenerating capacity. Second, the credit will be available only for additional or replacement cogeneration equipment that increases the system's capacity to produce the secondary energy product, not merely supplement production of the primary product.[118] Third, the credit is contingent on a use so narrowly defined that few will be able to benefit from it. Cogeneration equipment is defined in the 1980 Act as property that uses or produces both electricity and thermal energy or some other form of useful energy for industrial, agricultural, commercial, or space heating purposes. This definition greatly limits the potential energy-savings contribution of cogeneration that might result from a definition that provided an energy tax credit for the combination of thermal energy and either electricity *or* mechanical energy rather than simply thermal energy and electricity.[119]

Another controversial aspect of the cogeneration energy tax

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116 Widmer & Gyftopoulos, *Energy Conservation and a Healthy Economy,* TECHNOLOGY REV. at 32 (June, 1977). West Germany uses it to produce 18 percent of its total electricity.

117 125 CONG. REC. S12787 (daily ed. Sept. 17, 1979) (remarks of Sen. Packwood).

118 1980 Act § 222(f) (enacting I.R.C. § 48(l)(14)(D).

119 *Id.*

credit provisions is the exclusion of facilities using oil or natural gas as a fuel for other than startup, backup, or flame control purposes. In no case may oil or natural gas contribute more than 20 percent, on a BTU basis, of the total fuel consumed in a system in any taxable year. Since oil and natural gas serve as the primary fuel sources for American industry, exclusion of oil-burning facilities substantially reduces opportunities to induce energy savings. Exclusion is consistent, however, with the national energy policy of replacing oil and natural gas consumption with other fuels such as coal. Under the 1980 Act, coal-fired facilities, as well as those using alternative fuels, qualify for the cogeneration energy tax credit.

b. *Hydroelectric Generating Property*

Another new category of energy property added by the 1980 Act is small-scale hydroelectric property. While most dams built during the past 40 years incorporated electrical production into their design, older dams, built primarily to control floods or power small mills, did not. The Army Corps of Engineers has estimated the total unused hydroelectric potential at existing dams to be up to 54.6 billion watts annually, equivalent to the electrical output of 54 modern nuclear reactors.[120]

The 1980 Act provides for substantial subsidization of hydroelectric property expenditures and permits an 11 percent credit for generators, turbines, other hydroelectric equipment, and certain structures of up to 125 megawatt, installed capacity. As the total capacity increases from 25 to 125 megawatts, the energy tax credit is phased out. Significantly, hydroelectric property is eligible for the energy tax credit even if owned or operated by public utilities and even if the power is used or distributed by utilities. This is a commendable departure from the treatment of other energy property, including solar, wind, cogeneration, and geothermal, which remains ineligible for the energy tax credit if owned by a public utility. As a further stimulus to hydroelectric generating equip-

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120 ARMY CORPS OF ENGINEERS, ESTIMATE OF NATIONAL HYDROELECTRIC POWER POTENTIAL AT EXISTING DAMS (July 20, 1977). This figure includes the upgrading of generating capacity at existing hydropowered dams.

ment, the proceeds of tax-exempt industrial development bonds may be used to finance their purchase.[121]

c. *Ocean Thermal Energy Conversion*

The 1980 Act also adds to the existing categories of alternative energy property equipment designed to produce usable energy from the oceans by a process known as ocean thermal energy conversion (OTEC). Ocean thermal energy conversion is the process of exploiting the temperature differential between warm surface and cold deep sea waters to generate electricity. The 1980 Act provides a 15 percent energy tax credit (in addition to the basic 10 percent investment tax credit) through 1985, but only for qualifying equipment at two locations to be specified by the Treasury in consultation with the Department of Energy.[122]

Unlike solar, wind, or geothermal technology, OTEC applications are unproven in a commercial setting. Other legislation considered by the 96th Congress called for construction of demonstration and pilot plants,[123] would have provided a licensing mechanism, and proposed loan guarantees and tax-deferral mechanisms to stimulate private capital investment.[124]

2. Biomass Energy

Congress included several provisions in the 1980 Act intended to increase production of energy from biomass. Biomass refers to substances such as agricultural, industrial, or municipal waste, or organic substances (animal manure, crop residues, and wood) that can be utilized to produce energy through several conversion technologies, including biological, chemical, and thermal processes. The energy produced may be in the form of electricity or gaseous, liquid, or solid fuels, including methane, hydrogen, car-

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121 1980 Act § 242 (enacting I.R.C. § 103(b)(4)(H) (qualified hydroelectric generating facilities)).

122 *Id.* at § 222(b) (enacting I.R.C. § 48(l)(3)(A)(ix)).

123 Ocean Thermal Energy Conversion Development Act of 1979, S. 830, 96th Cong., 1st Sess., 125 CONG. REC. H13591 (Sept. 27, 1979).

124 Ocean Thermal Energy Conversion Act of 1980, Pub. L. No. 96-320, 94 Stat. 974 (to be codified at 42 U.S.C. §§ 9101 *et seq.* (1980)).

bon dioxide, and various heavy, combustible, fuel oils. Biomass energy is generally suitable for heating and cooling buildings, running generators, or manufacturing.[125]

In deciding upon the level of support to provide in this area, Congress rejected proposals to increase energy tax credit rates for biomass.[126] Instead, the December 31, 1982, expiration date for the existing 10 percent energy tax credit for biomass property was extended three more years to the end of 1985.[127] Property which converts biomass to alcohol fuel is also made eligible for the 10 percent credit.[128] In addition, Congress provided three other incentives for biomass production to supplement the income tax credit enacted in 1978: tax-exempt industrial development bonds, production credits, and alcohol fuels tax exemptions and credits.

Congress expanded the definition of solid-waste disposal facilities[129] eligible for tax-exempt industrial development bonds (IDB's). Proceeds from bonds issued after October 18, 1979, may be used for the solid-waste energy facilities.[130] Consistent with the "double dipping" provisions enacted for both residential and business energy tax credits, the amount of the biomass investment eligible for the 10 percent energy tax credit is reduced to the extent of the contribution of tax-exempt IDB proceeds received after 1983.[131]

A second incentive consists of the Alternative Fuel Production

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125 Its conversion can provide a renewable and economically viable alternative power source for large areas of the United States. The energy equivalent of 1.5 million barrels of oil per day is economically recoverable from municipal waste and animal manure. Methane produced from these materials can be introduced into the presently existing natural gas pipeline system. Electricity produced by a bioconversion plant can in turn be introduced into the nation's existing electric utility grid system for distribution to other regions of the country. *See* JOINT COMMITTEE ON TAXATION, ENERGY INCENTIVES AND OIL IMPORTS, 95TH CONG., 1ST SESS. 49 (Comm. Print 1977); U. BENEMANN, BIOFUELS: A SURVEY (Electric Power Research Inst.) (1978).

126 *E.g.*, H.R. REP. NO. 394, 96th Cong., 1st Sess. 84 (1979).

127 1980 Act § 211(a) (amending I.R.C. § 46(a)(2)(C)).

128 *Id.* at § 222(g) (enacting I.R.C. § 48(e)(15)(C)(iii)). However, to qualify for the extended energy tax credit period, the primary source of energy for the alcohol fuel facility may not be oil or natural gas or a product thereof.

129 *Id.* at § 241 (enacting I.R.C. § 103(g) (qualified steam-generating or alcohol-producing facilities)).

130 *Id.* at §§ 241(b)-(d).

131 *Id.* at § 223(c) (amending I.R.C. § 48(l)(11)).

Credit,[132] which provides a tax credit of $3 per energy equivalent of a barrel of oil for the production of energy from "alternative sources." Though subject to complicated effective dates and special rules, the $3 credit, in general, goes into effect when the average wellhead price for uncontrolled oil is $23.50 and phases out when it reaches $29.50. The production credit which generally applies to sales of oil from wood and other biomass fuels, shale and tar sands and gas, liquid and solid synthetic fuel or feed stock produced from coal. It is designed to protect producers of these forms of energy from decreases in the price of domestic oil, with which they compete. Because the current price of uncontrolled oil is above $29.50, however, it appears unlikely that this provision will ever become operative, despite the oil inflation-indexing factor set out in the provision.

A third major biomass energy tax incentive is directed specifically to alcohol fuels, primarily gasohol, a mixture of 90 percent gasoline and 10 percent alcohol that can be used in internal combustion engines.[133] Addressing a defect in the 1978 Act, the 1980 Act provides for a credit scaled to the amount of alcohol in the gasohol mixture. Under the 1978 Act, a blend of gasoline and at least 10 percent alcohol was exempt from the four cent-per-gallon federal excise tax on motor fuels.[134] As a result, retailers were encouraged to sell gasohol but lacked an incentive to increase the proportion of alcohol, for example, by using a 20 percent alcohol to 80 percent gasoline mixture, which requires no modifications of automobile engines.[135] Concentrations of alcohol above 20 percent require minor modifications.[136]

Therefore, it was proposed that the amount of the tax credits be

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132 *Id.* at § 231 (enacting new I.R.C. § 44D, credit for producing fuel from a nonconventional source).

133 In recent years, U.S. gasohol consumption has grown rapidly, primarily using ethanol from corn. It has been estimated that biomass alcohol fuel production could reach 500 to 600 gallons per year by 1985, which in a 10 percent mixture with gasoline would provide sufficient gasohol for 5 to 6 percent of national gasoline needs. Despite significant questions as to the potential of gasohol, Congress has enacted several forms of tax incentives to supplement numerous existing federal initiatives. *See* note 141 *infra.*

134 I.R.C. § 4081.

135 *The Brazilian Experiment,* 20 ENVIRONMENT at 17 (Dec., 1978).

136 OFFICE OF TECHNOLOGY ASSESSMENT, U.S. CONGRESS, GASOHOL: A TECHNICAL MEMORANDUM (Sept., 1979).

matched to the amount of alcohol in the alcohol gasoline mixture to provide this incentive.[137] Under the 1980 Act, a fuel which is more than 10 percent alcohol is not only eligible for the excise tax exemption (which was extended through 1992)[138] but also for an energy tax credit based on volume and proof of the alcohol used.[139] Since the tax credit is based on alcohol content, a more substantial proportion earns increased tax benefits. The credit is 40 cents per gallon of alcohol for 150 to 190 proof alcohol, reduced by the applicable amount of excise tax exemption.[140]

The credit is available for either ethanol or methanol, but not for alcohol produced from coal, petroleum or natural gas, on the theory that such exclusions are part of a national policy to reduce consumption of these resources. Exclusion of coal, however, is counter-productive because coal is the non-petroleum source of methanol closest to practical, large-scale exploitation. Furthermore, the Department of Energy has concluded that in the long term, methanol can be produced in much larger quantities than ethanol and should be less expensive. While only 6 percent of present coal production in the United States would be sufficient to supply a 10 percent alcohol mixture for all American automotive needs, the same quantity of ethanol from grain would consume 40 percent of the annual U.S. grain harvest.[141]

Anticipating rapid growth of alcohol production capacity due to the tax incentives of the 1980 Act, Congress relaxed existing regulation of distilled spirits plants by the Bureau of Alcohol, Tobacco and Firearms. The 1980 Act provides that fuel-producing distilled spirits plants which render their product unfit for beverage purposes are eligible for simplified entry and reduced regulation. Application, production control, and bonding requirements are to be simplified or even eliminated by the Treasury.[142]

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137 125 CONG. REC. S12787 (daily ed. Sept. 17, 1979) (remarks of Sen. Packwood).

138 1980 Act § 232(a) (amending I.R.C. §§ 4081(c), 4041(k)).

139 *Id.* at § 232(b) (enacting I.R.C. § 44E (alcohol used as fuel)).

140 *Id.* For example, if a taxpayer blends 7,000 gallons of gasoline and 3,000 gallons of 190 proof alcohol and sells the mixture to a service station, the amount of credit allowable would be $800, computed as follows: 3,000 gallons x $0.40 = $1,200, reduced by $400 ($10,000 gallons x $0.04).

141 M. SEGAL, GASOHOL: THE ALCOHOL FUELS 3 (Congressional Research Service, The Library of Congress, Feb. 25, 1980).

142 1980 Act § 232(e) (enacting I.R.C. § 5181 (distilled spirits for fuel use)).

3. Increased Business Energy Tax Credits for Solar, Wind, and Geothermal Energy Expenditures

Congress increased the 10 percent, refundable energy tax credit for equipment which uses solar, wind, or geothermal energy to generate electricity or to provide heating, cooling, or hot water in a structure. From 1980 through 1985, the energy tax credit will be increased from 10 percent to 15 percent for expenditures of this type.[143] Thus, if a solar application is eligible for the basic 10 percent investment tax credit, a 25 percent total credit is now available. However, the 1978 Act is amended by repealing the refundable feature of the solar and wind energy tax credits for investments made after 1979.[144]

The regular 10 percent investment tax credit is not available for solar, wind, or geothermal property which requires or constitutes structural modifications or components, such as building-wide heating and cooling systems. Since space heating and cooling is a primary use of solar and geothermal energy, this "structures" rule has served as an impediment to business use of these resources. The solution proposed by the Senate would have specifically made property which is eligible for the 15 percent energy tax credit also eligible for the 10 percent investment tax credit.[145] This proposal, however, was rejected by the conference committee. Thus, solar space heating and cooling qualifies for a 15 percent total credit, while mechanical, electrical, or process heat applications are eligible for a 25 percent total credit.[146] Manufacturers of solar equipment anticipate that, as a result, solar investment will be skewed towards process heat.[147]

To achieve an economically viable alternative to oil and natural gas, it is critical that Congress provide a sufficient incentive to spur commercialization of solar energy in the commercial, agricultural, and industrial sectors. Business energy tax credits may be more ef-

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143 *Id.* at § 221(a) (amending I.R.C. § 46(a)(2)(C)).

144 *Id.* at § 223(b) (amending I.R.C. § 46(a)(10)).

145 S. REP. No. 394, 96th Cong., 1st Sess. 85 (1979).

146 The 1980 Act specifically named solar process heat as a qualifying application even though it appears that process heat was eligible for the business solar and wind energy tax credit under the Energy Tax Act of 1978. 1980 Act § 222(c) (amending I.R.C. § 48(1)(4)(C)).

147 Statement by Dr. Michael Crisp, Director, Federal Government Technical Liaison, Owens-Illinois, Washington, D.C. (May, 1980).

fective than residential incentives in stimulating renewable energy source technological development.[148] Special emphasis on large commercial applications can build volume quickly with a minimum of sales, installation, and service problems. A large business market can produce economies of scale that may bring the cost of solar energy systems within the range of more residential buyers. Also, large users typically have a higher degree of technical and financial expertise than homeowners. As a result, sites would probably be better engineered and monitored, leading to more substantial improvements in solar collection systems. Finally, many industrial customers are likely to be confronted with fuel curtailments during the coming decade and will need to select a replacement energy source for the first time.

To be effective, it may be that the amount of energy tax credit available to businesses for solar, wind, and geothermal equipment should be increased over the level provided in the 1980 Act. The cost-benefit analysis of whether to install solar equipment, for example, is different for a business than for a homeowner. For a business, fuel costs constitute a tax deductible expense, as does the depreciation attributable to most investments in equipment and machinery. A homeowner is entitled to neither of these deductions, nor to an investment tax credit. Consequently, before purchasing solar equipment, a business must consider the after-tax costs of fuel and of equipment, as well as the reduction in capital costs resulting from the combined energy and investment tax credits. Ignoring any factors attributable to the cost of money, and assuming the use of the investment tax credit, a business in the 46 percent federal income tax bracket realizes a 34 percent reduction in its capital costs of purchasing solar equipment solely from the use of the energy tax credit. The combined use of the maximum investment and energy tax credits results in a reduction of capital costs of about 46 percent.[149] However, the economic value of the

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148 Oral presentation by Owens-Illinois, Solar Energy Policy Forum, Illinois Institute of Technology (June 26, 1978).

149 For each $100 of cost, a business taxpayer will receive an investment tax credit of $10, and, over the useful life of the property, a tax benefit attributable to depreciation of $46. These tax benefits result in an after-tax cost of equipment of $44. Consequently, the energy tax credit results in a 34 percent ($15/$44) reduction of the after-tax cost of the property. If both credits are treated as a single incentive, they result in a 46 percent ($25/$45) reduction in the after-tax cost of the property.

tax credits to a business must be considered in view of a business' lower after-tax unit fuel costs and potentially more efficient use of fuel; these factors may result in a business having less incentive than a homeowner to invest in something like solar equipment.[150]

Congress is currently considering legislation which would greatly enhance the value of energy tax credits in the 1980 Act. In an effort to increase economic productivity generally, the legislation would shorten the depreciation period for business capital expenditures.[151] Under one such proposal, the straight-line depreciation schedule for solar, wind, and geothermal equipment would be reduced to five years.[152] Accelerated depreciation, a 25 percent combined energy and investment tax credit, rising costs and shortages of fossil fuels may combine in the near future to make business renewable energy source investment viable on purely economic grounds.

4. General Provisions of the Business Energy Tax Credit

Congress enacted several provisions in the 1980 Act which apply generally to the renewable energy source business incentives. These relate to IDB's, protection against double dipping, and the authority of the Treasury to expand the list of eligible property. In addition, the conference committee rejected efforts to allow public utilities to claim energy tax credits.

Consistent with provisions for solid waste disposal and hydroelectric generating facilities, the 1980 Act allows proceeds of tax-exempt IDB's issued by a state or its political subdivisions to be used to finance energy production from renewable energy sources,[153] specifically, solar, wind, geothermal, waste heat, biomass, and water energy resources.[154] While Congress rejected a proposed income tax exemption for IDB's for cogeneration prop-

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150 According to industry analysts, even the combined 25 percent tax credit available for solar equipment is insufficient to surmount current economic barriers that require at least a 40 to 50 percent tax credit to make business investments in solar property economically viable. *See* note 81 *supra.*

151 The initial accelerated depreciation proposal considered in the 96th Congress was known as "10-5-3," or The Capital Cost Recovery Act of 1979, S. 1435, 96th Cong., 1st Sess., 125 CONG. REC. S8694 (daily ed. June 27, 1979).

152 *Id.*

153 1980 Act § 243.

154 *Id.* at § 243(a)(2).

erty, it appears that by specifically including waste heat as a qualifying energy source, some cogeneration applications are eligible for tax-exempt renewable energy source IDB's.

The provisions of the 1980 Act designed to coordinate the business energy tax credits with other government energy subsidies to prevent "double dipping" closely reflect provisions enacted for the same purpose in the residential sector. The 1980 Act requires that the energy investment be reduced to the extent expenditures are financed by IDB's or other government-subsidized financing. This rule is not effective until 1983, except for equipment eligible for energy tax credits for the first time under the 1980 Act. The rule is effective for newly eligible property in 1980.[155] Companies investing in renewable energy source equipment will have to choose between tax credits and subsidized financing.

In recognition of the need for continuing technology review, Congress rejected efforts to terminate the Treasury's authority to expand the statutory list of equipment eligible for energy tax credits. However, Congress did limit the Treasury's discretion by making it subject to the same complicated standards mentioned earlier for purposes of identifying additional equipment eligible for residential conservation and renewable energy source tax credits.[156]

The 1980 Act retains the exclusion of public utilities found in the 1978 Act. Regardless of ownership, any renewable energy source equipment, the product of which is carried on public utility grids and sold as publicly regulated property, is ineligible. Today, private companies are entering into innovative arrangements in which they build, own, and operate windmills (often on property owned by utilities) and sell the electricity generated to a utility. Under the 1978 Act, these windmills, although privately owned, are considered "public utility property" because the electricity is sold to utilities and resold to consumers at regulated rates. More commonly, utilities lease equipment and operate it themselves.

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155 *Id.* at § 223(c)(2). These include hydroelectric cells, solid waste equipment, and solar process heat, even though tax credits were allowed for solar process heat prior to the 1980 Act.

156 S. REP. No. 394, 96th Cong., 1st Sess. 84 (1979); 1980 Act §§ 222(d)(2) (amending I.R.C. § 48(l)(5)), 201(b) (amending I.R.C. § 44C(c)).

Nonetheless, under the 1978 Act, the private lessors of this equipment are also ineligible for the credit.[157]

Wind, geothermal, hydroelectric, biomass, cogeneration, and ocean thermal energies are well suited to utility use. All can be used in centralized electrical generation and can be transmitted over public utility grids. These energy sources can often be best harnessed on a large scale. The reasons for the exclusion are therefore unclear. Perhaps Congress did not feel that energy tax credits for utilities were warranted because rate making agencies were not required to pass through resulting savings to consumers.[158]

IV. Conclusions

The 1978 Act was designed to encourage energy conservation and utilization of new energy technologies by individuals and businesses. For the first time individuals became entitled to conservation energy tax credits of up to $300, plus energy tax credits for solar, wind, and geothermal equipment of up to $2,000. The I.R.S. has promulgated regulations that would greatly restrict the application of these credits for residences and limit their effectiveness. Nonetheless, the allowance of energy tax credits for residences represented a serious effort on the part of Congress to address the energy crisis in the United States. Similarly, the allowance of the energy tax credit in addition to the investment tax credit provided an expanded incentive for businesses to invest in qualified energy property.

In 1980, Congress again acted on the energy problem facing the United States by expanding the categories of property eligible for energy tax credits and clarifying some of the ambiguities in the 1978 Act. Although Congress failed to resolve all of the problems with the 1978 Act and rejected a number of promising proposals, it did create even greater incentives for energy investment and conservation in the 1980 Act. For residences, it increased and simplified energy tax credits for renewable energy source expenditures sufficiently, in the judgment of the authors, to induce in-

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157 *See generally* I.R.C. § 48(l)(3)(B) (exclusion for public utility property).

158 However, utilities may take the newly-enacted hydroelectric generating property tax credit. 1980 Act § 222(i)(1) (enacting I.R.C. § 48(l)(17)).

creased market penetration of solar, wind, and geothermal technologies.

For businesses, OTEC, small-scale hydroelectric, and cogeneration properties were added to the list of qualified investments. Production of alcohol fuels received greater tax benefits. Overall, the 1980 Act strengthened incentives for energy investment, although opportunities for further improvement of these incentives remain.

While the Treasury will suffer a loss of billions of dollars of revenue based on the energy tax credits of the 1978 Act and 1980 Act,[159] every dollar represents a step toward energy self-sufficiency in the United States. The effect of these incentives is not only to create new tax benefits for businesses and individuals, but also to relieve, in part, the reliance of the United States on foreign oil.

159 *See* S. REP. No. 394, 96th Cong., 1st Sess. 78 (1979).

NON-ATTORNEY JUSTICE: A SURVEY AND PROPOSED MODEL

LINDA J. SILBERMAN*

Mounting dockets and limited resources in the regular judicial system have recently prompted a new focus on lay-judge courts in the United States. While the movement toward judicial reform in the 1960's curtailed the jurisdiction of such courts and placed them under central administrative authorities, recent efforts have been directed not toward drastic change, but rather toward such measures as lay-judge training intended to increase the effectiveness of the present system and its participants. At the same time, the Supreme Court's decision in North v. Russell *upholding the constitutionality of lay-judge courts has fueled continued emphasis on due process requirements in non-attorney courts.*

In this Article, Professor Silberman provides a broad overview of current lay-judge statutes and procedures. With the assistance of a special study she conducted for the Institute of Judicial Administration and the National Center for State Courts, she outlines the strengths and shortcomings of non-attorney justice and offers recommendations and conclusions designed to help state officials drafting legislation in those states in which financial or demographic constraints necessitate the use of lay judges.

Introduction

Judicial reform in the twentieth century has been punctuated by attempts to reduce or eliminate the role of non-attorney judges in the United States. As early as the 1930's, several states had overhauled their largely non-attorney justice of the peace courts, and in the 1940's several states introduced requirements that lower courts be staffed by judges educated in law. By the mid-1960's, although non-attorney judges were permitted in most states, reforms had curtailed their jurisdiction, implemented selection procedures, revised compensation structures, and placed these courts of limited jurisdiction under the supervision of central administrative authorities.[1]

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1 INSTITUTE OF JUDICIAL ADMINISTRATION, THE JUSTICE OF THE PEACE TODAY (1965), Vanlandingham, *The Decline of the Justice of the Peace*, 12 KAN. L. REV. 389 (1964).

The attack on non-attorney judges in the United States reached a peak in 1974 with the decision of the California Supreme Court in *Gordon v. Justice Court,*[2] which held that a defendant who was charged with a criminal offense punishable by a jail sentence and tried before a non-attorney judge was constitutionally denied the effectiveness of his right to counsel.

However, just as the obituary for the non-attorney judge was being written, the Supreme Court of the United States rendered its decision in *North v. Russell*[3] upholding the constitutionality of lay-judge courts. The Supreme Court's reprieve for non-attorney judges refocused attention on existing non-attorney courts and the need for continuing judicial reform to ensure compliance with the requirements of *North* and to improve the type of justice being dispensed in these courts.

In 1979, the Institute of Judicial Administration and the National Center for State Courts, pursuant to a grant from the Law Enforcement Assistance Administration, jointly published a comprehensive study, (hereinafter "the IJA study") of non-attorney justice in the United States in the post-*North* era.[4] This Article, which is an outgrowth of that study, will focus on recent legislative and judicial developments that have taken place and must still take place if a system of non-attorney justice is to endure.

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> Q. Are you familiar with the 14th Amendment to the Constitution of the United States and as to what it provides?
> A. Yes, sir.
> Q. What does that provide?
> A. Right offhand, I don't — something about judicial. I think one of them is judicial procedure or something another. I'm not for sure.[5]

Non-attorney judges historically have enjoyed a fundamental

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2 12 Cal.3d 323, 525 P.2d 72, 115 Cal. Rptr. 632 (1974), *cert. denied,* 420 U.S. 938 (1975).

3 427 U.S. 328 (1976).

4 INSTITUTE OF JUDICIAL ADMINISTRATION AND NATIONAL CENTER FOR STATE COURTS, NON-ATTORNEY JUSTICE IN THE UNITED STATES: AN EMPIRICAL STUDY (1979) [hereinafter cited as NON-ATTORNEY JUSTICE]. Parts of this article have been taken from that published study, of which Professor Silberman was project director and author. *See* note 190 *infra.*

5 Jurisdictional Statement for Appellant, app. at 22a-23a, North v. Russell, 427 U.S. 328 (1976) (direct examination of City Judge C. B. Russell).

role in the American judicial system.[6] They have provided a grass-roots forum for the settlement of minor criminal and civil matters since colonial times, when attorneys were fewer, laws simpler, and populations more scattered. Yet the above cross-examination of the non-attorney judge in *North* illustrates an alarming lack of legal knowledge among some lay judges.[7] The growing complexity of constitutional and statutory law has aggravated the problem caused by the absence of formal legal training among lay judges.[8] A rising number of attorneys, the relative ease of transportation, and an increasing density of the population have revived the inquiry into the continuing need for a system of non-attorney justice.[9]

The defense of the continued use of non-attorney judges in the modern era takes two tacks. The first accepts the traditional role of and justifications for non-attorney judges: they can replace lawyer judges in rural or under-populated areas, where the small number of attorneys, sparse population, and poor economic base make it uneconomical and impractical to have attorney judges in many local courts;[10] the non-attorney judge fulfills the same function as the attorney judge — that of formal adjudication according to accepted legal norms. The second line of argument sounds an almost populist call for dispute-resolution mechanisms which are

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6 A brief historical sketch of the growth of non-attorney justice in the United States, authored by Theodor Fetter of the National Center for State Courts, appears in NON-ATTORNEY JUSTICE, *supra* note 4, at 331-45. *See also* Ewing, *Justice of the Peace — Bedrock of Democracy,* 21 TENN. L. REV. 484 (1950). For a comprehensive view of the role lay judges assume in various countries, *see* J. DAWSON, A HISTORY OF THE LAY JUDGE (1960).

7 427 U.S. at 340 n.1 (Stewart, J., dissenting). Examples of egregious conduct by non-attorney judges were noted in several of the *amicus* briefs before the Supreme Court in *North. See* Brief of the American Civil Liberties Union Foundation, Inc., addendum at 1a-10a; Brief of the Petitioners and Classes of Petitioners in Wyse v. Hopkins and in Sanchez v. Tonkin at 7; Brief of the American Judicature Society at 13. The briefs include examples of non-attorney judges who refused to give jury trials because of expenses, judges who were unfamiliar with the purpose of a preliminary hearing and who had no understanding of the concept of probable cause, judges who were unaware of criminal defendants' right to counsel, and judges who conceded that they had no standards for setting bail.

8 *See* Note, *Limiting Judicial Incompetence: The Due Process Right to a Legally Learned Judge in State Minor Court Criminal Proceedings,* 61 VA. L. REV. 1454 (1975).

9 *Id.*

10 Such a rationale has been the basis for non-attorney courts in Kentucky, *see* North v. Russell, 427 U.S. 328, 336, 338 (1976), Utah, *see* Shelmidine v. Jones, 550 P.2d 207, 210-11 (Utah 1976), and Washington, *see* Young v. Konz, 588 P.2d 1360, 1365 (Wash. 1979).

community-oriented, non-formalistic, and non-legalistic. While the populist proponents are primarily concerned with the evolution of new mechanisms of dispute resolution, such as community mediation centers,[11] the success of these modern ventures[12] may provide new support for lay justice on similar grounds.

Both themes will be examined in this Article in an attempt to re-evaluate modern non-attorney justice systems. A description of the existing legislative models of non-attorney justice will provide the background against which to view recent legal developments, and data gathered from two empirical studies will offer guidance for an evaluation of various non-attorney justice systems and a perspective for recommended change.

I. SURVEY AND PROFILE OF LAY COURTS

The constitutional and statutory schemes of forty-four states permit the use of non-attorney judges in some judicial proceedings. Only six states — California, Hawaii, Illinois, Kentucky, Maine, and Massachusetts — and the District of Columbia presently require that all judges of all courts have attorney status.[13] In several other states — Florida, Minnesota, and New Jersey — new judges in all courts must be attorneys, but incumbent lay judges have been grandfathered in and may be reappointed or re-elected.[14] Indiana will abolish its non-attorney judgeships by

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11 Transcript of Speech by Paul Nejelski, Deputy Assistant Attorney General, Office for Improvements in the Administration of Justice, New York University School of Law, Lay Judge Seminar (April 28, 1978) (unpublished).

12 *See generally* D. McGILLIS & J. MULLEN, NEIGHBORHOOD JUSTICE CENTERS — AN ANALYSIS OF POTENTIAL MODELS (1977); Felstiner, *Influences of Social Organization on Dispute Processing,* 9 LAW & SOC'Y REV. 63 (1974).

13 *See* CAL. CONST. art. 6, § 15, CAL. GOV'T CODE § 71701 (West 1976); Gordon v. Justice Court, 12 Cal. 3d 323, 525 P.2d 72, 115 Cal. Rptr. 632, *cert. denied,* 420 U.S. 938 (1975); District of Columbia Self-Government Reorganization Act, Pub. L. No. 93-198, § 433, 87 Stat. 774, as amended by Pub. L. No. 95-131, § 3(b), 91 Stat. 55 (1977); HAWAII CONST. art. 5, § 3; ILL. CONST. art. 6, § 11; KY. CONST. § 122; ME. REV. STAT. ANN. tit. 4, § 157 (1979); Massachusetts traditionally has appointed lawyers to all judicial positions, but it has no statutory requirement that all judges be lawyers. AMERICAN JUDICATURE SOCIETY, COURTS OF LIMITED JURISDICTION: A NATIONAL SURVEY 172 (1977).

14 FLA. STAT. ANN. § 34.021 (West Supp. 1979) (allows a non-attorney judge in counties of less than 40,000 population to be grandfathered if the judge was actively serving when the law was changed in 1978); MINN. STAT. ANN. § 487.03, .04, .08 (West Supp. 1980) (allows non-attorney county court judges to be re-elected, but does not allow them to hear cases involving jurisdiction beyond that exercised by them in 1971); N.J. STAT. ANN. § 2A: 8-24, -7, -22 (West 1952 & Supp. 1980) (provides for grandfathered non-attorney municipal judges to hear civil cases with amounts in controversy not exceeding $100 and non-indictable offenses where the maximum penalty is $1000 or one year imprisonment).

1983.[15] In some of the remaining forty states, the lay judges have a relatively limited judicial role. For example, in Alabama, Connecticut, and Maryland, non-attorney judges sit as probate judges and exercise limited jurisdiction.[16] In several states, non-attorneys function as magistrates and handle only preliminary or uncontested matters.[17] In other states, the non-attorneys exercise only local traffic and municipal jurisdiction.[18] And, in a few states, though non-attorney judges are authorized to hold judicial positions, few — if indeed any — actually serve.[19] In all, twenty-nine states still grant substantial jurisdiction to non-attorney judges.[20]

The actual number of non-attorney judges in the United States is difficult to determine with precision. Based on a survey of state court administrators, the 1979 IJA study estimated that of the 20,280 judges on minor courts, 13,329 were non-attorneys.[21] The actual figure may be somewhat higher, since several state court administrative offices reported that they did not have precise information about the number of lay judges who staff local and municipal courts. The IJA study projected a possible total of 14,000 non-attorney judges.

The study showed that Georgia, New York, and Texas have the

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15 IND. CODE ANN. § 33-10.5-1-3a (Burns Supp. 1979).

16 ALA. CONST. AMEND. No. 328, § 6.07; ALA. CODE § 12-13-31 (1975); CONN. CONST. art. 5, § 4; CONN. GEN. STAT. ANN. § 45-6 (West 1960) (Connecticut Probate Court); MD. EST. & TRUSTS CODE ANN. §§ 2-102, 13-105, -106 (1974) (Maryland Probate Court).

17 ALA. CODE §§ 12-12-52, 17-251 (1975) (Alabama Magistrates); MICH. COMP. LAWS ANN. §§ 600.8511, .8512 (Supp. 1979) (Michigan Magistrates).

18 *E.g.*, MO. ANN. STAT. §§ 479.010, .020 (Vernon Supp. 1979) (Missouri Municipal Court); WIS. STAT. ANN. § 755.045 (West Spec. Pamphlet 1979) (Wisconsin Municipal Court).

19 N.H. REV. STAT. ANN. § 502-A:3 (1968) (non-attorneys permitted). Out of 100 judges in New Hampshire's District and Municipal Courts, only 16 are non-attorneys. NON-ATTORNEY JUSTICE, *supra* note 4, at 256; OKLA. CONST. art. 7, § 8(h); OKLA. STAT. ANN. tit. 11, § 27-104 (West 1978). Non-attorneys may sit in Oklahoma as special judges only if no qualified attorneys are available. Out of a total of 48 special judges, only 1 was a non-attorney. On the other hand, 208 of 220 municipal court judges were non-attorneys. *See* NON-ATTORNEY JUSTICE, *supra* note 4, at 257. The Family Court Act of Rhode Island, R.I. GEN. LAWS §§ 8-10-1 *et seq.* (1956 & Supp. 1978) does not require Family Court Judges to be attorneys, although traditionally only attorneys are appointed. AMERICAN JUDICATURE SOCIETY, COURTS OF LIMITED JURISDICTION: A NATIONAL SURVEY 323 (1977).

20 The IJA survey published in 1979 showed substantial roles for lay judges in the following states: Alaska, Arizona, Arkansas, Colorado, Delaware, Georgia, Idaho, Iowa, Kansas, Louisiana, Mississippi, Montana, Nebraska, Nevada, New Mexico, New York, North Carolina, North Dakota, Oregon, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Washington, West Virginia, Wyoming. *See* NON-ATTORNEY JUSTICE, *supra* note 4, at 285-317.

21 NON-ATTORNEY JUSTICE, *supra* note 4, at 25.

largest number of lay judges with 2,312,[22] 1,983,[23] and 1,543,[24] respectively. Other states with significant numbers of lay judges include Louisiana with 616[25] and South Carolina with 606.[26]

Recent legislative developments reflect the continuing debate over the question of non-attorney justice. Florida's attempt to eliminate non-lawyer judges was defeated in a 1978 constitutional amendment referendum,[27] but the legislature itself imposed a requirement that all new county court judges be attorneys.[28] In 1979, the North Carolina legislature proposed a constitutional amendment to be submitted to the electorate in 1980 which would require that all judges be authorized to practice law, though it would not apply to the magistrates of the district courts.[29] Effective in 1980, Virginia abolished the position of the non-attorney judge, though non-attorneys may sit as magistrates to handle uncontested matters.[30]

In other states, however, non-attorney justice systems continue to retain their vitality. A recent attempt to reduce the role of non-lawyer assistant judges in Vermont met with defeat.[31] In 1974, a West Virginia constitutional change mandated that qualifications for the judges of the inferior courts be set by the legislature, but prohibited the legislature from enacting a requirement that such judges be lawyers or be trained in the law.[32] In 1979, Wyoming eliminated its requirement that justices of the peace be authorized to practice law.[33] Also in 1979, Utah eliminated a criminal defend-

22 *Id.* at 254.
23 *Id.* at 256.
24 *Id.* at 258.
25 *Id.* at 255.
26 *Id.* at 257.
27 Proposed Revision of the Florida Constitution, FLA. STAT. ANN. (West. Spec. Pamph. 1978) (Rev. No. 1, art. 5, § 8).
28 FLA. STAT. ANN. § 34.021 (West Supp. 1979).
29 1979 N.C. SESS. Laws ch. 638. The constitutional amendment will be submitted for ratification by a majority of voters in the November, 1980 election.
30 VA. CODE §§ 16.1-69.10, -69.15, 19.2-45 (1975 and Supp. 1980).
31 The most recent attempt, in 1977, was part of a court unification bill (Vt.-H.319) which would have unified the District and Superior Courts in Vermont into one bench and which would have provided for more administrative control by the Vermont Supreme Court. Assistant judges would have been limited to fact-finding functions, civil jury-waived actions, matrimonial proceedings, and tax appeals.
32 W. VA. CONST. art. 8, § 10. In 1976, the West Virginia state legislature restructured its lay court system. *See* Note, *Judicial Reform in West Virginia: The Magistrate Court System*, 79 W. VA. L. REV. 304 (1977).
33 WYO. STAT. § 5-4-201(b) (1977), as amended by 1979 WYO. SESS. LAWS ch. 42, § 10.

ant's right to have a case transferred from the magistrate to a legally trained judge, even when the defendant faces a possible jail sentence.[34]

A. *Parameters of Jurisdiction*

Lay judges usually hear both civil and criminal cases,[35] although almost always within some outer bound on size and complexity.[36] Typically, the relevant statute imposes an amount-in-controversy limit in civil cases and restricts lay judges' criminal jurisdiction to misdemeanors carrying limited penalties.

The maximum allowable amount in controversy in civil cases ranges from $200 (in Georgia)[37] to $5,000 (in North Carolina, Oklahoma, and Tennessee)[38] with many states' limits set between $500 and $1,500.[39] Some states provide for exclusive lay court jurisdiction over cases claiming up to a stated amount in controversy and then concurrent jurisdiction with a higher attorney-judge court over cases involving a greater amount.[40]

Some state statutes bestow a general jurisdictional grant and then enumerate exceptions, eliminating from lay jurisdiction actions to determine title to real property, actions for malicious prosecution, slander or libel, or other actions that may require resolu-

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34 UTAH CODE ANN. § 78-5-4 (Supp. 1979). The Utah State Legislature first enacted the defendant transfer option in 1975, providing that the case would be automatically transferred unless the defendant has waived that right. *See also* Shelmidine v. Jones, 550 P.2d 207 (Utah 1976). In 1977, a statutory amendment required that the defendant demand a transfer in order to receive one.

35 Certain lay municipal courts hear only criminal matters. *See, e.g.,* KAN. STAT. ANN. § 12-4104 (1975); OR. REV. STAT. § 221.340(3) (1977). A few lay courts have only civil jurisdiction. *See, e.g.,* ARK. CONST. art. 7, § 32; ARK. STAT. ANN. § 17-3903 (Supp. 1979).

36 *See* text accompanying notes 37 to 60 *infra.*

37 *See* GA. CODE ANN. § 24-1001 (1971) (Georgia Justice Court).

38 *See* N.C. GEN. STAT. § 7A-243 (1969) (North Carolina District Court); OKLA. STAT. ANN. tit. 20, § 123 (West Supp. 1979) (Oklahoma District Court, Special Judges). TENN. CODE ANN. § 19-301 (Supp. 1979) (Tennessee Court of General Sessions). The Tennessee Court also has jurisdiction over actions to recover personal property for the value up to $10,000.

39 *See, e.g.,* MISS. CODE ANN. § 9-11-9 (Supp. 1979) (Mississippi Justice Court); MONT. CODE ANN. § 3-10-301 (1979) (Montana Justice Court).

40 For example, in Arizona, "Justices of the peace have exclusive original jurisdiction of all civil actions when the amount involved ... is less than $500 except when concurrent jurisdiction has been conferred upon the superior court, and have jurisdiction concurrent with the superior court of all civil actions when the amount involved ... is $500 or more and less than $2,500." ARIZ. REV. STAT. ANN. § 22-201 (Supp. 1980).

tion of complex questions of law.[41] In other states, jurisdiction is granted directly over specific subject-matter areas such as landlord-tenant matters,[42] or contract or probate actions.[43] A minority of lay courts also have specialized "small claims" jurisdiction.[44] "Small claims" range from a low of $200[45] to a high of $2000.[46] Other categories which appear in specific jurisdictional grants include actions to recover personal property,[47] juvenile proceedings,[48] competency hearings,[49] and family law matters.[50] A number of lay judges are also authorized to perform marriages.[51]

In criminal cases, the most common category of lay court jurisdiction is misdemeanor jurisdiction. A maximum fine or term of imprisonment usually defines the misdemeanor and consequently the scope of lay court jurisdiction, but many states independently limit the fines or jail terms which a lay judge or minor court may impose.[52] Maximum fine limitations in lay courts range from $50[53] to $1000,[54] with maximum limits most often set between $200[55] and $500.[56] In several courts, the lay judge may not

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41 *See, e.g.*, KAN. STAT. ANN. § 61-1603 (1976); MONT. CODE ANN. § 3-10-301 (1979); UTAH CODE ANN. §§ 78-5-2, -5-9 (1977).

42 *See, e.g.*, MONT. CODE ANN. § 3-10-302(1979); N.Y. JUD. LAW UJCA § 204 (McKinney Supp. 1979).

43 *See, e.g.*, CONN. CONST. art. 5, § 4; CONN. GEN. STAT. § 45-4 (1979) (Connecticut Probate Court); MONT. CODE ANN. § 3-10-301 (1979).

44 *Cf.* UTAH CODE ANN. § 78-6-1 (Supp. 1979) (creating a special department of small claims in Circuit and Justice Courts).

45 *See, e.g.*, OR. REV. STAT. § 55.011 (1977), Or. Laws ch. 875. (Oregon Justice Court).

46 *See, e.g.*, ALASKA STAT. § 22.15.040 (1979) (if no important or unusual point of law is involved).

47 *See, e.g.*, TENN. CODE ANN. § 19-301 (Supp. 1979) (Tennessee Court of General Sessions).

48 *See, e.g.*, NEB. REV. STAT. § 24-520 (1975) (Nebraska County Court); TENN. CODE ANN. § 37-202(8), -203 (Supp. 1979) (Tennessee County and Juvenile Courts).

49 *See, e.g.*, S.C. CODE § 14-23-1150 (Supp. 1979) (South Carolina Probate Court).

50 *See, e.g.*, N.C. GEN. STAT. § 7A-244 (1969) (North Carolina District Court).

51 *See, e.g.*, GA. CODE ANN. § 53.201 (1974); OHIO REV. CODE ANN. § 1909.2 (Page 1968); S.D. CODIFIED LAWS ANN. § 16-12A-11 (1978); WYO. STAT. § 5-4-106 (1977).

52 *See, e.g.*, ARIZ. REV. STAT. ANN. § 22-301 (Supp. 1979) (misdemeanors and criminal offenses punishable by fine not exceeding $1000 and/or imprisonment not exceeding six months); MONT. CODE ANN. § 3-10-303 (1979) (misdemeanors punishable by a fine not exceeding $500 and/or imprisonment not exceeding six months).

53 *See, e.g.*, N.C. GEN. STAT. § 7A-273 (Supp. 1979) (North Carolina Magistrates).

54 *See, e.g.*, N.H. REV. STAT. ANN. § 502-A:11 (Supp. 1979).

55 *See, e.g.*, OKLA. STAT. ANN. tit. 20, § 123(4) (West Supp. 1979) (Oklahoma District Court, Special Judges); TEX. CRIM PRO. CODE ANN. art. 4.11, .14 (Vernon 1977), (Texas Justice and Municipal Courts).

56 *See, e.g.*, MONT. CODE ANN. § 3-10-303 (1979) (Montana Justice Court); NEV. REV. STAT. § 4.370 (1973) (Nevada Justice Court).

impose prison sentences at all.[57] Usually, maximum prison sentences range from 30 days[58] to 1 year,[59] with a typical limit being six months.[60]

Lay courts often receive jurisdiction over specified minor offenses such as disorderly conduct, non-aggravated assault and battery, petit larceny, breach of the peace, and willful injury to property.[61] Municipal ordinance violations[62] and traffic offenses[63] constitute two other categories of lay court jurisdiction often specifically mentioned in the statutes.[64] In some instances, statutes also specify penalties along with the jurisdictional grant.[65]

Most lay judges can issue search and arrest warrants[66] and can set bail.[67] A substantial number of lay judges also have authority to conduct preliminary hearings to determine probable cause in felony cases which otherwise are beyond their jurisdiction.[68]

B. *Other Features of Lay Courts*

In all states except Vermont, non-attorney judges sit in their own right. They determine facts and rule on questions of law,

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57 *See, e.g.*, OKLA. STAT. ANN. tit. 11, § 27-104 (West 1978) (Oklahoma Municipal Court Not of Record); TEX. CRIM. PRO. CODE ANN. art. 4.11, .14 (Vernon 1977) (Texas Justice and Municipal Courts).

58 *See, e.g.*, S.C. CODE § 22-3-540 (1976) (South Carolina Magistrate Court).

59 *See, e.g.*, N.H. REV. STAT. ANN. § 502-A:11 (Supp. 1979) (New Hampshire District Court).

60 *See, e.g.*, ARIZ. REV. STAT. ANN. § 22-301 (Supp. 1979) (Arizona Justice Court); MONT. CODE ANN. § 3-10-303 (1979) (Montana Justice Court).

61 *See, e.g.*, DEL. CODE ANN. tit. 11, § 2702 (1979) (Delaware Justice Court); NEV. REV. STAT. § 4.370 (1974) (Nevada Justice Court).

62 *See, e.g.*, MO. ANN. STAT. §§ 479.010, .020 (Vernon Supp. 1979) (Missouri Municipal Court); IOWA CODE ANN. § 602.60 (West Supp. 1979) (Iowa District Court).

63 *See, e.g.*, IOWA CODE ANN. § 602.60 (West Supp. 1979); 42 PA. CONS. STAT. ANN. § 1302 (Purdon Pamph. 1980) (Pennsylvania Traffic Court).

64 The number of courts actually hearing traffic cases is quite substantial since many legislatures treat traffic offenses as either general misdemeanors or municipal ordinance violations.

65 *See, e.g.*, COLO. REV. STAT. § 13-10-113 (1973) (Colorado Municipal Court) ($300 or 90 days); OKLA. STAT. ANN. tit. 11, § 27-104(D) (West 1979) (Oklahoma Municipal Court Not of Record) ($20 fine).

66 *See, e.g.*, MISS. CODE ANN. §§ 99-15-5, -15-11 (1972) (Mississippi Justice Court); N.H. REV. STAT. ANN. §§ 592-A:8; 595-A:1 (1974) (New Hampshire District Court).

67 *See, e.g.*, S.C. CODE § 22-5-510 (1976) (South Carolina Magistrate Court); W. VA. CODE § 50-2-3 (Supp. 1980) (West Virginia Magistrate Court).

68 *See, e.g.*, ARIZ. REV. STAT. ANN. § 22-301 (Supp. 1979) (Arizona Justice Court); KAN. STAT. ANN. §§ 22-2902, 20-302b (Supp. 1979) (Kansas District Court); NEB. REV. STAT. § 24-519(5) (1975) (Nebraska County Court); N.Y. JUD. LAW UJCA § 2001 (McKinney Supp.

without benefit of any legally trained advisor.[69] In Vermont, two lay judges sit together with one attorney judge as a three-person tribunal;[70] all civil and criminal matters, including felonies, fall within the tribunal's jurisdiction, but in criminal cases the lay judges may participate only in deciding the facts, not in determining the legal issues.[71]

Most states with lay judges permit them to serve throughout the state,[72] while a minority of states limit the jurisdiction of lay judges by allowing them to serve only in districts whose populations fall below a certain level.[73]

In several states, lay judges and attorney judges serve on the same court.[74] On some of these courts, however, the attorney judges enjoy broader jurisdiction than their lay counterparts.[75]

A typical lay judge serves for a term of about four years.[76] In most states, voters of the political subdivision in which the judge

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1979); N.Y. CRIM. PRO. LAW § 10.30 (McKinney 1971) (New York Town and Village Court).

69 Compare the English magistrate system, where each court is staffed with a clerk who is required to be a barrister or solicitor. *See generally* R.M. JACKSON, THE MACHINERY OF JUSTICE IN ENGLAND, 301-06 (7th ed. 1977); L. PAGE, JUSTICE OF THE PEACE 233-49 (3d ed. R. Jackson 1967).

70 VT. STAT. ANN. tit. 4, § 111(a) (Supp. 1979). "A county court shall be held in each county ... consisting of one presiding judge, who shall be one of the superior judges and two assistant judges elected by the county ..." *Id. See* text accompanying notes 173 to 177 *infra*.

71 State v. Dunkerly, 134 Vt. 523, 365 A.2d 131 (1976); VT. R. CRIM. PROC. 54. (Supp. 1979). *See* text accompanying notes 173 to 177 *infra*.

72 *E.g.*, MONT. CODE ANN. §§ 3-10-201, -10-202 (1979). The number of judges in any one district may depend on population. For example, in West Virginia magistrates are elected in each county and the number depends solely on the population. W. VA. CODE § 50-1-2 (Supp. 1979).

73 *E.g.*, COLO. REV. STAT. § 13-6-203 (1973) (non-lawyers may serve in size C and D counties); MO. ANN. STAT. § 479.020 (Vernon Supp. 1979) (non-lawyers may serve in cities with populations below 7500); N.M. STAT. ANN. § 35-2-1 (Supp. 1979) (counties with populations below 200,000); WASH. REV. CODE §§ 3.12.071, 3.34.060 (1979) (cities with populations below 5000).

74 *See, e.g.*, S.D. CODIFIED LAWS ANN. §§ 16-12A-2, -12A-2.1 (1979).

75 *See, e.g.*, IDAHO CODE §§ 1-2208, 2210 (1979) (Idaho magistrates); IOWA CODE ANN. §§ 602.52, .60 (West Supp. 1979) (Iowa magistrates) NEB. REV. STAT. §§ 24-508, -519 (1975) (Nebraska associate judges); OKLA. STAT. ANN. tit. 20, § 123 (West Supp. 1979). (Oklahoma District Court special judges). Other states relegate the non-lawyers to relatively minor roles to handle preliminary matters or take guilty pleas. *See, e.g.*, MICH. COMP. LAWS ANN. § 600.8511 (Supp. 1980) (Michigan magistrates); VA. CODE § 19.2-45 (Supp. 1980) (Virginia magistrates).

76 *See, e.g.*, ARIZ. REV. STAT. § 22-111 (1975) (Arizona Justice Court); DEL. CONST. art. 4, § 29 (Delaware Justice of the Peace Court); LA. REV. STAT. ANN. § 13:2581.1 (West Supp. 1979) (Louisiana Justice of the Peace Courts).

serves elect him.[77] Some states also allow the mayor to sit as a judge of the municipal or mayor's court.[78] The remaining states provide that the judge be appointed either by the governor,[79] by local government officials,[80] or by the chief judge in a superior court.[81]

Most lay judges receive a salary set either by the state[82] or the local authority.[83] In a few states, lay judges are compensated by fees derived from an enumerated schedule.[84]

The salary range for judges on these minor courts differs widely

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77 *See, e.g.*, N.Y. CONST. art. 6, § 17(d) (New York Town and Village Courts); UTAH CODE ANN. § 17-16-5 (Supp. 1979) (Utah Justice Court).

78 *See, e.g.*, ARK. STAT. ANN. §§ 19-1102, -1102.1 (1956 & Supp. 1979) (Arkansas City Court); OHIO REV. CODE ANN. § 1905.01 (Page Supp. 1979) (Ohio Mayor's Court); S.C. CODE § 14-25-10 (1976) (South Carolina Magistrate Court).

79 *See, e.g.*, DEL. CONST. art. 4, § 30 (Delaware Justice Court); N.H. REV. STAT. ANN. § 502-A:3 (1968) (New Hampshire District Court).

80 *See, e.g.*, IOWA CODE ANN. § 602.50 (West 1975) (magistrates usually appointed by county commission); OR. REV. STAT. § 221.140 (1977) (municipal judges appointed by city counsel).

81 *See, e.g.*, ALASKA STAT. § 22.15.170(c) (1976) (Alaska District Court); S.D. COMPILED LAWS ANN. § 16-12A-4 (1978) (South Dakota Magistrate Court).

82 IDAHO CODE § 1-2205(c) (1979); IOWA CODE ANN. § 602.54 (West Supp. 1979).

83 *See, e.g.*, OR. REV. STAT. § 204.101 (1979) (county court or board of county commissioners); UTAH CODE ANN. § 78-5-1.3 (1977) (county, city, or town assumes salary).

84 *See, e.g.*, GA. CODE ANN. § 24-1601 (Supp. 1979) (Georgia Justice Court); MISS. CODE ANN. § 25-7-25 (Supp. 1979) (Mississippi Justice Court). *See also* AMERICAN JUDICATURE SOCIETY, COURTS OF LIMITED JURISDICTION: A NATIONAL SURVEY 25 (1977).

Several Supreme Court decisions have resolved constitutional issues presented by various fee systems under which lay judges are paid. *See, e.g.*, Tumey v. Ohio, 273 U.S. 510 (1927), which involved an Ohio statutory scheme permitting a mayor-judge to earn substantial fees for himself and his village only when he convicted and fined criminal defendants. The Supreme Court held that this system of fee payment violated the due process clause because the judge, instead of being a neutral and detached magistrate, had a "direct, personal, substantial, pecuniary interest in reaching a conclusion against [the defendant]." *Id.* at 523. In Ward v. Village of Monroeville, 409 U.S. 57 (1972), another Ohio statute was considered, permitting a non-attorney mayor-judge, who was responsible for village finances, to earn a substantial portion of the village income through levying fines, forfeitures, costs, and fees upon criminal and civil litigants. The Supreme Court held that this practice violated the fourteenth amendment because of the 'possible temptation' [that] the mayor's executive responsibilities ... may make him partisan to maintain the high level of contribution from the mayor's court." *Id.* at 60. The Supreme Court dismissed as irrelevant a statute providing for the disqualification of individual, biased judges and stated that the availability of de novo appeal afforded inadequate protection since a defendant is entitled to a fair trial in the first instance. *Id.* at 61-62. Recently, in Connally v. Georgia, 429 U.S. 245 (1977) (per curiam), the Supreme Court, relying on the above cases, held unconstitutional a Georgia law under which a lay justice of the peace earned $5.00 for every search warrant he issued. The Court rejected Georgia's argument that the fee was de minimis, noting that the justices' financial welfare was enhanced by issuing rather than denying a warrant. *Id.* at 250. *See also* Bennett v. Cottingham, 290 F. Supp. 759 (N.D. Ala. 1968), *aff'd. mem.*, 393 U.S. 317 (1969) (fees and costs assessed only when guilty verdict was

in the various states. Lay "assistant judges" in Vermont earn a mere thirty-nine dollars per diem,[85] and some of Maryland's probate court judges earn as little as twenty dollars a day.[86] Florida's county court judges, however, receive $28,000 per year, a salary which partially accounts for Florida's ability to phase out non-lawyer judges in recent legislation.[87] A typical lay judge salary is about $13,000.[88] In some states, the judicial salary range itself may vary, depending on the judge's caseload, on the population of the district, or on the judge's professional status.[89]

Various restrictions as to who may serve as a judge on courts of limited jurisdiction highlight the tension between a desire for affordable and community-oriented decision-making on the one hand, and legally trained adjudicators on the other. Since most states require the judge to reside in a district in which he serves,[90] in many instances there may be no attorneys in a community available to accept the judicial position.[91] Moreover, even where

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reached); Gore v. Emerson, 262 Ark. 463, 557 S.W.2d 880 (1977) (law permitted non-attorney mayors' courts to levy fees on guilty defendants only, providing 79 percent of the city's income); City of Hilliard v. May, 48 Ohio Misc. 4, 356 N.E.2d 510 (1976) (fines levied by lay mayor's court where the mayor was responsible for city finances). *But cf.* Allen v. State, 240 Ga. 567, 242 S.E.2d 61 (1978) (lay justice constitutionally can receive a fee for presiding over an arrest warrant proceeding, where the disposition of the hearing and the ultimate disposition of the case bear no relationship to the fee).

85 VT. STAT. ANN. tit. 32, § 1141 (Supp. 1979).

86 MD. EST. & TRUSTS CODE ANN. § 2-108 (v) (Supp. 1979) ($20 a day, not to exceed $2400 per year).

87 Prior to 1978, non-attorneys were permitted to be elected county court judges in counties with populations under 40,000. Judges in such counties were paid a salary of $24,000, whereas in counties over 40,000 salaries were $28,000. FLA. STAT. ANN. § 34.024 (1974). The substantial salaries were one indication that attorneys could be attracted to these positions, and in 1978 Florida abolished its non-attorney judges. FLA. STAT. ANN. § 34.021 (Supp. 1979).

88 This is a typical salary for a full-time lay judge in 1980. *See, e.g.*, DEL. CODE ANN. tit. 10, § 9209 (Supp. 1978).

89 For example, in Minnesota, if the judge is a non-attorney, the salary is $31,500, but if the judge is an attorney, the salary is $48,000. MINN. STAT. ANN. § 15A.083 (West Supp. 1980). In Nebraska, the salaries of associate judges of the county court are set by the county judge, who is to consider the caseload and time commitment of the associate judge. The maximum salary is three-fourths of the salary of a county judge, who ordinarily receives $28,500. NEB. REV. STAT. § 24-513 (Supp. 1979). In West Virginia, magistrates' salaries range from $14,000 to $21,000, depending on population. W. VA. CODE § 50-1-3 (Supp. 1980).

90 *See, e.g.*, MISS. CONST. art. 6, § 171; OR. REV. STAT. § 51.240 (1977); S.D. CONST. art. 5, § 6.

91 For example, in Wyoming, the main reason for the 1979 repeal of the requirement that all judges be attorneys was that rural areas, unable to find attorneys, were doing without justices of the peace. Apparently, the earlier proviso that a willing resident could be appointed if no attorney were available did not suffice. Telephone conversation with Jerry Fox, Wyoming State Legislative Bureau, Sept. 12, 1979.

attorneys are available, some states prohibit an attorney judge from practicing law altogether[92] or from appearing in certain types of cases.[93] These restrictions, which attempt to minimize conflicts of interest, also tend to discourage attorneys from accepting minor court judgeships where positions are often part-time and the salaries are low.[94] Other requirements,[95] including state residency[96] or minimum age,[97] would usually pose no obstacle to attracting attorney judges. Some states, even though they permit lay judges, express a statutory preference for attorney judges.[98]

A recent legislative development in the administration of lay justice is upgraded training opportunities and requirements for lay judges. For example, in 1976, Delaware offered legal training to its justices.[99] In 1976, West Virginia passed a statute requiring that all new magistrates complete a training program prior to entering office and take such continuing educational instruction as the state Supreme Court would mandate.[100] Utah passed a statute in 1977 requiring all justices of the peace to attend at least one qualifying seminar or training course supervised by the judicial counsel each year, and providing that any justice who fails to attend the annual training institute for two consecutive years will lose his certificate.[101] Within the past two years, both Georgia and Mon-

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92 A justice in Delaware may not engage either in the practice of law or any occupation concerned with or growing out of the collection of any judgment rendered by the justice or hold any state office or employment. DEL. CODE tit. 10, § 9209 (Supp. 1978).

93 West Virginia allows lawyer magistrates to practice law as long as they do not practice from the magistrate office and as long as they do not participate in any magistrate court proceeding as an attorney or agent. W. VA. CODE § 50-1-12 (Supp. 1979). *See also* Note, *Judicial Reform in West Virginia: The Magistrate Court System*, 79 W. VA. L. REV. 304, 306 (1977).

94 *See, e.g.*, IOWA CODE ANN. §§ 602.50, .54 (West 1975 & West Supp. 1979).

95 *See, e.g.*, ARIZ. REV. STAT. § 11-402 (1977) (requires the justice to be able to read and write English); ARK. CONST. art. 7, § 29 (requires judges to be of "upright character" and have a "good business education"); COLO. REV. STAT. § 13-6-203 (Supp. 1979) (requires high school education); LA. REV. STAT. ANN. § 13:2581.1 (West Supp. 1980) (requires the justice to be of "good moral character" and "be able to read and write the English language correctly").

96 *See, e.g.*, ALASKA STAT. § 22.15.160 (1976).

97 *See, e.g.*, MO. ANN. STAT. § 479.020 (Vernon Supp. 1979) (21 years of age); TENN. CONST. art. 6, § 4 (30 years of age).

98 *See, e.g.*, IOWA CODE ANN. § 602.52 (West Supp. 1979) (preference for attorney part-time magistrates); N.H. REV. STAT. ANN. § 502-A:3 (1968) (wherever possible, members of the bar); N.D. CENT. CODE §§ 27-18-02, -18-06 (1974) (non-attorney judges allowed only when no attorney will serve).

99 DEL. CODE tit. 10, § 9210 (Supp. 1978).

100 *See* W. VA. CODE § 50-1-4 (Supp. 1980).

101 UTAH CODE ANN. § 78-5-27 (1977).

tana have enacted similar requirements,[102] but Oregon last year rejected such legislation.[103]

C. *Procedural Mechanisms in Lay Courts*

Courts of limited jurisdiction must attempt simultaneously to serve two conflicting goals: quick disposition of cases and adequate protection of the rights of litigants. From this tension have emerged different approaches to such protective procedures as jury trial, and review and transfer mechanisms.

A substantial number of lay courts provide for trial by jury.[104] Those states which do not so provide may allow the defendant to transfer his case to an attorney-judge court, where trial by jury is available.[105] Alternatively, jury trials may be available at a *de novo* trial on appeal from the lay court.[106]

In most lay courts, some form of *de novo* review exists, whereby the appellate court disregards the proceedings below and conducts a new trial.[107] In certain states the decision whether to allow a *de novo* trial on appeal is within the discretion of the reviewing court based on its examination of the sufficiency of the record made in the lay court.[108] In other states, appeal entails only ordinary record review.[109] Some states provide for record review in civil cases (if a record is kept), but give a trial *de novo* in criminal cases.[110]

The transfer or "divestiture" mechanism, another protective device, provides for removal of a case from a lay to an attorney

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102 GA. CODE ANN. § 24-1607a (Supp. 1979); MONT. CODE ANN. § 3-10-203 (1979).

103 *See* 1979 Or. Laws S. 656.

104 *See, e.g.*, N.M. STAT. ANN. § 35-8-1 (1978) (New Mexico Magistrate Court); W. VA. CODE § 50-5-8 (Supp. 1979) (West Virginia Magistrate Court).

105 *See, e.g.*, N.H. REV. STAT. ANN. §§ 502-A:14, -A:15 (1968 and Supp. 1979) (New Hampshire District Court) (civil cases); WIS. STAT. ANN. § 300.04(d) (West Supp. 1979) (Wisconsin Municipal Court) (criminal cases).

106 *See, e.g.*, N.H. REV. STAT. ANN. § 502-A:11 (Supp. 1977) (New Hampshire District Court) (criminal cases); State v. Dickson, 116 N.H. 175, 355 A.2d 822 (1976).

107 *See, e.g.*, MONT. REV. CODE ANN. § 25-33-301 (1979) (Montana Justice Court); N. M. STAT. ANN. §§ 35-13-12, -15-7 (1978) (New Mexico Magistrate and Municipal Courts).

108 *See, e.g.*, ARIZ. REV. STAT. § 22-374 (1975) (Arizona Justice Court); IDAHO CODE § 1-2213 (1979) (Idaho District Court, Magistrates).

109 *See, e.g.*, S.C. CODE § 18-3-70 (1976).

110 *See, e.g.*, KAN. STAT. § 20-302b(c) (Supp. 1979).

judge before the trial begins. At least eight states now authorize some form of transfer in criminal or civil matters.[111] In several of these states, lay courts sit without a jury and if a party demands and is entitled to a jury trial, the case is transferred to an attorney-judge court for the jury trial.[112] In other states, lay courts hear certain criminal matters only when the defendant consents, and in the absence of such consent, the case is transferred to an attorney judge or attorney-judge court.[113] Still other states differentiate the type of matter that will qualify for transfer. In South Dakota, for example, non-attorney magistrates have jurisdiction to act as committing magistrates, but the defendant can demand to have a preliminary hearing conducted by a legally trained magistrate.[114] In New York, a lay court may be divested of its jurisdiction in criminal matters only upon a showing of good cause by the defendant.[115] And in West Virginia, a party have his case transferred from the magistrate court to an attorney-judge court only in a civil case.[116] However, in 1979, Utah, which formerly provided a defendant facing a possible jail sentence with the right to transfer, abolished this right.[117]

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111 ALASKA STAT. § 22.15.120(6) (Supp. 1979) (Alaska magistrate) (misdemeanors); DEL. CODE tit. 11, § 5303 (1979) (Delaware justice or alderman) (criminal cases where incarceration can be imposed); N.H. REV. STAT. ANN. § 502-A:15 (1968) (New Hampshire District judge) (civil jury cases); N.Y. CRIM. PROC. LAW § 170.25 (McKinney 1971 & McKinney Supp. 1979) (New York Town and Village justice) (misdemeanors for good cause); OR. REV. STAT. § 51.050(2) (1977) (Oregon justice) (misdemeanors); S.D. COMPILED LAWS ANN. § 16-12A-14 (1979) (South Dakota magistrate) (preliminary hearing); W. VA. CODE § 50-4-8 (Supp. 1980) (West Virginia magistrate) (civil cases); WIS. STAT. ANN. § 300.04(d) (West Supp. 1979) (Wisconsin Municipal judge) (criminal jury cases).

112 *See, e.g.,* N.H. REV. STAT. ANN. § 502-A:15 (1968 & Supp. 1977) (civil cases; in criminal cases, a jury trial *de novo* is authorized on appeal); WIS. STAT. ANN. § 300.04(d) (West Supp. 1979) (criminal cases).

113 *See, e.g.,* Alaska Stat. § 22.15.120(6) (Supp. 1979); DEL. CODE tit. 11, § 5303 (1979); OR. REV. STAT. § 51.050(2) (1977).

114 S.D. COMPILED LAWS ANN. § 16-12A-14 (1979).

115 N.Y. CRIM. PROC. LAW § 170.25 (McKinney 1971 & McKinney Supp. 1979).

116 W. VA. CODE § 50-4-8 (Supp. 1979).

> "At any time before trial in a civil action involving less than three hundred dollars the action may be removed to circuit court upon the concurrence of all parties and upon the payment of the circuit court filing fee. At any time before trial in a civil action involving three hundred dollars or more, any party may, upon payment of the circuit court filing fee, cause such action to be removed to the circuit court . . ."

Id.

117 UTAH CODE ANN. § 78-5-4 (Supp. 1979).

II. RECENT DEVELOPMENTS IN THE COURTS

A. *North* v. *Russell*

The modern chapter of non-attorney justice must begin with the Supreme Court's 1976 decision in *North* v. *Russell,*[118] where the Court considered for the first time the constitutionality of a state's non-attorney judge system.[119] While falling short of a broad endorsement, the *North* decision did carve a constitutional niche for lay judges in the United States.

Petitioner North was found guilty of drunken driving by the lay police judge of Lynch, Kentucky, who was a retired coal miner with no formal education. The judge denied North's request for a jury although Kentucky law gave North the right to a jury trial[120] and sentenced him to 30 days in jail. Instead of requesting a *de novo* trial on appeal before an attorney judge as was his right under Kentucky's two-tier system,[121] North sought a writ of *habeas corpus,* contending that his federal constitutional rights of due process and equal protection had been abridged because he had been convicted by a non-attorney judge.

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118 427 U.S. 328 (1976). The *North* decision has been the subject of substantial commentary. *See, e.g.,* Ashman & Lee, *Non-Lawyer Judges: The Long Road North,* 53 CHI.-KENT L. REV. 565 (1977).

119 Prior to *North,* several states had already ruled that the use of non-attorney judges did not violate a defendant's constitutional rights. *See, e.g.,* Melikian v. Avent, 300 F. Supp. 516 (N.D. Miss. 1969) (defendant in civil action not denied access to effective representation because of lay status of judge); Crouch v. Justice Court, 7 Ariz. App. 460, 440 P.2d 1000 (1968) (practice of lay judge instructing jury in misdemeanor case not a violation of due process); Decatur v. Kushmer, 43 Ill.2d 334, 253 N.E.2d 425 (1969) (misdemeanor conviction by a lay magistrate constitutional); Ditty v. Hampton, 490 S.W.2d 772 (Ky.), *appeal dismissed as moot,* 414 U.S. 885 (1973) (Kentucky lay judge procedures not a violation of due process or equal protection clause of the fourteenth amendment); State v. Lindgren, 306 Minn. 133, 235 N.W.2d 379 (1975) (de novo review procedures sufficient to uphold Minnesota lay judge adjudication); Tsiosdia v. Rainaldi, 89 N.M. 70, 547 P.2d 553 (1976) (guardianship of defendant's rights lies chiefly with his attorney, not with the judge); In re Hewitt, 81 Misc.2d 202, 365 N.Y.S.2d 760 (1975) (divestiture procedure for good cause and mandatory training program for judges sufficient protection of defendant's rights); Ex parte Ross, 522 S.W.2d 214 (Tex.), *cert. denied,* 423 U.S. 1018 (1975) (attorney status not a prerequisite for fairness); Shelmidine v. Jones, 550 P.2d 207 (Utah 1976) (delay and expense involved in traveling to city with attorney judge considered a more serious abridgement of due process rights than a system of lay judges).

120 KY. CONST. § 11; KY. REV. STAT. §§ 25.014, 26.400 (1971) (repealed 1976, effective 1978).

121 KY. REV. STAT. § 23.032 (1971) (repealed 1976); KY. RULES CRIM. PROC. 12.06 (1975), (repealed 1976).

The Circuit Court of Kentucky, relying heavily on its earlier decision in *Ditty* v. *Hampton,*[122] denied relief. On appeal, the Supreme Court of the United States upheld Kentucky's lay judge system. The Court ruled that Kentucky's offer of a *de novo* trial on appeal remedied North's due process concerns, because it afforded him the opportunity to have his case heard without prejudice by an attorney judge, regardless of whether he pled guilty or was found guilty at the first trial.[123] That the charge entailed a possible jail sentence did not alter the Court's conclusion. The Court also rejected North's equal protection argument[124] noting that within a given city and within cities of the same size, individuals were treated equally.[125]

A strong dissent by Justice Stewart argued that a trial before a lay judge that results in a prison sentence violates the due process clause of the Constitution in that it deprives the defendant of his right to a fair trial with the effective assistance of counsel,[126] an argument that had been accepted by the California Supreme Court in its pre-North *Gordon* v. *Justice Court*[127] decision. Justice Stewart pointed to specific tasks that might prove difficult for a

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122 490 S.W.2d 772 (Ky.), *appeal dismissed as moot,* 414 U.S. 885 (1973).

123 427 U.S. at 334-35.

124 This argument was based on the fact that the Kentucky judicial system, at that time, divided cities into classes according to population size. KY. CONST. § 156. State statutes required that judges of police courts in first and second class cities (those with larger populations) be attorneys, while lay judges could (and usually did) serve in the smaller cities. KY. REV. STAT. § 26.150 (1971) (repealed 1976) (attorney judges required in towns larger than 20,000); KY. REV. STAT. § 26.190 (1971) (repealed 1976) (lay judges permitted in towns not larger than 20,000). Kentucky law was changed in 1976 through the adoption of a new judicial article, which reorganized the judiciary and required all judges to be attorneys licensed to practice in Kentucky. In addition, it authorized the use of trial commissioners in certain districts if no attorney was available. KY. CONST. § 113. The Supreme Court did not find *North* mooted by the judicial amendment because the police courts were to continue to function until January 1, 1978 and because the new amendment permitted non-attorney "trial commissioners" to sit. 427 U.S. at 331 n.3.

125 *Id.* at 338-39.

126 *Id.* at 340-43.

127 12 Cal.3d 323, 525 P.2d 72, 115 Cal. Rptr. 632 (1974), *cert. denied,* 420 U.S. 938 (1975). The petitioners in *Gordon* had been brought before non-attorney judges on misdemeanor charges — one for disturbing the peace, another for driving while intoxicated. At pretrial, the petitioners sought to prevent the non-attorney justices from proceeding with the trial on the grounds that where a jail sentence could be imposed, defendants were entitled to trial before attorney judges. The lower court's denial of relief was reversed by the California Supreme Court. The California Supreme Court held that the likelihood of a fair criminal trial, while not impossible in a trial before a lay judge, was substantially dimin-

non-attorney judge, such as determining the voluntariness of confession, advising the defendant of his rights, and determining the admissibility of evidence.[128] Justice Stewart also rejected the claim that a *de novo* trial on appeal could remedy the unfairness of the original proceeding.[129]

By ostensibly requiring *de novo* recourse to an attorney judge, the Supreme Court implicitly acknowledged the existence of potential due process objections[130] to the unrestricted use of judges without legal training. Whether due process requires the exact *de novo* appeal mechanism of the Kentucky system, or whether other safeguards, such as elective transfer to an attorney-judge court or training programs for lay judges,[131] might also suffice were left unanswered by the Court.

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ished, especially in light of the increasing complexities of criminal procedure and of legal arguments advanced by competent attorneys. 12 Cal. 3d at 328, 332, 525 P.2d at 75, 78, 115 Cal. Rptr. at 635, 638.

128 427 U.S. at 342, 344.

129 *Id.* at 346.

130 The claim is that a defendant's fourteenth amendment right to due process is violated when he is tried by a lay judge in a criminal case, particularly when the defendant is subject to a possible jail sentence. The non-attorney judge may encounter legal problems in the course of a misdemeanor trial that could be as complex as those in a felony trial; they would be difficult to resolve without legal training. As the California Supreme Court stated in *Gordon,* it is not that "a fair criminal trial is impossible in a court presided over by a non-attorney judge, but that the likelihood of such a trial would be substantially diminished." 12 Cal.3d at 329, 525 P.2d at 76, 115 Cal. Rptr. at 636. An additional argument advanced under the due process clause is based on the defendant's right to counsel, guaranteed by the sixth amendment and made applicable to the states under the due process clause of the fourteenth amendment. The claim is that a trial before a non-attorney judge that results in the imprisonment of the defendant deprives the accused of his right to the effective and meaningful assistance of counsel. *See* North v. Russell, 427 U.S. at 340 (Stewart, J., dissenting); Gordon v. Justice Court, 12 Cal.3d 323, 525 P.2d 72, 115 Cal. Rptr. 632 (1974), *cert. denied,* 420 U.S. 938 (1975); State v. Dunkerly, 134 Vt. 523, 365 A.2d 131 (1976). But in *North,* the Supreme Court found that it was "unnecessary to reach the question whether a defendant could be convicted and imprisoned after a proceeding in which the only trial afforded is conducted by a lay judge," 427 U.S. at 334, since the *de novo* trial "erased" the consequences of the proceedings below. *Id.* at 337.

131 In a footnote, the Supreme Court referred to the mandatory and voluntary training programs in effect in many states. 427 U.S. at 333-34 n.4. In his dissent, Justice Stewart pointed out that the particular non-lawyer judge involved in *North* had never received any training concerning his duties as a lay judge. "This is not a case, therefore, involving a lay judge who has received the kind of special training that several States apparently provide." 427 U.S. at 340 n.1 (Stewart, J., dissenting). For subsequent state decisions which have relied on training and education programs to sustain their lay judge systems, *see* Treiman v. State ex rel. Miner, 343 So.2d 819 (Fla. 1977); In re Hewitt, 81 Misc.2d 202, 365 N.Y.S.2d 760 (1975); State v. Boone, 218 Kan. 482, 543 P.2d 945 (1975), *cert. denied,* 425 U.S. 915

B. *State Court Decisions After North*

The *North* rationale was directly applied in a subsequent New Hampshire decision[132] which upheld the use of a non-attorney municipal court judge in a misdemeanor drunken driving case. The court observed that, as in *North,* the defendant could demand a *de novo* trial on appeal before an attorney judge, thus vacating the lower court judgment, and that the defendant did not lose this right upon pleading guilty unless he expressly waived it.[133]

The absence of *de novo* review for defendants who pled guilty in Washington's non-attorney courts was challenged as failing to provide an adequate review procedure. In order to have a case heard in the first instance by a non-attorney judge, and preserve the opportunity for a *de novo* trial before an attorney judge, the accused is forced to sustain the expense and delay of a trial in the first instance.[134] Nonetheless, in *Young* v. *Konz,*[135] the Washington Supreme Court, in an *en banc* opinion, found the *North* decision controlling and upheld Washington's system of non-attorney justice. It noted that "a *voluntary* plea of guilty normally waives the right of appeal whether entered before a lawyer or nonlawyer judge or whether entered in an inferior or superior court,"[136] and it rejected the claim that every defendant was thereby required to endure a full trial to preserve an appeal and a *de novo* trial before an attorney judge.[137] The Washington court referred to many instances in which a non-guilty plea and a stipulation to the prosecution's case or a submission of the matter to the court on a reading of the arresting officer's written report expedited the process leading to the *de novo* trial.[138] In reiterating the

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(1976); State v. Duncan, 269 S.C. 510, 238 S.E.2d 205 (1977), discussed in text accompanying notes 165 to 167 *infra.* An extensive overview of existing state and national education and certification programs for non-attorney judges appears in NON-ATTORNEY JUSTICE, *supra* note 4, at 235-52.

132 Jenkins v. Canaan Municipal Court, 116 N.H. 616, 366 A.2d 208 (1976).

133 116 N.H. at 618, 366 A.2d at 209.

134 Washington uses non-attorney judges only in small, sparsely populated areas and only in misdemeanor or gross misdemeanor cases. Young v. Konz, 588 P.2d 1360, 1364 (Wash. 1979).

135 *Id.*

136 *Id.* at 1363.

137 *Id.*

138 *Id.*

view that there was no due process violation, the Washington Supreme Court stated:

> Due process of the law requires a fair trial of each defendant; the fair trial guarantee is protected *through the appeals process.* It is conceded that a fair trial may in certain cases not be afforded by a non-lawyer judge; but we may properly point out that it is also true that a lawyer judge may commit error and thereby deny a fair trial. The due process safeguard in both cases is appeal, the one critical difference being that a defendant in a court of limited jurisdiction has the *automatic right* to a new trial, irrespective of error in the first trial.[139]

The Washington court distinguished its decision from California's *Gordon* decision on the basis of the different demographic conditions of California, where "vastly more attorneys are available to act as judges as well as to provide legal counsel to defendants."[140] In this vein, the court observed that the relevant local community in the case before it supported only two or three practicing attorneys and that it was relatively isolated from neighboring population centers:

> ... the anomaly advocated at once becomes apparent. One of the attorneys no doubt is the prosecuting attorney for Ferry County. If there be two, one, under defendants' theory, would necessarily become the justice court judge, leaving none readily available to act on behalf of a defendant. If there be three, a defendant would have little choice as to who would represent him.[141]

Two Arizona decisions,[142] upholding an alternate review procedure in their lay courts, explore other ramifications of the *North* due process mandate. Arizona affords an absolute right to *de novo* trial on appeal before an attorney judge if no transcript is kept by the magistrate court,[143] but offers only appellate review on the

139 *Id.* at 1363-64 (on rehearing, quoting from the earlier opinion Young v. Konz, 88 Wash.2d 276, 280-81, 558 P.2d 791, 793 (1977)) (emphasis in original).

140 *Id.* at 1365.

141 *Id.*

142 Palmer v. Superior Court, 114 Ariz. 279, 560 P.2d 797 (1977); Conkling v. Pollock, 27 Ariz. App. 670, 558 P.2d 35 (1976).

143 The Arizona Court of Appeals has rejected the due process challenge of a defendant convicted and sentenced to jail for speeding and drunk driving by a lay city magistrate. The court noted that where no transcript was kept, Arizona law afforded the defendant an absolute right to a trial *de novo* before an attorney judge. Conkling v. Pollock, 27 Ariz. App. 670, 558 P.2d 35 (1976); *see* ARIZ. REV. STAT. § 22-374(A) (1975).

record when a sufficient transcript is kept.[144] If the lay-judge court kept a transcript, then a legally trained Superior Court judge evaluates the lower court transcript, and if he deems it to be complete and without deficiencies will consider the appeal on the record; however, when the record is deemed deficient, he will order a trial *de novo.*[145] In upholding the Arizona system, the Arizona Supreme Court expressed a preference for record review because duplicative trials have proven "expensive, delaying and oppressive."[146]

A slightly different procedural mechanism has apparently protected Delaware's and New York's non-attorney justice systems from successful constitutional attack. Transfer mechanisms in those states allow defendants to elect under certain circumstances to appear before an attorney-judge court in the first instance.[147] In *Shoemaker* v. *State,*[148] a case involving a disorderly conduct conviction by a Delaware lay judge, the Delaware Supreme Court noted that a defendant had the absolute right under Delaware law to elect a trial in the Court of Common Pleas, an attorney-judge court.[149] Because the defendant was not required either to plead guilty or to undergo a lay-judge trial before reaching an attorney judge, the court considered Delaware's procedures to be even more protective of defendant's rights than *North* required.[150] The court overturned the conviction, however, finding inadequate the procedures for advising the defendant of his automatic right to a transfer.[151]

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144 In Palmer v. Superior Court, 114 Ariz. 279, 560 P.2d 797 (1977), a lay judge sentenced the defendant to one month in prison for failure to support his dependents. On appeal, the decision was reviewed on the record by an attorney judge, who was not required to rehear the entire case. *See* ARIZ. REV. STAT. § 22-374(A) (1975). This was found to be sufficient under *North* to meet the due process requirements of the fourteenth amendment.

145 114 Ariz. at 281, 560 P.2d at 799.

146 *Id.*

147 *See* note 111 *supra* and accompanying text.

148 375 A.2d 431 (Del. 1977).

149 *Id.* at 440-41. The Delaware statute at that time provided: "The accused, in all criminal cases where a justice of the peace in the county where the charge is brought has jurisdiction and power to hear and finally determine the matter, may elect at any time prior to day of trial to have the case tried by the [Common Pleas] Court." DEL. CODE tit. 11, § 5303 (1974) (amended 1977).

150 375 A.2d at 441.

151 The court held that waiver of the right to an attorney judge was a condition precedent to the lay court's jurisdiction and that the magistrate must inform the defendant of his right to a lawyer judge. Additionally, the court required that a statement of rights be given

In *People* v. *Skrynski,*[152] the New York Court of Appeals, in an unsigned per curiam opinion, ruled that New York's use of non-lawyer town and village justices withstood a due process challenge because the accused had the effective alternative of a criminal trial before an attorney judge through New York's divestiture procedure.[153] In New York, however, the defendant must sustain a showing of good cause in order to achieve divestiture,[154] and the lay status of the judge apparently does not itself provide a sufficient basis for the required showing.

Where *de novo* review or divestiture procedures are not available, state courts have generally sustained the constitutionality of their non-attorney judge systems, despite the potentially limiting language of *North.* In so doing, they sometimes have relied on another means of guarding the due process right: specialized training of the lay judge.

Until recently,[155] Florida law permitted non-attorney county court judges to sit in counties that had populations under 40,000,[156] grandfathering in non-attorney judges in larger counties. Their jurisdiction included both civil and misdemeanor criminal cases in which they could issue fines and order short prison terms.[157] The law provided for an appeal to the circuit court

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orally by the magistrate and submitted to the defendant in writing for his signature. Finally, all the proceedings material to that waiver were required to be electronically or stenographically recorded, in any proceeding in which a prison sentence was authorized by law. 375 A.2d at 442-43. In a second Delaware case, State v. Casto, 375 A.2d 444 (Del. 1977), the court laid out similar procedures for the acceptance of guilty pleas in lay courts. 375 A.2d at 449-50.

152 42 N.Y.2d 218, 366 N.E.2d 797 (1977).

153 New York's law provides as follows:

> At any time before entry of a plea of guilty to or commencement of a trial of a local criminal court accusatory instrument containing a charge of misdemeanor, a superior court having jurisdiction to prosecute such misdemeanor charge by indictment may, upon motion of the defendant made upon notice to the district attorney, showing good cause to believe that the interests of justice so require, order that such charge be prosecuted by indictment and that the district attorney present it to the grand jury for such purpose.

N.Y. CRIM. PROC. LAW § 170.25(1) (McKinney 1971).

154 *Id.*

155 Florida law now requires all judges to be attorneys. A 1978 statutory amendment implemented the requirement of attorney status for all county court judges, with a grandfather exception. FLA. STAT. ANN. § 34.021 (West Supp. 1979).

156 FLA. CONST. art. 5, §§ 20(c)(11), 20(d)(7); FLA. STAT. ANN. § 34.021 (West Supp. 1974) (amended 1978).

157 FLA. STAT. ANN. § 34.01 (West Supp.1979).

based on the record.[158] In *Treiman* v. *State ex rel. Miner,*[159] the Florida system of non-attorney justice was challenged as unconstitutional.[160] Noting that *North* was not dispositive,[161] and distinguishing the *Gordon* decision,[162] the Florida Supreme Court stated that any lay judge who had completed Florida's newly-created two-year training program at the University of Florida Law School would be able effectively to discharge his duties in a manner consistent with due process.[163] The court applied this test retroactively and granted petitioner's request for a writ of prohibition because the judge who had heard the case had not completed the training program.[164]

Relying on the *Treiman* decision, the South Carolina Supreme Court in *State* v. *Duncan*[165] upheld the use of lay judges without requiring a *de novo* trial on appeal. The court relied in part on the lay judge's participation in a state-sponsored program of judicial education for non-attorneys[166] and in part on the availability of both an appeal on the record after the trial of first instance and a second-stage appeal to the state Supreme Court, although neither appeal offered a trial *de novo.*[167] Other decisions in New York[168]

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158 FLA. CONST. art. 5, § 20(c)(3); FLA. STAT. ANN. § 26.012(1) (West Supp. 1979).

159 343 So.2d 819 (Fla. 1977).

160 Defendants who were arrested on misdemeanor charges for which imprisonment was a possible penalty moved to disqualify the presiding non-attorney judge. Their constitutional arguments were based on due process and equal protection grounds. *Id.*

161 The Florida court noted that the availability, at the request of the defendant, of a second, *de novo* trial before a lawyer judge in the *North* case was not a feature of the Florida system. 343 So.2d at 822.

162 The Florida court quoted language from *Gordon* concerning the absence of any California requirement for training or educating non-attorney judges. 343 So.2d at 822-23.

163 The court scrutinized the materials and curriculum of the Florida Non-Lawyer County Judge Training Program and found that judges who had completed the program and passed the proficiency examinations should be able to perform their duties. The court also referred to the fact that both the majority and dissenting opinions in the *North* case implied that the constitutionality of non-attorney decision-making might turn on whether a state provided special training for those judges. 343 So.2d at 823-24. *See* note 131 *supra.*

164 343 So.2d at 824.

165 269 S.C. 510, 238 S.E.2d 205 (1977). In *Duncan,* the defendant who pled guilty to petty larceny before a non-attorney judge appealed the conviction on grounds that he was denied proper advice as to his right to counsel and that he was denied due process and equal protection by being tried before a non-attorney judge when he might have received a jail sentence.

166 *Id.* at 517-18, 238 S.E.2d at 208.

167 The testimony of witnesses in a criminal proceeding before a magistrate must be taken down in writing, S.C. CODE § 22-3-790 (1976), and the appeal is on the record. S.C. CODE § 18-3-70 (1976).

168 *See* In re Hewitt, 81 Misc.2d 202, 365 N.Y.S.2d 760 (1975); People v. Sabri, 47 Ill.

and Kansas[169] have also relied on judicial training and educational programs to sustain the constitutionality of their non-attorney justice systems.

Only the Vermont and Tennessee Supreme Courts have departed from this post-*North* trend,[170] and both in somewhat unique contexts. In Tennessee, where non-attorney judges have the power to hear juvenile matters, its Supreme Court held in *Anglin v. Mitchell*[171] that a non-attorney judge's adjudication of delinquency and commitment to juvenile authorities violated the Tennessee Constitution. Noting that juvenile delinquency hearings "literally bristle with tantalizing and technical questions of constitutional and statutory law," the court found that the nature of the offense and the substantial period of confinement distinguished the case from *North.*[172]

Vermont's use of non-attorney judges is unique in the United States; its court of general jurisdiction — the Superior Court — generally sits as a three-judge tribunal, consisting of one attorney judge and two non-attorney assistant judges.[173] The presiding attorney judge rides circuit, and the two "assistant" or "side" judges are elected in each county and sit with the attorney judge. Their jurisdiction extends to most civil and criminal cases, including capital offenses.[174] In *State v. Dunkerly,*[175] the defendant, who was charged with first-degree murder, moved to prevent the two non-attorney judges on the panel from participating in the proceedings. The Vermont Supreme Court, relying on Justice Stewart's dissent in *North* as well as the *Gordon* decision in California, found a potential denial of due process, in that the defendant's right to an attorney was effectively eclipsed because a

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App.3d 962, 362 N.E.2d 739 (1977) (noting that other states have used training of lay judges to uphold their non-attorney justice systems).

169 State v. Boone, 218 Kan. 482, 543 P.2d 945 (1975).

170 An attempt by the Indiana legislature to permit non-attorneys who passed an examination administered by the state supreme court to serve as county judges was held to be a violation of the separation of powers provision of the Indiana Constitution. In re Judicial Interpretation of 1975 Sen. Enrolled Act No. 441, 263 Ind. 350, 332 N.E.2d 97 (1975).

171 No. ___, slip op. (Tenn. S. Ct. Jan. 21, 1980).

172 *Id.* at 28.

173 VT. STAT. ANN. tit. 4, §§ 111(a), 112 (Supp. 1979). *See* note 70 *supra.*

174 VT. STAT. ANN. tit. 4, §§ 113, 114 (Supp. 1979).

175 134 Vt. 523, 365 A.2d at 131 (1976). The *Dunkerly* decision is commented upon in Note, *Do All Judges Have to be Lawyers? Side Judges in Vermont: The Case of State v. Dunkerly,* 3 VT. L. REV. 147 (1978).

non-attorney judge majority could decide the legal issues. The court rejected the notion that special education could elevate a non-attorney judge to the level of competence of an attorney judge, where legal questions as complex as those of the instant felony could arise.[176] At least in capital criminal cases, the Vermont court held, the requirements of due process barred lay assistant judges from participating in decisions on legal issues.[177]

The *Dunkerly* decision illustrates a concern for the context in which the non-attorney judge functions. Except for Vermont, every state limits the jurisdiction of its non-attorney judges to minor civil and criminal cases.[178] However, in several states, the lay judge will also preside over difficult preliminary matters in criminal cases, including issuance of arrest and search warrants based upon a finding of probable cause, granting and setting the level of bail, and holding of preliminary hearings to determine whether there is probable cause for a felony indictment and trial.[179] The *North* decision has stimulated questions concerning the propriety of allowing non-attorneys to exercise these functions.

The leading decision upholding the constitutionality of using non-attorneys to handle preliminary matters is the United States Supreme Court's decision in *Shadwick v. City of Tampa,*[180] which predated the *North* decision. In *Shadwick,* the Supreme Court af-

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176 134 Vt. at 526, 365 A.2d at 132-33.

177 Shortly after *Dunkerly,* the Vermont rules of criminal procedure were amended to specify the lay judges' role in criminal cases. The attorney judge of the three-person panel is to decide questions of law, but all three judges, by majority vote, are to decide questions of fact. VT. R. CRIM. PROC. 54 (c)(1)(ii) (Supp. 1979). Given the difficulties inherent in separating issues of law and fact, lay judges' participation in felony and capital cases may continue to provoke due process challenges.

178 *See* text accompanying notes 35 to 65 *supra.*

179 *See* text accompanying notes 65 to 68 *supra.*

180 407 U.S. 345 (1972). Supreme Court Justice Rehnquist, dissenting on other grounds in Franks v. Delaware, 438 U.S. 154 (1978), affirmed his support for the *Shadwick* decision, stating that, "Magistrates need not be lawyers, ... lawyers have no monopoly on determining whether or not an affiant who appears before them is or is not telling the truth." *Id.* at 185. Elsewhere in his dissent, Justice Rehnquist seems to suggest that lay judges might in some ways be preferable to attorney judges. "I am quite confident that if our system of justice were not administered by judges who were once lawyers, it might well be less satisfactory than it now is. But I am equally confident that one improvement which would manifest itself as a result of such a change would be willingness, reflected in almost all callings in our society except lawyers, to refrain from constant relitigation, whether in the form of collateral attack, appeal, retrial, or whatever, of issues that have originally been decided by a competent authority." *Id.* at 183.

firmed the Florida Supreme Court's holding that the lay clerk of Florida municipal court was, for legal purposes, a "neutral and detached magistrate," able and authorized to decide whether an arrest warrant satisfies the requirements of due process.[181] In so holding, the Court acknowledged the importance of lay elements in the most traditional aspects of our judicial system (*e.g.* grand jury and jury trial duty) and stressed the practical need to use magistrates to reduce "stiff and unrelenting caseloads."[182]

However, at least one California appeals court, relying on the *Gordon* decision, refused to permit a non-attorney judge to issue a search warrant.[183] The California court doubted the ability of a lay judge to "appreciate the subtleties of search and seizure questions."[184] Most courts, however, including a different California appeals court,[185] have permitted lay judges to issue search warrants.

The preliminary hearing has been another area in which the proper role for a non-attorney judge is under debate. Prior to *North,* courts in Kansas,[186] Wyoming,[187] and Oregon[188] all approved the use of a lay magistrate or judge to conduct preliminary hearings in felony cases.[189]

The preceding sketch of the case-law background indicates that, at least for now, and within the procedural and jurisdictional

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181 407 U.S. at 350.

182 *Id.* at 351-53.

183 People v. Escamilla, 65 Cal. App. 3d 558, 135 Cal. Rptr. 446 (1977).

184 65 Cal. App. 3d at 562-63, 135 Cal. Rptr. at 448-49.

185 People v. Mack, 66 Cal. App. 3d 839, 136 Cal. Rptr. 283 (1977).

186 State v. Boone, 218 Kan. 482, 543 P.2d 945 (1975). The Kansas Supreme Court rejected the due process challenge of a defendant charged with a felony in a preliminary examination held by a lay magistrate. The court held that the lay judge did not decide guilt or innocence but only the issue of probable cause. The court also rejected the defendant's equal protection challenge, noting that the scarcity of lawyers in rural areas of the state necessitated the use of non-attorneys in certain regions and that non-attorneys in Kansas received intensive training, thereby minimizing the difference between lay and attorney adjudication. *Id.*

187 Thomas v. Justice Court, 538 P.2d 42 (Wyo. 1975). In *Thomas,* the Wyoming Supreme Court refused to prohibit the non-lawyer justice court judge from conducting the preliminary hearing in a manslaughter case, again relying on the distinction between determinations of guilt and innocence at the trial itself and findings of probable cause at the preliminary hearing.

188 State v. Pfeiffer, 25 Or. App. 45, 548 P.2d 174 (1976).

189 *See also* State v. Dziggel, 16 Ariz. App. 289, 492 P.2d 1227 (1972); Schramm v. State, 366 A.2d 1185 (Del. 1976). The court in *Schramm* noted that preliminary hearings deal with factual and practical probabilities of every day life upon which prudent men, who are not legal technicians, can competently act. 366 A.2d at 1192.

parameters outlined above, the courts have given their imprimatur to varying styles of non-attorney justice. Apparently, the courts are content to leave the issues of the appropriate use of and need for non-attorney judges to the state legislatures. The architects of state policy, then, will be the state legislators, who must now decide whether to employ a lay-judge system and how best to define and delimit the authority of their states' non-attorney judges.

III. Empirical Observations

Empirical evidence on which to base an evaluation of the quality of non-attorney justice is scarce, and the data that does exist derives from a very limited sampling. However, the data collected for the recent IJA study[190] does provide some insight into the operations of lay courts in several states. In addition, findings from an American Judicature study on local justice in a non-metropolitan setting[191] suggest some tentative comparisons of attorney and non-attorney judges.

The IJA study noted that most courts staffed by non-attorneys are "volume"[192] courts, handling large numbers of cases. In many

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190 This study was undertaken jointly by the Institute of Judicial Administration and the National Center for State Courts, pursuant to Law Enforcement Assistance Administration grant no. 77DF-00-0028. The study laid the foundation for a serious review of the use of lay judges. The study contains a comprehensive legal memorandum reviewing the legal status of lay judges, a survey of lay judge jurisdiction, a description of site visits undertaken in Washington, South Dakota, Arizona, New Mexico, Florida, New York, Vermont and Pennsylvania, a study of training opportunities for lay judges, and an extensive bibliography. In addition, a seminar concerning lay judges was held at New York University School of Law, April 28, 1978. *See generally* NON-ATTORNEY JUSTICE note 4 *supra*.

191 Ryan and Guterman, *Lawyer versus Non-lawyer Town Justice: An Empirical Footnote to North v. Russell*, 60 JUD. 272 (1977) [hereinafter cited as Ryan and Guterman]. This article compares the perceptions and performances of attorney and non-attorney judges. The authors use statistics gathered through mail questionnaires sent to all town, village and city court justices in New York communities with populations between 10,000 and 50,000. Ryan and Guterman's work was part of a broader study on misdemeanor courts conducted by the American Judicature Society. *See also* Alfini & Doan, *A New Perspective on Misdemeanor Justice*, 60 JUD. 425 (1977) (data on larger misdemeanor study).

192 In 1973, the average town justice court caseload in New York was 1,057 and the mean New York village justice court caseload was 1,699. J. KRESS & S. STANLEY, JUSTICE COURTS IN NEW YORK STATE: THE COURTS CLOSEST TO THE PEOPLE 77 (1976) [hereinafter cited as KRESS & STANLEY]. According to the Court Report of the City of Gallop, New Mexico (1977), the non-attorney judge heard between 9,000 and 10,000 cases on the city level and a similar number on the county level each year. NON-ATTORNEY JUSTICE, *supra* note 4, at 49.

courts, vehicle and traffic offenses constituted the bulk of the caseload.[193] Observers characterized criminal matters in these courts as "non-contested,"[194] and often the result of plea-bargaining. Proceedings were summary in nature and the judge's role in many of the criminal cases consisted of formally arraigning defendants, taking guilty pleas, and imposing sentences.[195] In a number of states, preliminary hearings on felony cases were part of the caseload.[196] In courts where lay judges also exercised minor civil jurisdiction, researchers noted that simple contract and tort actions and landlord-tenant matters constituted a substantial majority of the cases.[197]

Judges on lay courts also heard lawsuits involving neighborhood disputes, juvenile matters, and domestic disturbances.[198] Often, by undertaking the role of mediator or conciliator at an early stage of the litigation, the judge was able to facilitate a settlement between the parties without the necessity of further formal proceedings.[199]

Nonetheless, many non-attorney judges on these courts of minor jurisdiction viewed their role only as that of formal adjudicator within legal norms. Hypotheses that lay judges will stress community norms rather than legal rules were not supported by the site visits, at least when the judge was called upon to "decide" a case. On the other hand, many lay judges carried a sizable informal caseload and offered support and quasi-judicial services, par-

193 Kress and Stanley indicate that a 1976 study of the New York justice courts reported that an average caseload in the State consisted 90 percent of vehicular and traffic offenses. KRESS & STANLEY, *supra* note 192, at 93-95. In addition, some lay courts may hear only traffic offenses. *See, e.g.*, 42 PA. CONS. STAT. ANN. §§ 1302, 1321 (Purdon Pamph. 1979) (Philadelphia Traffic Court).

194 NON-ATTORNEY JUSTICE, *supra* note 4, at 50. In some jurisdictions, most cases heard by non-attorney judges are non-contested because their jurisdiction has been limited to taking guilty pleas. For example, until 1977, in criminal cases in South Dakota, the jurisdiction of lay magistrates was limited to taking guilty pleas for cases for which the punishment was a fine not exceeding $100 or imprisonment not exceeding 30 days. In 1977, lay magistrate jurisdiction was expanded to include certain petty offenses. S.D. COMPILED LAWS ANN. § 16-12A-16 (1979).

195 NON-ATTORNEY JUSTICE, *supra* note 4, at 50.

196 In Arizona, for example, one judge estimated that 85 percent of his criminal caseload involved arraignments and preliminary examinations in felony cases. *Id.*

197 *Id.*

198 *Id.*

199 For example, in New York where intra family disorderly conduct or assault cases must be transferred to the family court, the Justice Courts have been able to resolve half of these matters within 72 hours and avoid transfer. *See* KRESS & STANLEY, *supra* note 192, at 106.

ticularly in communities without alternative sources of dispute mediation and counseling.[200]

In their roles as judges, laymen were not always as "informal," non-rational, or non-rule-minded as some stereotypes would suggest. The IJA study reported that many lay judges held formal, open court proceedings and that the judges often wore judicial robes.[201] Nor was it lay or attorney status that determined whether the judges knew or had contact with a litigant; familiarity with the litigants was usually a function of the size of the community served by the judge.[202] However, several non-attorney judges interviewed by IJA researchers expressed the opinion that their status as non-attorneys did contribute to a more relaxed courtroom atmosphere.[203] They pointed out that an attorney judge for the community would have been an outsider, and that their position as well-respected members of the community was psychologically important to litigants.[204] They also believed that their relationship to the community made it possible for them to resolve disputes informally and to give other types of assistance.[205]

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200 In addition to their judicial duties, New York justices handled approximately 246,000 informal requests for assistance. The justices acted as informal arbiters and gave advice on legal and personal problems. Many also served an informal ombudsman responsibility in the community, acting as liaison between citizens and various administrative offices of municipal government. *See* KRESS & STANLEY, *supra* note 192, at 73.

201 The IJA study noted that some of the judges observed were robed, including those in the Philadelphia traffic court. In New York, where both lawyers and non-lawyers staffed the justice courts, some attorney and non-attorney justices wore robes, while others did not. There was a general feeling among the IJA observers that the robes dignified the proceedings. NON-ATTORNEY JUSTICE, *supra* note 4, at 53.

202 For example, municipal and justice court judges — both attorney and non-attorney — observed in and around Phoenix, Arizona did not know most of the litigants who appeared before them. However, in Florida and South Dakota, the justices serving in small towns indicated that they did know most of the litigants who appeared before them. *Id.* Itinerant judges, who served several towns within the district, would be less likely to know the litigants personally than would judges serving only one town. *Id.*

203 *Id.* at 69.

204 One judge said that litigants related to him not as a judge, but as a respected neighbor and acquaintance. Many justices reported that they were called upon to resolve informal real estate and juvenile disputes and were relied upon for legal counseling and advice as to whether an attorney should be consulted. One New Mexican judge, who said he often was consulted during informal disputes, suggested that the ordinary citizen was more comfortable with a lay judge and would prefer to consult with a lay judge rather than with an attorney judge. *Id.* at 71.

205 In New Mexico, lay judges generally consider themselves to be "town patrons," available at almost any hour to settle interpersonal and community difficulties. One such judge, who described the community he served as ethnically-mixed, characterized by a high American Indian population, and plagued by liquor and drug problems, emphasized his

Relying on site observations and interviews, the IJA study indicated that the proceedings reflected the general difficulties of minor court adjudication but were not seriously affected by the lawyer or non-lawyer status of the presiding judge. Neither counsel nor prosecutor approached a case differently when the judge was a non-attorney; the individual judge — whether attorney or non-attorney — set the tone for the proceedings.[206]

The drawbacks of "lay" courts appear to be the generic problems that plague all courts of limited jurisdiction: the lack of supporting staff and the difficulty of providing high-quality facilities in courts of limited jurisdiction.[207] Courts in these communities are part-time institutions, and judges often move around, presiding in different places for varying lengths of time. It is fair to note, however, that these problems seem to be typical of courts of limited jurisdiction, even where attorney judges hear the cases.[208]

Cases in the non-attorney courts were generally uncomplicated proceedings.[209] Even where jury trials were authorized, they were infrequent occurrences in the courts observed by IJA researchers.[210] In one state where lay and lawyer judges both presided on a single court, the lawyer judge generally conducted the jury trials.[211]

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function as a community dispute mediator. He said he frequently consulted late at night on domestic and child problems and often was asked for advice from potential adversaries in prospective lawsuits. He was able to solve many of these disputes informally. *Id.* at 70-71.

206 Impressions by IJA observers were that the decorum established in the courtroom by the judge — whether attorney or non-attorney — set the tone for the proceeding. Judges who formally called the cases or formally announced that court was in session, seemed to command respect. But where the judge did not exhibit "judicial behavior" the proceedings seemed disorganized and disorderly. *Id.* at 69.

207 In general, lay courts convened in public buildings, either county courthouses or city halls. Most of the physical courtroom facilities observed during the IJA study were deemed adequate, although relatively few had conference or witness rooms. Many times, witnesses would be asked to step outside the courtroom, and occasionally an attorney would have to hold a conference with his client behind only a sliding door. Very few of the lay courts had the assistance of court clerks or bailiffs. Occasionally, a judge's retired friend or spouse would act as court clerk without remuneration. On the other hand, the Philadelphia traffic court had excellent support staff; each courtroom had a clerk, stenographer, crier, and some security personnel. *Id.* at 51, 52, 60.

208 *Id.* at 103-04.

209 *Id.* at 95, 98.

210 One Arizona judge estimated that he handled one criminal jury trial per month, and another indicated he had only six per year. One New York lay justice stated that he had 30 trial dates set, but that most of those cases would not get to trial. *Id.* at 60.

211 In South Dakota, where lay magistrates can conduct jury trials, such trials are usually handled by lawyer magistrates who have better facilities and staff due to their broader jurisdiction. *Id.*

An important observation made by the IJA study related to the prevalence of counsel in the courts staffed by non-attorney judges. The observers did not find that the existence of counsel in a case depended upon whether the judge was or was not an attorney.[212] However, they did note that in rural and small-town courts, most litigants were not represented by counsel, even in contested misdemeanor matters, whereas in urban non-attorney courts, counsel was usually present in criminal matters other than traffic offenses.[213] To the extent that non-lawyer judges are found most frequently in rural areas, counsel may not be present in many lay courts. This data is consistent with the findings of the nationwide study on misdemeanor courts conducted by the American Judicature Society, which indicated that both prosecutors and defense attorneys were more likely to be present in the urban misdemeanor court than the rural court.[214] However, their data, in contrast to the IJA study, also showed that prosecutors and defense counsel were more likely to be present in a court staffed by a lawyer judge than a non-lawyer judge.[215]

The presence of counsel and the judge's behavior toward counsel are of particular significance in courts of limited jurisdiction because of the importance of pretrial discussion or negotiation which often takes place prior to the case-disposition process, and which often results in a plea bargain. Although based on a very limited sampling, the American Judicature findings reported that there was some indication that non-lawyer judges might hold pretrial discussions with the prosecution alone.[216] That same study

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212 In Washington, Arizona, and Florida, counsel appeared before lay and attorney courts with approximately the same frequency. Both attorney and non-attorney judges in those states indicated that they encouraged defendants to retain counsel, since they believed that cases with counsel move more quickly. *Id.* at 57-58.

213 One Florida lay judge, who stated that most litigants who appeared before him did not have counsel, noted that counsel usually were present in drunk driving cases in which defendants might lose their driving privileges for a year. However, in the urban lay courts in Arizona and New Mexico, both lawyer and non-lawyer judges indicated that defendants in criminal matters usually retained attorneys to defend them. NON-ATTORNEY JUSTICE, *supra* note 4, at 55-56.

214 Transcript of Speech by James Alfini, Research Director of the American Judicature Society, New York University School of Law, Lay Judge Seminar (April 28, 1978) (unpublished speech transcript on file at the Harvard Journal on Legislation).

215 *Id.*

216 Ryan and Guterman's findings, which involved only New York town and village courts, found that both lay and attorney justices decided whether to hold a pre-trial discussion upon consideration of the seriousness of the crime. However, non-attorney judges ad-

also found an attitudinal difference between lawyer and non-lawyer judges in their perceptions of the quality of local prosecutors: non-lawyer judges had a more favorable impression of prosecutors than did the lawyer judges in terms of case preparation, efficiency, and presentation.[217] This data led the American Judicature researchers to conclude that non-lawyer judges rely more strongly on local law-enforcement officials than do lawyer judges.[218] These fears that lay judges rely too heavily on prosecutors or state attorneys, however, were not really borne out by the IJA study. Although the monitors could cite evidence of an occasion when a judge indicated he might ask a prosecutor about a legal question, they felt these occasions were only isolated instances.[219]

The IJA study confirmed that litigation in lay courts did not usually involve complex legal issues, but called attention to the fact that the proceedings could give rise to legal issues that would pose difficulties for non-attorney judges.[220] Determinations of legal standards of probable cause, standards for issuing search warrants and attachments of property, and supervision of jury trials were cited as examples.

The IJA findings also indicated that potential legal issues could be obscured in proceedings before non-attorney judges, particularly where there were no other lawyers present in the lay-court

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mitted having discussed a criminal case with the prosecution without defense counsel present. Ryan and Guterman, *supra* note 191, at 278-79.

217 *Id.* at 276-77. Using a psychological technique known as "semantic differential" testing, researchers found that non-lawyer judges also perceived local policemen to be "substantially better" witnesses and investigators than did the lawyer judges. *Id.*

218 Because the non-lawyer judges tended to have strong positive perceptions of prosecutors and policemen, and because so many criminal cases turn on the credibility of police testimony and the strength of the prosecutor's case, the American Judicature study concluded that non-lawyer judges tend to rely more on and to be more sympathetic to the prosecutor's case than do lawyer judges. *Id.* at 280.

219 Several judges indicated that if a difficult question of law arose, they would ask the prosecutor or city attorney to research it. Several other judges said that the state or county attorney general's office often offered assistance. However, other judges insisted that they did not consult with local prosecutors or states attorneys, and that they relied instead on the statutes and bench manuals. *See* NON-ATTORNEY JUSTICE, *supra* note 4, at 67-68.

220 Many courts are authorized to conduct jury trials, if participants demand them. *Voir dires* and technical evidence rules may be too difficult for a non-attorney judge to master. However, most lay judges in the IJA study indicated that jury trials rarely were demanded in their courts. *Id.* at 60, 98.

model.[221] Of course, criminal cases are usually prosecuted by the prosecutor, but it is unlikely that the prosecutor will raise legal issues available to the defense. Although defendants may be represented by counsel in a large number of cases, particularly in urban areas, the potentiality for disregard of defendants' rights does exist, particularly in the rural courts where defendants often go unrepresented.

Most of the interviewed non-attorney judges did not believe that many legal questions arose in their proceedings.[222] If such questions arose, most judges said they relied on statutes or benchbooks provided to them or used legal materials from a local law library. Occasionally an attorney or another judge provided assistance,[223] and those non-attorney judges who sat with attorney judges on a single court indicated that the lawyer judge often provided assistance.[224] Nonetheless, the IJA study questioned whether lay judges could assure competent and fair adjudication of legal issues when they arose.[225]

The IJA study did not disclose any disparity in sentencing based on the attorney or non-attorney status of the judge.[226] The perceptions of attorney and non-attorney judges differed somewhat; many of the non-attorney judges believed that they were more "compassionate" in sentencing than their attorney counterparts, while some of the attorney judges characterized their non-attorney colleagues as often being "overharsh" in sentencing.[227] Findings by American Judicature researchers indicated some slight dif-

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221 *Id.* at 54, 58. Several lay judges said that counsel was often helpful because it was more likely that all the issues would be raised and brought to the attention of the court.

222 Lay judges themselves characterized their cases as "simple" and did not find that many legal questions arose in their proceedings. One lay judge confessed that he did not know a lot of law but asserted that "there isn't a lot a law to know in the type of cases — mostly repetitive traffic violations — which I hear." Even where there were many contested matters in the lay court proceeding the disputed issues usually were factual rather than legal. *Id.* at 66-67.

223 *Id.* at 65, 67.

224 *Id.*

225 *Id.* at 98-99.

226 Although the IJA study was not able to find a disparity in the sentencing patterns of attorney and non-attorney judges, it did find that lay judges very often imposed fines rather than prison sentences, mainly because they exercised only a limited criminal jurisdiction. Lay judges often were flexible, permitting charitable work or drug or alcohol treatment to stand as alternatives to prison terms, or allowing prison sentences to be served on nights and weekends. *Id.* at 72-73

227 *Id.* at 72.

ferences between lawyer and non-lawyer judges in their attitudes to poor people and related governmental policies, and they found a higher percentage of lawyer judges expressing positions sympathetic to poor people.[228] However, there was no necessary correlation shown between these attitudes and judicial behavior on sentencing.[229]

Because the jurisdiction of the lay courts is limited to minor offenses, it is not surprising that the IJA study noted that fines rather than jail terms were usually imposed.[230] Additionally, the study noted that, in the aftermath of *Argersinger v. Hamlin,*[231] judges may not appoint counsel in such cases and may merely refrain from imposing jail sentences.

Another facet of the IJA study involved an empirical evaluation of the various mechanisms through which the states have tried to prevent lay justice from shading into injustice. The available evidence casts some doubt on the effectiveness of these measures.

The IJA study concluded that the educational and training programs were not sufficient to sensitize lay judges to legal issues and to enable lay judges to analyze them.[232] Training programs, however, did help the judges to handle the more routine matters that came before them and helped protect basic legal rights of defendants — like that of the right to counsel.

Benchbooks, legal materials, and planned orientation programs also helped them cope with some of their judicial tasks. However, the IJA researchers did not believe that such programs and aids could substitute for the kind of legal training received by attorney judges and did not ensure the same competency that should come with formal legal training.[233]

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228 Ryan and Guterman, *supra* note 191, at 277-78. Lawyer judges were more likely to disagree that people are unemployed by choice, more likely to agree that day care centers should be provided, more likely to disagree with enforced sterilization, and more likely to disagree with resistance to scatter site housing projects. However, many non-lawyer judges also agreed with the opinions expressed by their attorney-judge counterparts. *Id.*

229 *Id.*

230 *See* NON-ATTORNEY JUSTICE, *supra* note 4, at 72.

231 407 U.S. 25 (1972). *Argersinger* upheld the right of the indigent to counsel in criminal cases if a jail sentence may result. NON-ATTORNEY JUSTICE, *supra* note 4, at 72.

232 NON-ATTORNEY JUSTICE, *supra* note 4, at 98-99, 235-49. Some states do not have training programs. Those states that do have training programs often have failed to arrive at conclusions as to what the programs should achieve.

233 *Id.* at 118.

Furthermore, few lay courts are generating transcripts that would suffice for appellate review on the record. Proceedings in lay courts are occasionally tape-recorded,[234] but in many courts judge's or clerk's notes constitute the only record of proceedings.[235] Court reporters are sometimes used for civil and criminal trials, but often only if the litigant pays for them.[236]

De novo review on appeal, the due process safeguard upon which the Supreme Court relied heavily in *North,*[237] is available in most courts on which non-lawyer judges serve.[238] However, as a practical matter, litigants rarely take appeals.[239] In some instances, they may be unaware of the right;[240] in others, defendants may recognize that the law could expose them to a more severe sentence than the one the lay judge imposed.[241] In some cases it appears that the defendants merely want to end the process as quickly as possible.[242]

Use of transfer mechanisms to protect the rights of defendants

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234 *Id.* at 59. *See, e.g.,* S.D. COMPILED LAWS ANN. § 16-12A-26 (Supp. 1978) (verbatim record is to be kept of all proceedings).

235 In New York, the justice courts are not "courts of record," but a justice is required to maintain an official record of all proceedings initiated in his court. Judges often keep their own notes, although individual town and village boards may authorize the payment of stenographers. *See* NON-ATTORNEY JUSTICE, *supra* note 4, at 59.

236 *Id.*

237 North v. Russell, 427 U.S. 328 (1976). *See* text accompanying notes 118 to 129 *supra.*

238 The IJA study found that most lay courts provided some form of *de novo* review by an attorney-judge court. In the Philadelphia traffic court, for example, jury trials were available only upon *de novo* review. In New Mexico, appeals from the justice court offered a trial *de novo.* Arizona permitted the reviewing judge to decide whether the appeal would be on the record or *de novo.* NON-ATTORNEY JUSTICE, *supra* note 4, at 60-61.

239 *Id.* at 61. One disincentive for appeal is generally that a bond (and in some states, a double bond) must be posted.

240 *Id.* at 99-100. For example, defendants appearing before the Philadelphia traffic court were apparently unaware that the reversal rate on appeal was 90 percent. Moreover, the requirement that a bond be posted pending appeal provided a disincentive to appeal. *Id.* at 61-63.

241 *See* Colten v. Kentucky, 407 U.S. 104 (1972) where the Supreme Court upheld a harsher sentence on appeal, stating that due process is offended only if the possibility of increased punishment reflected a realistic likelihood of vindictiveness. Note, however, that New Mexico has specifically outlawed the imposition of a more severe sentence on an appeal. *See* NON-ATTORNEY JUSTICE, *supra* note 4, at 62. *Compare* Colten v. Kentucky and Chaffin v. Stynchcombe, 412 U.S. 17 (1973) *with* North Carolina v. Pearce, 395 U.S. 711 (1960), and Blackledge v. Perry, 417 U.S. 21 (1974).

242 One New Mexico judge stated that some defendants were anxious to pay their fines or serve their time, and were not interested in becoming involved further in the legal system. NON-ATTORNEY JUSTICE, *supra* note 4, at 62.

may suffer from the same problems that render the appeal safeguard ineffectual. Defendants are often ignorant of their transfer right and only rarely have states established procedures to apprise them of this possibility.[243]

The IJA study arrived at the following conclusion:

> In general, our sample of site visits included both good and bad judges — in both groups there were attorneys and non-attorneys. We did find that some of the part-time attorney judges were plagued by time pressures and potential conflicts of interests, and that many lay judges exhibited a great amount of enthusiasm and interest in their jobs. The majority of the lay judges we interviewed seemed intelligent and experienced; they themselves stressed education and training as the best means for upgrading non-attorney justice. Nonetheless, in the best of all possible worlds, an attorney judge would be preferred even to handle these minor matters. . .[244]

However, noting that the realities made the abolition of non-attorney justice impractical, the IJA study offered a set of more limited recommendations.

IV. Recommendations for Non-Attorney Jurisdiction

These conclusions and recommendations, adapted from those of the IJA study, may prove helpful in drafting legislation for those states in which financial or demographic constraints necessitate the use of non-attorney judges. Non-attorney judges can successfuly resolve some controversies, thus eliminating the need in those cases either for extensive travel by the litigants, or for adjudication of simple matters by attorneys from outside the community or by part-time attorney judges who might have serious conflicts of interest.[245]

Non-attorneys should not be authorized to act as judges when attorney judges are a viable option.[246] To that end, the state

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243 In New York, most judges interviewed by the IJA researchers stated that they were unaware of the divestiture procedure. One New York lawyer pointed out that the statute's undefined requirement of "good cause" made it almost impossible to get a transfer. *Id.* at 64-65.

244 *Id.* at 101.

245 *See* text accompanying notes 84 to 94 *supra.*

246 There are, of course, those who defend lay adjudication as a philosophical matter. *See* text accompanying notes 10 to 12 *supra.* However, most critiques of trial courts of

legislatures should balance the desirability and feasibility of local lay courts against that of centralized attorney courts. They should consider such factors as population density, lawyer demographics, availability of funds, and ease of travel.[247]

It is recommended that lay courts retain civil jurisdiction only in "simple" civil actions where the amount in controversy does not exceed $2,000. Matters omitted are those which are likely to require resolution of complex questions — such as attachments and garnishments, real property actions, slander or libel, and malicious prosecution — and those actions where serious social consequences are likely to ensue, such as cases involving novel theories of liability.[248]

The criminal jurisdiction of lay judges should be narrowly defined to ensure that legal rights of defendants are within the control of attorney judges, whenever possible. Since traffic and ordinance violations often involve only factual disputes, both are prime categories of jurisdiction to be entrusted to lay judges.[249] Additionally, penalties in these cases are usually fines and not prison sentences, a characteristic which makes them attractive cases for lay judges to hear.

The more difficult category of cases encompasses other types of misdemeanors that may involve legal issues that lay judges may be incapable of handling[250] and that may also call for the imposition of prison sentences. However, many of these cases are eventually plea-bargained,[251] and efficient adjudication of this large

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limited jurisdiction have recommended that non-lawyer judges be replaced by lawyer judges. *See, e.g.,* Uhlman, *Justifying Justice Courts,* 52 JUD. 22 (1968); ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, FOR A MORE PERFECT UNION — COURT REFORM (1971); TASK FORCE ON THE ADMINISTRATION OF JUSTICE, TASK FORCE REPORT: THE COURTS (1967). Moreover, many legal commentators suggest that the use of non-attorney judges may be unconstitutional. *See* Ashman & Chapin, *Is The Bell Tolling for Non-Lawyer Judges?,* 59 JUD. 417 (1976); Comment, *The Right to a Legally Trained Judge: Gordon v. Justice Court,* 10 HARV. C.R.-C.L. L. REV. 739 (1975); Note, *Limiting Judicial Incompetence: The Due Process Right to a Legally Learned Judge in State Minor Court Proceedings,* 61 VA. L. REV. 1454 (1975).

247 *See* text accompanying notes 89 to 98 *supra.*

248 Many states impose a maximum amount in controversy of about $2,000. Many states also limit the subject matters lay judges can hear, either by listing exceptions to a general grant or enumerating permissible subject matters. *See* text accompanying notes 37 to 50 *supra.*

249 States making such specific jurisdictional grants include Indiana, Missouri, and Ohio. *See* text accompanying notes 62 to 65 *supra.*

250 *See* text accompanying notes 219 to 225 *supra.*

251 *See* text accompanying notes 215 to 219 *supra.*

volume of cases is an important goal. Where misdemeanors are initially uncontested, therefore, they should remain within the adjudicative capacity of the non-attorney judge, provided that the maximum penalty falls within the jurisdictional grant. The presence of counsel should provide some safeguard to assure that plea negotiations are conducted appropriately.[252] Additional procedural protections can ensure that a defendant's guilty plea is knowingly and intelligently made. The lay judge should apprise a defendant of his rights and submit a written statement for his signature. If the defendant can be sentenced to a jail term, the defendant should also see a legible transcript of the plea submission proceedings.[253] In contested misdemeanor cases (and some traffic and ordinance violations which carry prison terms), jurisdiction should be concurrent with that of an attorney-judge court and the defendant should be able to have the case transferred if desired.[254]

In no event should lay judges conduct jury trials.[255] Non-attorneys should not have to deal with the complexities of the *voir dire* or thread their way through the labyrinthine rules of evidence. To the extent that lay judges may commit reversible error more frequently than attorney judges, it saves time and money to bring the case before an attorney judge in the first instance.

Some preliminary matters in criminal cases also fall neatly within the bailiwick of the lay judge.[256] Bail hearings, probation hearings, and sentencing within prescribed limits are particularly suitable matters. In some instances the lay judge's familiarity with the litigants and the community will guide him in making decisions, and the need to apply difficult legal standards is unlikely to arise. Lay judges should also continue to hear formal arraignment proceedings. Complex legal issues may well surface in connection

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252 The IJA study noted the presence of counsel in lay courts particularly in more urban areas. *See* text accompanying notes 212 to 216 *supra*.

253 A Delaware court has mandated procedures similar to these. *See* note 151 *supra*.

254 Alaska, Delaware, and Oregon presently have such statutory provisions. *See* text accompanying notes 110 to 117 *supra*.

255 Several states, including New Mexico, Oregon, Texas, and West Virginia, do allow lay judges to preside over jury trials. However, jury trials rarely occur before lay judges. *See* text accompanying notes 104 and 209 to 211 *supra*.

256 *See* text accompanying notes 65 to 68 and 192 to 195 *supra*.

with the issuance of search or arrest warrants or writs of *habeas corpus* and the holding of felony pre-hearings.[257] In order to protect not only the rights of the defendant, but also the validity and strength of the prosecution's case, it is important that the outcomes of these preliminary proceedings withstand appellate scrutiny. However, despite the advisability of using attorney judges where possible,[258] lay judges can be trained to conduct these hearings if no attorney judge is available.

Every state should require some provision for transfer of and/or review by an attorney judge. The *de novo* review procedure[259] that the Supreme Court sanctioned in *North v. Russell* is too expensive, time-consuming, and burdensome. Defendants, and the state, have to bear the expense and court time of two full trials. Alternatively, a defendant may feel required to plead guilty at the first trial even when he believes himself innocent. The *North* procedure, then, can turn the first trial into a sham and impinge on the defendant's right to a speedy trial.[260]

More effective procedures are those involving transfer. Defendants in all cases involving possible prison sentences should have an automatic right to transfer to an attorney-judge court.[261] Transfer should also be available to defendants in preliminary hearings in felony cases.[262] In civil cases, lay-judge court jurisdiction[263] should be made concurrent with that of an attorney-judge court and a defendant should have the right to transfer an action brought

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257 *See* text accompanying notes 183 to 189 *supra.*

258 In South Dakota, lawyer and non-lawyer judges often sit on the same court. Broader jurisdiction is given to legally trained magistrates, but a non-lawyer magistrate can conduct preliminary hearings if the defendant does not request a transfer to a legally trained magistrate.

259 In most lay courts some form of *de novo* review exists. In some states, including Arizona and Idaho, the decision whether to allow *de novo* review depends on the sufficiency of the record made in the lay court. *See* text accompanying notes 106 to 110, 118 to 130, and 142 to 146 *supra.*

260 *See* North v. Russell, 427 U.S. 328, 346 (1976) (Stewart, J., dissenting).

261 To the extent that the prosecutor initially can bring the case to an attorney-judge court with concurrent jurisdiction, the transfer right need be granted only to the defendant. At least eight states now authorize some form of transfer in civil or criminal matters. *See* text accompanying notes 110 to 117 *supra.*

262 South Dakota provides for such transfer. *See* text accompanying notes 113 to 114 *supra.*

263 The parameters for such jurisdiction are set out in text accompanying notes 247 to 248 *supra.*

before a lay judge to an attorney-judge court.[264] In essence, a litigant's consent is a basis for lay-court jurisdiction, and presumably a litigant will consent when it appears that the attorney court is too distant, slow, or expensive.

The court should inform defendants in both civil and criminal cases of their transfer right, both orally and in writing. In criminal cases, defendants should also receive transcripts of hearings in which they waive this right.[265] Availability of transfer might promote forum shopping, but this drawback seems to be a small price to pay in order to obtain the increase in fairness, efficiency, and integrity of our legal system that the transfer mechanism affords.

Even when a defendant elects to proceed before a lay judge, an appeal procedure will still be necessary. Therefore, lay trials should be tape recorded or transcribed in order to afford the possibility of review without the need for an entirely new trial. Given the original transfer option, appellate review of the record should satisfy the requirement of due process. The United States Supreme Court has not yet ruled on whether such a transfer procedure satisfies the constitutional requirement of due process. However, the essential aspect of fairness upon which the court relied in *North*[266] also characterizes the transfer-and-review process discussed in this Article and can be further assured by appropriate training of lay judges.

Ideally, a mandatory training program should be implemented in each state, and it should be geared to the particular way in which lay judges are used in that state.[267] However, since such programs are economically viable only in states that make extensive use of lay judges, other states should assure that funds are provided to send their lay judges to an accessible national training center.[268]

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264 West Virginia allows transfer upon request of both parties if the amount in controversy is less than $300, and upon demand of any party if the amount is greater. *See* note 116 *supra*.

265 A Delaware court has mandated similar protective procedures for criminal cases that may entail prison sentences. *See* note 151 *supra*.

266 *See* text accompanying notes 118 to 189 *supra*.

267 *See* text accompanying notes 98 to 103 *supra*. For an overall description and discussion of lay-judge training programs, *see* Clark, *Lay Judge Training Programs*, in NON-ATTORNEY JUSTICE, *supra* note 4, at 235-49. *See also* Fairbanks, *The American Academy of Judicial Education: A National Program for Courts of First Jurisdiction*, 54 JUD. 226 (1971); NATIONAL CENTER FOR STATE COURTS, STATE JUDICIAL TRAINING PROFILE (1976).

268 *See* NON-ATTORNEY JUSTICE, *supra* note 4, at 241.

Unfortunately, no consensus has yet been reached as to either the desired goal of the training program or the best method of structuring it. However, once the parameters of lay-court adjudication have been set, certain premises should emerge.

Extremely lengthy training programs which attempt to approximate formal law school education are impractical. Training programs should not be short-cut legal education; they should not attempt to teach intricate legal analysis. Law schools establish rigid admission requirements because they purport to do a specialized type of teaching and training. Lay-judge training programs should focus on a very few things which lay judges can be well-trained to do and should concentrate on the areas within the limited jurisdiction of the lay court. In misdemeanor cases, non-attorney judges can be educated to advise defendants of the right to counsel, to transfer a case to an attorney judge, and to appeal to an attorney judge. Similarly, if lay judges are empowered to hold felony prehearings or issue warrants, the training can emphasize the legal issues that arise in these matters. By limiting civil jurisdiction to simple contract and tort cases, the focus of the training programs can be narrowed, and judges can be trained regarding relevant issues.

Non-attorneys can learn to use benchbooks and legal materials, and the initial training can be supplemented annually with additional programs and seminars.[269] Communication between lay and attorney judges should be encouraged through regular meetings of lower court judges associations, and the state bar should organize a system whereby non-attorney judges who are presented with difficult legal issues can obtain legal advice.

Besides imparting specialized legal knowledge, training can focus on the mediating role that lay judges often play. Training programs can also emphasize court administration and court management.

The model of specialized administrative agencies staffed by commissioners and hearing officers with developed expertise in particular areas[270] suggests a somewhat more refined and special-

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269 *See* text accompanying notes 212 to 224 *supra*.

270 Lay adjudication of this type includes parole hearings, license revocation hearings, and dismissal hearings. For an overview of non-attorney administrative adjudication, *see* NON-ATTORNEY JUSTICE, *supra* note 4, at 216-24.

ized lay-judge model than that which presently exists. Laymen with advanced degrees in psychology or with considerable expertise in counseling or youth organization work might be valuable resources for staffing a specialized juvenile court. These highly skilled individuals may be able to master judicial skills sufficient to enable them to function as judicial officers in specialized courts.

Other models are also possible. An individual with a background in social work or counseling, together with an attorney judge, might constitute a tribunal which would hear, for example, domestic relations cases. Or the approaches advocated above might be combined. Individuals with marriage counseling or social work backgrounds may obtain sufficient training to preside alone at uncontested divorces, or even supervise agreed-upon property settlements. At other times, such individuals might sit with attorney judges in contested family law matters, where their expertise would provide valuable input into the decision-making process. Another possibility would be to establish a specialized non-attorney court, with a liaison legal staff to provide advice on the legal issues.

In some communities, lay judges also play an important quasi-judicial role.[271] The stature and political base of lay judges in many communities contributes to their effectiveness as mediators and suggests an emerging role for the lay judge as mediator rather than adjudicator. Lay-judge jurisdiction should be redefined to approximate jurisdiction used in other neighborhood dispute-resolution centers. An emphasis can be placed on this mediating role for non-attorney judges, or in some instances, non-attorney judges can be integrated into pre-adjudication dispute models.

All of these alternative delineations of lay-judge adjudication merit further study. These few suggestions only serve to illustrate ways in which to expand and reshape our lay-judge courts. As government budgets shrink, lay adjudication may assume an increasingly important role in our legal system. State legislatures must provide means to assure competent adjudication in their jurisdictions with adequate protection of litigants' rights. The suggestions in this Article are designed to provide some guidance toward that end.

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271 Lay judges in New Mexico, for example, carry a sizable quasi-judicial caseload. *See* text accompanying notes 198 to 200 *supra*.

STATUTE

A MODEL NON-ATTORNEY JUDGE IMPROVEMENTS ACT

HARVARD LEGISLATIVE RESEARCH BUREAU*

The preceding article by Professor Linda Silberman thoughtfully reviewed the status of non-attorney justice in the United States and advanced a number of recommendations to improve that status. To facilitate the adoption of these recommendations, the Harvard Legislative Research Bureau has drafted the following Model Act.

The Act does not attempt to develop a comprehensive structure of non-attorney courts. The Act assumes that non-attorney judges serve at the trial bench. It is designed to apply to existing courts where non-attorneys may preside, by mandating special limitations for non-attorneys. This focus should make the Act readily adaptable to any particular state's court structure. However, because of wide divergence in the use of non-attorney judges, the Act and its language should be carefully scrutinized to ensure compatibility with existing legislation.

A MODEL ACT

Section 1. *Short Title*

This Act shall be known and may be cited as the "Non-attorney Judge Improvements Act of 19____."

COMMENT: The title of the Act reflects its basic purpose: to improve the quality of justice dispensed by non-attorney judges.

Section 2. *Definition of Non-attorney*

For the purpose of this Act, "non-attorney" means any person not licensed to practice law in this state.

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* The Model Act was drafted by two members of the Harvard Legislative Research Bureau: Russell E. Isaia, Bureau Director, B.A., University of Illinois, 1977; J.D., Harvard Law School, 1980; and Doris S. Goldstein, B.A., Brandeis University, 1979; candidate for the J.D. degree, Harvard Law School, 1982.

COMMENT: Non-attorney is largely a self-defined term. However, one feature of this section's definition merits comment. Any person licensed to practice law in other states, but not this state, is considered a "non-attorney." Such a person's lack of knowledge of local law justifies this classification.

Section 3. *Operative Provision*

Wherever, under the laws of this State, a non-attorney is permitted to serve in a judicial capacity, the provisions of this Act shall supplement, and where in conflict shall be, the provisions applicable to the non-attorney in the judicial capacity.

COMMENT: Section three is the operative provision of the Act. The basic notion is to "attach" the provisions of this Act to every statute which permits non-attorneys to serve in judicial capacities. These provisions will then supplement the provisions which define the particular judicial office in question, or, when there is conflict between the provisions of the acts, will control. However, these provisions operate only as to non-attorneys in the judicial capacity. If an attorney is serving in a judicial capacity for which a non-attorney could serve, he or she would not be subject to these provisions. Conceivably then, two persons serving in a similar judicial capacity could be subject to differing limitations and qualifications depending upon their status as attorney or non-attorney.

Section 4. *Minimum Qualifications*

A non-attorney shall not serve in any judicial capacity unless he or she

(a) has graduated from high school or has attained the equivalent of a high school education as indicated by the possession of a certificate of equivalency issued by the state department of [education] based upon the record made on the general education development test;
(b) is a resident of the judicial district or circuit in which he or she would serve;
(c) successfully completes a training course or seminar of not less than two weeks duration prior to undertaking the duties and responsibilities of the judicial capacity. The State Supreme Court

shall administer the trainng course, which may include instruction in relevant statutes, ordinances, litigant rights, and court procedure. In addition to, or as an alternative to, a separately administered course, the State Supreme Court may require attendance at, and completion of, an independently administered training course or seminar; and

(d) successfully completes any subsequent training courses or seminar which the State Supreme Court may require.

Actual and necessary expenses incurred by a non-attorney judge in fulfilling the requirements of subsections (c) and (d) shall be reimbursed.

COMMENT: Section four presents additional minimum qualifications for non-attorney judges. Subsections (a) and (b) are routinely part of any statute establishing a judicial capacity: they are included primarily to "round out" the section. The requirement of subsection (b) is especially relevant in the context of non-attorney judges: it attempts to preserve the asserted advantage that non-attorney judges know many of the people who appear before them and thus can dispense justice in a less intimidating atmosphere.

Subsections (c) and (d) require that the non-attorney's education include some knowledge of the legal system and its operation. The State Supreme Court has the responsibility for overseeing this mandated training course, although in adapting the Act to particular states, the legislature may wish to consider delegating this responsibility to judicial councils or administrators of the courts, where they exist. In any case, the responsible body may either administer a course of its own design, or require attendance at courses administered and designed by other entities, such as public or private universities or national institutes, or require both. If it chooses to design a separate training course, the content is solely within its discretion; the items listed in subsection (c) are merely suggestive.

Subsection (d) continues the emphasis on education by empowering the State Supreme Court to require participation in training courses subsequent to the course required by subsection (c). Ideally, the Court would require annual "refresher" courses.

Section 5. ***Conflicts of Interest in Employment***

A non-attorney shall not serve in any judicial capacity if he or she operates, is employed by, or has an interest in

(a) a bail bond agency; or
(b) a debt collection agency.

COMMENT: Section four seeks to protect the integrity of the judicial function by preventing persons with interests that conflict with the obligations of the judicial office from serving as non-attorney judges. This section is appropriately applicable to all persons, not just non-attorneys, but the scope of this Act requires that the section be limited to non-attorneys. A special focus on non-attorneys is at least partially justified, however; many non-attorney judge positions are part-time thus presenting a greater possibility of employment or business conflicts.

Section 6. ***Maximum Population of District***

A non-attorney shall not serve in a judicial capacity where the judicial district of that capacity has a total population exceeding [ ], as determined on the basis of the last federal decennial census.

COMMENT: One of the asserted justifications for non-attorney justice is a need to fill positions for which willing and able attorneys are not available. To a great extent, availability of attorneys correlates with population. Therefore, section six restricts non-attorney judges to more sparsely populated districts. Yet the number chosen to define such districts should be expansive to reflect the crudeness of the measure.

The district's population is derived from the federal census. Since districts' boundaries may diverge significantly from census boundaries, consideration should be given to deletion of this section.

Section 7. ***Subject Matter Jurisdiction***

In civil matters, a non-attorney serving in a judicial capacity

(a) shall not preside over

(1) cases where the amount in controversy exceeds two thousand dollars exclusive of interest and costs;

(2) attachments or garnishments;
(3) real property actions;
(4) slander, libel or, malicious prosecution actions; or
(5) domestic relations cases, including suits for separation, divorce, or child custody;

and in criminal matters, a non-attorney serving in a judicial capacity

(b) shall not preside over
(1) cases where the maximum sentence may exceed six months imprisonment or a fine of one thousand dollars; or
(2) juvenile proceedings; and

(c) shall not issue
(1) writs of habeas corpus;
(2) search warrants; or
(3) arrest warrants.

COMMENT: Section seven limits the non-attorney judge's subject matter jurisdiction. In general, it excludes from the non-attorney's jurisdiction cases where the consequences could be substantial or where legal issues predominate.

The dollar limitation on civil cases, and the fine and imprisonment limitations on criminal cases, embrace the broadest aspects of existing non-attorney jurisdiction. Where no attorney judges are available for criminal matters, non-attorney judge jurisdiction could be expanded if the case could automatically be transferred to an attorney judge with the necessary subject matter and personal jurisdiction.

Section 8. *Transfer of Cases*

Any case to be tried before a non-attorney judge shall be transferred to an attorney judge, in the same court or a different court with the necessary subject matter and personal jurisdiction,

(a) where transfer is requested by
(1) either party in a civil case; or
(2) the defendant in a criminal case; or

(b) where either party has made a demand for, and has the right to, a trial by a jury.

On all cases, the non-attorney judge shall promptly and in a timely manner inform the parties to the case of their respective rights under this section and shall secure a written waiver of these rights whenever a party elects to forego these rights.

COMMENT: Section eight provides for the free transfer of cases from non-attorney to attorney judges. It establishes the principle that non-attorney justice is an accommodation to the lack of lawyers *and* a convenience to litigants; when non-attorney justice becomes inconvenient, accommodation is no longer likely and the case is transferred. The only exception is the prosecutor in a criminal case. The prosecutor's exclusion from the right of transfer is founded on the belief that the prosecutor's freedom of choice is typically expressed in his choice of the initial forum: it is therefore appropriate that he be held to that choice. In a civil case, plaintiff's right to transfer could be eliminated if a choice of forum with concurrent jurisdiction were available.

The second critical foundation of section eight is the communication of these rights to the parties. That communication is the responsibility of the non-attorney judge who must secure written proof that the parties have determined to proceed before him despite the knowledge that the case could be transferred to an attorney judge.

Section 9. *Transcripts and Appeal*

Any defendant in a civil or criminal case before a non-attorney judge shall have the right to a transcript of the proceeding and appeal on the record.

COMMENT: Section nine mandates the right to transcripts and appeal for defendants appearing before a non-attorney judge. By providing for transcripts, the section allows for the possibility of review without the need for an entirely new trial.

Given the original transfer option, appellate review of the record should satisfy the requirement of due process. Essential fairness characterizes the transfer-and-review process provided in this section and section eight of the statute.

Section 10. ***Severability***

If any provision of this Act, or the application of such provision to any person or circumstance, shall be held invalid, the remaining provisions of this Act, or the application of such provision to persons or circumstances other than those as to which it is held invalid, shall not be affected.

Section 11. ***Effective Date***

This Act shall take effect immediately upon enactment.

NOTE

FOREIGN HOLDING COMPANY ACQUISITION OF AMERICAN BANKS: LEGISLATIVE RESTRICTIONS AND REGULATORY POLICY

JAMES L. MCELROY*

In the last few years, the number of foreign banks in the United States has increased considerably. Faced with the rapid growth in importance of these foreign banking offices, Congress has responded with such regulatory measures as the International Banking Act of 1978 and a recent law imposing a moratorium on foreign acquisitions of large American banks.

In this Note, Mr. McElroy examines these congressional responses to foreign bank acquisitions and discusses the problems which may arise from such acquisitions. He outlines the criteria used by the Federal Reserve Board to assess those acquisitions, the effect and constitutionality of state laws regulating state bank acquisitions, and the effects of foreign acquisitions on the purposes and implementation of bank holding company regulation. He concludes that any permanent restriction on such acquisitions would impair market efficiency and would contribute little to bank soundness or regulatory efficiency. Instead, he urges repeal of section 3(d) of the Bank Holding Company Act to slow the rate of foreign acquisitions by easing restrictions on domestic acquisitions, rather than by imposing artificial constraints on transnational market positions.

The growing presence of foreign banks in the United States has been a source of intense concern in recent years. Faced with a rapid growth in the number and importance of foreign banking offices in this country, Congress has reacted sharply. The first significant congressional reaction came two years ago in the form of the International Banking Act of 1978,[1] which provided for federal regulation of foreign banks' non-subsidiary offices in this country.[2]

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* J.D., Harvard Law School, 1980. This Note is based on a paper written in satisfaction of Harvard's third-year paper requirement. The author wishes to acknowledge the assistance of his advisor, Professor Robert E. Clark, Harvard Law School.

1 12 U.S.C. §§ 3101-3108 (Supp. II 1978).

2 The primary types of foreign banking offices other than the subsidiary are the branch, the agency, and the representative office. A branch is an office that is not separately incorporated in this country and at which essentially full banking services may be offered. An agency, the primary form in which foreign banks operate in the United States, is an office

Within the past year, congressional concern over acquisitions of American banks by foreign bank holding companies has prompted passage of a new law[3] which imposed a moratorium until July 1, 1980 on foreign acquisitions of large American banks. The moratorium applied to acquisitions by foreign banks, foreign holding companies, and foreign individuals,[4] with limited exceptions.[5] The purpose of the moratorium was to provide time for Congress, the administration, and the Federal Reserve Board (the Board) to examine the desirability of foreign bank acquisitions, "not . . . to prejudice the case one way or the other. . . ."[6] The implication, however, is that either a permanent ban or other restrictions might be enacted now that the moratorium has expired.

The immediate product of the moratorium was the approval last year by the Board[7] of the acquisitions of four large American banks by foreign bank holding companies.[8] Concern also had been stimulated by the unsuccessful attempt of a Netherlands company to acquire Financial General Bankshares, Inc., a large American holding company with subsidiary banks in Washington, D.C., Maryland, New York, Tennessee, and Virginia.[9] There have been rumors that other major acquisitions are being planned,[10] and, unless permanent restrictions are enacted, it is unlikely that either

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that carries on most banking activities, but may not normally accept deposits or exercise fiduciary powers. A representative office is one that does little more than generate and maintain contact with customers on behalf of the foreign bank. *See* U.S. DEP'T OF COM., FOREIGN BANKING IN THE UNITED STATES (1976), *reprinted in* 4 U.S. DEP'T. OF COM., FOREIGN DIRECT INVESTMENT IN THE UNITED STATES, App. F, at F-5 to F-10 (1976) [hereinafter cited as FOREIGN BANKING IN THE U.S.].

3 Depository Institution Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, tit. 9, 94 Stat. 132 (1980).

4 *Id.*

5 The exceptions include acquisitions that were pending on March 5, 1980; takeovers that are necessary to prevent bankruptcy or insolvency; acquisitions of banks having less than $100 million in deposits; reorganization; acquisitions of banks that already are owned by a foreign person; and acquisitions related to an order of divestiture to a holding company. *Id.*

6 H. REP. No. 842, 96th Cong., 2d Sess. 85, *reprinted in* [1980] FED. BANKING L. REP. (CCH), No. 808, Part II (Mar. 28, 1980).

7 The Bank Holding Company Act, 12 U.S.C. § 1842(a) (1976), requires prior approval by the Board of all acquisitions of banks by bank holding companies.

8 Standard Chartered Bank, Ltd., 65 Fed. Res. Bull. 350 (1979); Hongkong and Shanghai Banking Corp., *id.* at 354; National Westminster Bank, Ltd., *id.* at 357; Algemene Bank Nederland, *id.* at 658.

9 *See* Credit and Commerce American Holdings, *id.* at 254.

10 *See, e.g.*, 125 CONG. REC. S8560, S8561 (daily ed. June 26, 1979) (remarks of Sen. Heinz).

the trend of foreign acquisitions or the concern about them will soon dissipate.

This Note examines the laws governing foreign banks' acquisitions of American banks and the problems that may arise from such acquisitions. It considers whether a ban or less drastic restrictions would be desirable, and addresses the need for other changes to present banking laws which also could affect foreign acquisitions. Part I surveys the broad economic arena in which foreign acquisitions have occurred and assesses the probable economic consequences of permanent restrictions on foreign acquisitions of American banks. Part II examines the pre-moratorium regulation of foreign acquisitions under federal and state laws. It examines the criteria by which the Board assesses proposed bank acquisitions, the effect and constitutionality of state laws which regulate state bank acquisitions by foreigners, and the policy considerations which should affect state and federal control over foreign acquisitions. Finally, Part III considers the effects of foreign acquisitions on the purposes and implementation of bank holding company regulation.

I. Foreign Acquisitions and Economic Policy

Assessment of the desirability of foreign acquisitions of American banks requires at the outset a consideration of the overall economic framework in which these acquisitions have taken place. Since that framework involves both the international and the American banking markets, the first step toward understanding involves a brief sketch of the role of foreign acquisitions in their international and domestic contexts.

From one perspective, the recent spate of acquisitions represents a logical and predictable consequence of the internationalization of banking since World War II.[11] United States banks led the way in this movement, establishing branches, agencies, and sometimes even banking subsidiaries in countries in which American industrial and commercial firms did business.[12] More recently, as

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11 *See generally* Foreign Banking in the U.S., *supra* note 2, at F-2 to F-5; Note, *Foreign Banking in the United States*, 6 Vand. J. Transnat'l L. 595 (1973).

12 *See* U.S. Dep't of Com., Foreign Banking in the U.S., *supra* note 2, at F-3; U.S. Dep't of the Treasury, Report to Congress On Foreign Government Treatment of

foreign corporations have begun to invest heavily in the United States,[13] foreign banks also increased dramatically their operations in this country.[14] Through their United States offices, foreign banks are able to perform numerous services for parent banks and their foreign-based customers, particularly when the latter have significant American subsidiaries or other operations. The large volume of United States foreign trade — an activity in which foreign banks typically have been more experienced than American banks — and the role of the dollar as a medium of international payments also have drawn foreign banks to the American banking market.[15]

However, the fact that banking has become an international activity does not fully explain the recent wave of acquisitions. Besides acquisitions, many states now allow foreign banks to establish operations in the United States *de novo* through any of several forms of entry, and either a branch bank or a *de novo* banking subsidiary would permit a foreign bank to offer full-service operations.[16] Therefore, other market forces must be investigated to explain the attractiveness of acquisitions as a method of entry.

A partial explanation comes from the fact that acquisition of an established bank is the most effective way for a foreign bank to penetrate the American banking market. *De novo* entry generally has proven difficult, and foreign banks have had only modest success in attracting depositors away from established domestic banks especially in the highly competitive retail banking market.[17] Ac-

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U.S. COMMERCIAL BANKING ORGANIZATIONS 5-11 (1979) [hereinafter cited as FOREIGN GOVERNMENT TREATMENT OF U.S. BANKS].

13 On increasing foreign direct investment in the United States, *see* Note, *The Rising Tide of Reverse Flow: Would a Legislative Breakwater Violate U.S. Treaty Commitments?*, 72 MICH. L. REV. 551 (1974).

14 In 1972, foreign banks' assets in the United States totalled $35 billion, a figure which, by 1975, had increased to $61.9 billion. By 1978, there were 122 different foreign banks conducting business in the United States, with combined assets of $90 billion. Rooney, *Regulation of Foreign Banking Activity in the United States*, 10 ST. MARY'S L.J. 483, 483-84 (1979). *See also* D'Arista, *Foreign Bank Activities in the United States*, in HOUSE COMM. ON BANKING, CURRENCY AND HOUSING, 94TH CONG., 2D SESS., FINANCIAL INSTITUTIONS AND THE NATION'S ECONOMY (FINE), COMPENDIUM OF PAPERS PREPARED FOR THE FINE STUDY 731-80 (Comm. Print 1976).

15 FOREIGN BANKING IN THE U.S., *supra* note 2, at F-3 to F-4.

16 *See* note 2 *supra*.

17 Field, *Foreign Banks in New York: Biting into the Big Apple*, EUROMONEY, June 1978, at 49, 54. A "retail" bank deals primarily with small individual and commercial

quisition of an ongoing bank, with an established clientele, alleviates this problem.[18] Short-term trends also have made acquisitions attractive. For example, devaluation of the dollar relative to other major currencies in the 1970's provided an incentive for foreign direct investment in the United States,[19] and that incentive was intensified by the relative bargains available in recent years in American bank stocks.[20]

Because market forces account for the recent surge of foreign acquisitions, restrictions or a permanent prohibition might significantly disrupt the world banking market. Banking in the United States already is a highly regulated industry, and federal restrictions on interstate and anticompetitive acquisitions have severely limited the number of domestic holding companies that may acquire additional banks.[21] In view of that strict regulation, no permanent restrictions should be imposed until and unless the desirable and undesirable market effects have been weighed.

As a matter of economic theory, free trade (including direct investment) across national borders generally should promote efficiency.[22] Although direct investment in financial intermediaries such as banks is not the equivalent of direct investment in commercial industries, the similarities are close enough that there is not an *a priori* reason to depart from the general principle that free trade promotes efficiency.[23] Therefore, one effect of permanent restrictions on acquisitions would be the curtailment of internationalization and integration of the financial markets, or, in other words, the curtailment of the flow of capital across national borders and

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customers. A "wholesale" bank caters to more wealthy individuals, large commercial organizations, and institutional customers.

18 *Cf. European-American Bank and Trust,* 66 BANKING 54 (1974) (attractiveness of Franklin National Bank's retail network to foreign bank seeking to expand its American operations).

19 *See* FOREIGN BANKING IN THE U.S., *supra* note 2, at F-19.

20 *International Banking Act of 1978: Hearings Before the Subcomm. on Financial Institutions of the Senate Comm. on Banking, Housing and Urban Affairs,* 95th Cong., 2d Sess. 80 (1978) (statement of John Heimann) [hereinafter cited as *International Banking Act Hearings*]; *Edge Corporation Branching, Foreign Bank Takeovers, and International Banking Facilities: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs,* 96th Cong., 1st Sess. 18 (1979) (statement of Robert Carswell) [hereinafter cited as *1979 Hearings*].

21 12 U.S.C. § 1842(c)-(d) (1976 & Supp. II 1978).

22 R. CAVES & R. JONES, WORLD TRADE AND PAYMENTS 12-18, 22-24 (2d ed. 1977).

23 *See* Aliber, *Towards a Theory of International Banking,* FED. RES. BANK OF S.F. ECON. REV., Spring 1976, 5 at 5 (international banking may be analyzed in terms of both international trade theory and industrial organization theory).

the inhibition of efficiency.[24] Of course, permanent restrictions on acquisitions would not affect foreign banks' ability to establish branches or *de novo* subsidiaries, nor would such restrictions completely destroy the international capital markets. However, because acquisitions constitute the most effective method of entry into the American market, restrictions probably would prevent some banks that otherwise would have done so from establishing significant American operations.

Permanent restrictions on foreign banks' entry into this country also might lead to economic retaliation abroad. Federal banking authorities consistently have feared that the construction of artificial entry by foreign banks would make those banks' home countries less hospitable toward American banks.[25] Similarly, concern about retaliation abroad might explain why executives of large American banks which are likely to have numerous offices overseas oppose restrictions on foreign acquisitions, while spokesmen for smaller banks and those which are unlikely to do significant business in other countries favor them.[26] Foreign bankers faced with a bewildering array of state restrictions on entry also have been vocal in criticizing perceived discrimination against them in this country; they may react strongly against further "protectionist" legislation.[27] Retaliation abroad in response to restrictions on foreign acquisitions here may be unjust, because few foreign countries now permit American banks to acquire their banks.[28] Just or unjust, however, retaliation has occurred in the past in response to other restrictions, and its potential cannot be

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24 *See* Edwards, *Regulation of Foreign Banking in the United States: International Reciprocity and Federal-State Conflicts,* 13 COLUM. J. TRANSNAT'L L. 239, 241-43, 257 (1974).

25 *E.g., International Banking Act Hearings, supra* note 20, at 61 (statement of Robert H. Mundheim).

26 For the attitudes of spokesmen for large banks, *see 1979 Hearings, supra* note 20, at 295 (statement of Richard Thomas), 350-52 (letter from James O. Boisi); Rose, *A Touch of Zenophobia,* AM. BANKER, May 22, 1979, at 4. For the attitudes of spokesmen for smaller banks, *see 1979 Hearings, supra* note 20, at 503 (letter from Independent Bankers Ass'n of America).

27 *See* Reimpall, *U.S. Plans to Restrict Foreign Banks Leave a Bad Taste in German Mouths,* EUROMONEY, Sept. 1976, 61, at 61-62. *See also* O'Brien, *United States Sets the Boundaries for Foreign Banks,* 128 THE BANKER (LONDON) 15 (1978) (mildly criticizing U.S. for not adopting principle of reciprocity).

28 FOREIGN GOVERNMENT TREATMENT OF U.S. BANKS, *supra* note 12, at 25-27 (Table 5.8). Foreign governments' protectionism may be explained by the fact that the banking,

dismissed lightly.[29] Enactment of permanent restrictions on foreign acquisitions thus might trigger a wave of retaliatory actions abroad, which would magnify the adverse effects of American restrictions on the international capital markets.

Enactment of permanent restrictions could have harmful consequences in the United States as well. One probable effect is added distortion in the market for banks and bank stocks. That market already is distorted by geographical restraint on acquisitions so severe that foreign holding companies are often the only ones that may purchase controlling shares of sizable American banks.[30] Therefore, permanent restrictions on foreign acquisitions would be likely further to cripple the market for bank stocks and further depress their prices.[31]

Another likely effect of permanent restrictions is reduced competition within domestic banking markets. Foreign banks in this country generally have been vigorous competitors, especially for commercial and industrial loans.[32] Their principal weapon in this competition has been interest-rate cutting. Anecdotal evidence at least suggests that when foreign banks have entered a local market and begun lending below the going rate, local banks have responded by reducing their own interest rates.[33] In some instances, resulting interest rates have been below the prime lending rate. Although a prohibition on foreign acquisitions would not entirely destroy this price competition (because foreign branches would

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systems in most countries, unlike that in the United States, are dominated by a few huge institutions. *See, e.g., id.* at 55 (France), 59 (West Germany), 73 (Japan), 101 (United Kingdom). Hence a foreign acquisition of a bank in such a country would have a much greater impact than a foreign acquisition of an American bank.

29 Harrison, *Reciprocity in International Banking,* 160 BANKERS MAGAZINE *(Boston)* 31-32 (1977) (there have been cases where the absence of reciprocity in some American states has impeded, or at least delayed, the granting of a license to U.S. banks in Italy); FOREIGN GOVERNMENT TREATMENT OF U.S. BANKS, *supra* note 12, at 20-21, 135-36.

30 *See* note 89 *infra* and accompanying text.

31 *1979 Hearings, supra* note 20, at 27 (statement of Henry C. Wallich).

32 Gulkowitz, *Foreign Banking in the U.S. — End of the Honeymoon,* 129 BANKER (LONDON) 41, 42 (June 1979).

33 Field, *Foreign Banks in New York: Biting into the Big Apple,* EUROMONEY, June 1978, at 54. *See also* Terrell & Key, *The Growth of Foreign Banking in the United States: An Analytical Survey,* in FED. RES. BANK OF BOSTON, KEY ISSUES IN INTERNATIONAL BANKING 54, 58 (1977) ("The expected long-run results of this increased competition should be smaller net interest spreads on domestic U.S. lending and a closer convergence between domestic and Euro-currency spreads.").

continue to compete with domestic banks),[34] severe restrictions on or prohibitions of foreign acquisitions of American banks would be likely to produce a net decrease in the level of price competition by reducing the overall presence of foreign banks in the United States.

It has been suggested that, in one respect, this competition may be harmful. According to this argument, foreign banks have a competitive advantage over American banks in that foreign banks enjoy easier access than American banks to cheap Eurodollars, which enables the foreign banks to cut interest rates at lower costs. American banks, the argument continues, are forced to lower their rates even if they do not have easy access to cheap funds, and may be weakened by the increased competition and resulting lower profit margins.[35] However, this argument is unpersuasive. It ignores the fact that American banks, through their European branches, participate actively already in the Eurodollar market and that American banks abroad have been just as vigorous as foreign banks here in price competition.[36] Indeed, absent a more persuasive argument to the contrary, price competition should be viewed as a healthy result and a worthwhile goal of foreign banking in this country.

Prohibiting foreign acquisitions could harm long-run competition in yet another way. For example, if foreign holding companies were not permitted to acquire American banks at all, then the salvaging of failing banks through merger or acquisition by other American banks would become even more common. While current law permits acquisition of a failing bank by a competitor, acquisition by a foreign holding company without existing American bank affiliations is more consistent with general antitrust policy.[37]

34 *See* sources cited in note 33 *supra* (in discussing price competition, writers do not differentiate between foreign branches and foreign-owned subsidiaries).

35 Cohen, *The Impact of Foreign Direct Investment on U.S. Cities and Regions,* in *1979 Hearings, supra* note 20, at 471.

36 For a description of American banks' Eurodollar activities, *see* INTERNATIONAL BANKING: A SUPPLEMENT TO A COMPENDIUM OF PAPERS PREPARED FOR THE FINE STUDY, STAFF REPORT OF THE HOUSE COMM. ON BANKING, CURRENCY AND HOUSING, 94TH CONG. 2D SESS. 71-83 (1976). For a discussion of the price competition of U.S. banks abroad, *see* Fieleker, *The Growth of U.S. Banking Abroad: An Analytical Survey,* in FED. RES. BANK OF BOSTON, KEY ISSUES IN INTERNATIONAL BANKING 8, 33 (1977).

37 Acquisitions of failing banks by competitors are permitted by section 3(c) of the Bank Holding Company Act, 12 U.S.C. § 1842(c) (1976). For the role of foreign banks in pro-

The existence of this alternative has been important in the past: foreign banks have acquired a number of American banks that were in danger of failing.[38] Therefore, even if a permanent ban were imposed, an exception should be made for acquisitions of failing banks to mitigate the anticompetitive effects of a total prohibition. Indeed, the law which imposed the moratorium contains such an exception.[39] However, a "failing bank" exception presumably would apply only if the acquired bank's conditions were critical. Banks that need an injection of capital, but that are not in danger of immediate insolvency, would have to seek an acquisition partner among domestic holding companies — firms which might be at least potential competitors — because the alternative of a foreign acquisition would not be available.[40] Competition will be better served if foreign acquisitions are permitted.

Apart from considerations of competition and market efficiency, foreign acquisitions also help the nation's economy by strengthening the short-run balance of payments. Foreign holding companies which have acquired American banks have injected large amounts of capital in the form of consideration for the acquired bank's stock and in the form of substantial capital contributions to the subsidiary bank.[41] Over a longer term, of course, some or all of this capital will be repatriated through dividends or changes for intercompany transactions. While long-term effects may be difficult to assess, at least the short-term effect of foreign acquisitions on the balance of payments has been positive.[42]

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viding a better alternative to acquisition by competitors, *see* text accompanying notes 60 to 76 *infra.*

38 The most important example was the acquisition of New York's Franklin National Bank by the European-American Bank and Trust Company, which is discussed in more detail at text accompanying notes 73 to 76 *infra.* For other examples, *see* Banco de Santander, 62 Fed. Res. Bull. 690 (1976); Banco Centra, S.A., 63 Fed. Res. Bull. 741 (1977); and Banco Exterior de Espana, 63 Fed. Res. Bull. 1079 (1977).

39 Pub. L. No. 96-221, tit. 9, 94 Stat. 132 (1980).

40 Courts have construed the convenience and needs (the "failing bank") exception narrowly in cases under the Bank Merger Act, 12 U.S.C. § 1828(c)(5) (1976). *See* U.S. v. Third Nat'l Bank in Nashville, 390 U.S. 171 (1968). It is therefore reasonable to assume that they would do likewise with a failing bank exception to a general prohibition of foreign acquisitions.

41 *See, e.g.,* sources cited in note 8 *supra.*

42 *See* FOREIGN BANKING IN THE U.S., *supra* note 2, at F-28 to F-29. This study, however, does not distinguish between foreign branches and subsidiaries in assessing foreign banks' impact on the balance of payments. Since establishment of a branch entails a much smaller initial capital outlay than acquisition of an on-going bank, the conclusion

On the other hand, at least one writer has suggested that foreign acquisitions may be economically harmful.[43] According to this argument, foreign banks contribute to the leakage of Eurodollars into the American economy, which offsets to some extent the effects of the Board's actions on its chief tools for regulating the money supply, the discount rate and reserve requirements. However, Eurodollar transactions need not have such an effect;[44] and, even if they do, solution of the problem would require far more extensive reform than simply prohibiting foreign acquisitions of American banks.[45] The Board's discount rates and reserve requirements apply to American subsidiaries of foreign banks to the same extent that they apply to foreign-held American banks. Therefore, even if foreign acquisitions were prohibited, American branches of foreign banks could still serve as conduits for the importation of Eurodollars.[46] It is illuminating that the Board still has opposed restrictions on foreign acquisitions.[47]

Yet, even though economic considerations appear to favor foreign acquisitions, noneconomic or "second-best" arguments may provide sufficiently compelling reasons to justify imposing permanent restrictions on foreign acquisitions of American banks.[48] The two most important of these arguments are that foreign control of American banks may pose a significant danger to the country's economic independence or to a fair rationing of credit during tight credit periods. The arguments essentially are that the stock holdings of bank trust departments and the banks'

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that the net gains have been relatively small almost certainly understates the short-term gains resulting from acquisitions. *See id.* at F-15 (unusually large inflow of capital in 1974 due to acquisitions).

43 Cohen, *The Impact of Foreign Direct Investment on U.S. Cities and Regions*, in *1979 Hearings*, *supra* note 20, at 471.

44 Wood & Mudd, *Do Foreigners Control the U.S. Money Supply?*, 59 FED. RES. BANK OF ST. LOUIS MONTHLY REV. 8 (1977) ("The extent to which transactions in the Eurodollar market can affect M_1, and thereby make more difficult the Federal Reserve's task of monetary control, is at most very small").

45 *See generally* Schnitzel, *Euro-Dollar Growth and U.S. Monetary Policy*, 8 AKRON BUS. & ECON. REV. 33 (1977).

46 Foreign branches have generally complied with the Board's requests to maintain reserves in the form of non-interest bearing accounts on net Eurodollar borrowings above a certain level. Terrell & Key, *supra* note 33, at 63 n.24. The International Banking Act of 1978 partially alleviated the problem by allowing the Board to subject deposits at federal branches of foreign banks to reserve requirements. 12 U.S.C. § 3105(a) (Supp. II 1978).

47 *1979 Hearings*, *supra* note 20, at 36 (testimony of Henry C. Wallich).

48 *See* C. KINDLEBERGER, INTERNATIONAL ECONOMICS 265 (5th ed. 1973).

control of credit give banks inordinate influence over the policies and managements of commercial and industrial firms, and that foreign control of banks could mean indirect foreign control over important and, perhaps, strategic sectors of the economy.[49] These arguments have several weaknesses. First, there is no evidence that foreign banks entering the American market have had any motives other than making a profit.[50] Second, the arguments ignore strong evidence that institutional investors, including bank trust departments, rarely have used their voting power to oppose a company's management. If an institutional investor disagrees with a company's policies, the institution usually will sell its stock rather than risk economic loss in an attempt to influence the company's management.[51] There is no reason to suspect that the trust department of banks that are owned by foreign holding companies systematically would behave any differently than other institutional investors. And while banks have been able to influence corporate policies through their power to extend or withhold credit,[52] it is unlikely that foreign-owned banks would influence American corporations in a manner that is detrimental to American national interest. To reach a contrary conclusion, one must make three tenuous assumptions. First, one must assume that foreign-owned banks would use their control of credit to impose terms in loan agreements that have nothing to do with protection of the loans themselves, such as negative covenants regarding payment of dividends or sale of assets, in order to influence corporations to follow policies that somehow benefited the bank's home country or its philosophy rather than the bank itself. Since no evidence has been adduced to indicate that foreign-owned banks are inclined to operate in such nonprofit-maximizing ways, this objection must remain, at most, entirely theoretical.[53] Second, one must assume

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49 FOREIGN INVESTMENT IN THE UNITED STATES: HEARINGS BEFORE THE SUBCOMM. ON FOREIGN ECONOMIC POLICY OF THE HOUSE COMM. ON FOREIGN RELATIONS, 93D CONG., 2D SESS. 160-64 (Comm. Print 1974) (remarks of Rep. Wolff).

50 The evidence overwhelmingly supports the inference that foreign banks have come to the United States solely for business purposes. *See* Terrell & Key, *supra* note 33, at 55, and text accompanying notes 17 to 18 *supra.*

51 Solomon, *Institutional Investors: Stock Market Impact and Corporate Control,* 42 GEO. WASH. L. REV. 761, 781-86 (1974).

52 *Id.* at 784-85.

53 In some ways, including the types of assets they hold, foreign-owned subsidiary banks behave much like domestic banks. *See* Terrell & Key, *supra* note 33, at 76 to 79.

that they would have such a monopoly of lendable funds that they would be able to impose such conditions on their loans. Foreign-owned banks are not likely ever to attain this degree of power in the highly dispersed American banking market.[54] Third, one must assume that if additional regulation existed to enforce a "fair" allocation of credit, foreign-owned banks would not abide by such legally imposed restrictions. Yet, foreign-owned banks probably will be as likely as domestically owned banks to obey the law; if not, they will suffer the consequences. Therefore, the fear that foreign banks might somehow control any important sector of the American economy is not a persuasive second-best argument for imposing permanent restrictions.

In sum, general economic considerations argue against restricting foreign acquisitions. Permanent restrictions would further distort an already heavily regulated market, a result that could be magnified by retaliation abroad against American banks. Permanent restrictions would eliminate a source of foreign investment in the United States, thus hurting the nation's short-term balance of payments position. Domestic competition might also suffer to the extent that new restrictions would lead to an overall decrease in foreign banking presence and to the extent that a better alternative to acquisitions of banks by local competitors would no longer be available. Permanently restricting foreign acquisitions would be likely to have no significant effect on the Eurodollar market or the Board's ability to control the money supply. Finally, experience and logic suggest that foreign acquisitions of American banks need not endanger the nation's economic independence.

II. The Regulation of Bank Acquisitions

Foreign holding companies, like domestic holding companies, are subject to regulation at the federal level and often at the state level as well when they seek to acquire banks. The question explored in this Part is whether changes are needed in state or federal regulation of American banks by foreign holding companies.

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54 According to a member of the Board, in 1979, foreigners owned "only a tiny fraction of our more than 14,000 banks." Even including the acquisitions that the Board approved last year, the total assets of banks that have been acquired by foreign holding companies account for only 3 percent of all U.S. commercial bank assets. *1979 Hearings, supra* note 20, at 7 (statement of Henry C. Wallich).

A. *Federal Regulation of Foreign Acquisitions*

The basic pre-moratorium framework of federal regulation of bank acquisitions is provided by the Bank Holding Company Act.[55] Defining a bank holding company to include every company that through stock ownership or otherwise controls any American bank,[56] the Act makes it unlawful for a holding company to be formed or for an existing holding company to acquire a new bank without prior approval of the Federal Reserve Board.[57] The Board is required to solicit the views of the Comptroller of the Currency if the acquired bank is nationally chartered, or of state regulators if the acquired bank is state-chartered; final authority to approve or disapprove any application nonetheless rests with the Board, based upon its findings concerning the competitive effects of the acquisition, the financial and managerial resources of the institutions involved, and the convenience and needs of the community.[58]

The Bank Holding Company Act does not contain any special criteria by which proposed acquisitions by foreign persons are to be judged, and in evaluating foreign acquisitions the Board examines the same factors it relies upon in cases involving domestic holding company acquisitions.[59] Therefore, the criteria for evaluating proposed acquisitions appear neutral as far as the nationality of the acquiring company is concerned. In practice, however, these criteria tend to favor foreign over domestic holding company acquisitions: application of the statutory criteria frequently leads to disapproval of acquisitions by domestic holding companies, while it almost inevitably leads to approval of acquisitions by foreign holding companies.

This is most evident in the Board's consideration of the competitive effects of proposed acquisitions. Section 3(c) of the Act directs the Board to disapprove any acquisition that would tend to result in a monopoly or would promote any conspiracy or attempt to monopolize banking in any part of the United States. Addition-

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55 12 U.S.C. §§ 1841-1850 (1976 & Supp. II 1978).

56 *Id.* at § 1841(a) (1976).

57 *Id.* at § 1842(a) (Supp. II 1978).

58 *Id.* at § 1842(b).

59 Board of Governors of the Federal Reserve System, Statement of Policy on Supervision and Regulation of Foreign Bank Holding Companies, [1979] FED. BANKING L. REP. (CCH) ¶ 97,275.

ally, the Board may not approve an acquisition whose effect would be to lessen competition in the relevant market or tend to create a monopoly, unless the anticompetitive consequences are outweighed by positive effects on the convenience and needs of the community.[60] For example, if the holding company controls even a small bank that already competes directly with the bank to be acquired, the Board interprets this section strictly and is likely to disapprove the acquisition.[61] However, if the holding company controls a bank in another part of the state — so that the acquisition would eliminate only potential competition by foreclosing the possibility that the holding company would enter the market *de novo* — the Board is more likely to approve the acquisition.[62] Yet, even in the latter case, the Board has disapproved applications for acquisition of relatively large banks by the larger holding companies in the state on the ground that such acquisitions tend to increase the concentration of holding companies within the state.[63]

In contrast, acquisitions by foreign banks almost never pose serious anti-competitive concerns even though the foreign banks that have purchased American banks, like the American banks that they have purchased, tend to be extremely large. For example, the four foreign banks whose acquisitions of American banks were approved in 1979 ranged in size from the thirteenth to the seventieth largest commercial banks in the non-Communist world.[64] Even before their acquisitions of American banks, the four foreign banks had assets ranging from $13 billion to $38.5 billion, and the banks they acquired ranked from sixth to thirteenth in their respective states.[65] Even the relatively small foreign banks that

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60 12 U.S.C. § 1842(c) (1976).

61 *See* Austin & Hakala, *Bank Holding Company Formation and Acquisition: How To Tell If the Fed Is Likely to Say No,* 95 BANKING L.J. 213, 238-39 (1978) [hereinafter cited as Austin & Hakala].

62 *E.g.,* First Florida Bancorporation, 59 Fed. Res. Bull. 183 (1973).

63 *See* Austin & Hakala, *supra* note 61, at 239.

64 Standard Chartered Bank, Ltd., 65 Fed. Res. Bull. 350, 350 (1979) (70th largest bank); Hongkong and Shanghai Banking Corp., *id.* at 354 (67th largest bank in the "free world"); National Westminster Bank Ltd., *id.* at 358 (13th largest bank in the "free world"); Algemene Bank Nederland, *id.* at 659 (27th largest bank in the "free world").

65 Standard Chartered Bank, Ltd., 65 Fed. Res. Bull. 350, 351 (1979) (acquired sixth largest bank in state); Hongkong and Shanghai Banking Corp., *id.* at 354 (acquired seventh largest bank in state); National Westminster Bank, Ltd., *id.* at 358 (acquired thirteenth largest bank in state); Algemene Bank Nederland, *id.* at 659 (acquired sixth largest bank in state).

have purchased American banks have been among the largest financial institutions in their own countries.[66] Yet these acquisitions have been possible because the strictly foreign banks, by definition, have not been significant competitors in the American banking market. A foreign bank with only a representative office or an agency in this country does not compete in the retail banking market.[67] Moreover, where foreign banks do compete with potential American targets through branches or subsidiaries, the Board generally has found the degree of competition to have been insignificant.[68] Although several foreign banks have entered American markets *de novo* by establishing new banking subsidiaries,[69] the Board has tended to underemphasize the likelihood of that occurrence. Generally speaking, elimination of potential competition has not been seriously considered in the Board's decisions on foreign acquisitions.[70] The conclusion that emerges is that antitrust considerations are unlikely ever to lead to rejection of a foreign acquisition by the Board.

Furthermore, even though the strict antitrust concerns that restrict domestic acquisitions are mitigated somewhat by the "convenience and needs" exception in section 3(c), for an otherwise anticompetitive acquisition to be approved under this exception, proponents must show that the bank to be acquired is in danger either of failing or of becoming financially unsound, and that efforts to resolve its difficulties by less anticompetitive means have failed.[71] This means, in the words of the general counsel of the

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66 Royal Trust Co., 58 Fed. Res. Bull. 665 (1972) (acquiring bank had assets of $1.6 billion and was largest trust company in Canada); Banco de Santander, 62 Fed. Res. Bull. 690 (1976) (deposits of $3.2 billion).

67 *E.g.*, Banco Nacional de Mexico, 64 Fed. Res. Bull. 448, 448 (1978) (largest commercial bank in Mexico, with two agency offices in the United States, did not compete with acquired bank).

68 *E.g.*, Algemene Bank Nederland, 65 Fed. Res. Bull. 658 (1979) (branch); Standard Chartered Bank, Ltd., *id.* at 350 (subsidiary bank).

69 *E.g.*, Banco di Roma, 58 Fed. Res. Bull. 930 (1972); The Mitsubishi Bank, *id.* at 50; The Kyowa Bank, Ltd., 64 Fed. Res. Bull. 492 (1978); Mizrahi Holdings Ass'n, 65 Fed. Res. Bull. 319 (1979) (all approving establishment of *de novo* subsidiaries).

70 *See, e.g.*, Banco Nacionale de Mexico, 64 Fed. Res. Bull. 488 (1978) ("While it appears that Applicants could enter the relevant market *de novo*, in view of Bank's size and market position, as well as the fact that the market is highly competitive, consummation of this proposal would have no significant effect on potential competition.").

71 *See* United States v. Third Nat'l Bank in Nashville, 390 U.S. 171, 187-89 (1968) (construing convenience and needs test under Bank Merger Act); Via, *Antitrust and the Rescue of Distressed Banks by Acquisition*, 94 BANKING L.J. 508 (1977).

Federal Deposit Insurance Corporation, that antitrust problems "may be a major consideration" even when bank regulators are attempting to locate a purchaser of a failing bank.[72] The case of New York's Franklin National Bank, which in 1974 became the largest American bank ever to fail, is instructive. Before the bank formally was declared insolvent, its management sought local partners for merger or acquisition. Franklin's size ruled out all but the largest banks; all of the potential purchasers were concerned about antitrust problems, and one, which was particularly interested in acquiring Franklin, demanded prior assurance that the transaction would not lead to charges of violating the antitrust laws.[73] While federal authorities were willing to accept an acquisition by one of the largest local banks,[74] potential antitrust problems were obviated because the highest and ultimately the successful bidder for Franklin was the European-American Bank and Trust Company, a wholesale bank that was owned by a consortium of European banks. By the nature of its business, European-American hardly competed in the New York retail market to which Franklin's branches gave it access.[75] As the Franklin case illustrates, acquisition by a foreign holding company will be preferable in many instances to acquisition by a local one, because of the less serious potential antitrust problems.[76] Therefore, the convenience and needs clause does not negate the advantage of foreign banks over domestic ones under the antitrust criteria of section 3.

Similar results follow from consideration of the other statutory criteria, which focus upon the financial and managerial resources of the banks involved and the convenience and needs of the community affected. Although these factors have not been so important as the competitive effect factor in the Board's decisions on

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72 Bransilver, *Failing Banks: FDIC's Options and Constraints,* 27 AD. L. REV. 327, 339 (1975).

73 M.A. SCHAPIRO & CO., BANK STOCK Q., May 1978, at 18, *reprinted in* INTERNATIONAL BANKING ACT OF 1978: HEARINGS BEFORE THE SUBCOMM. ON FINANCIAL INSTITUTIONS OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 95TH CONG., 2D SESS. 371-72 (Comm. Print 1978); Rose, *What Really Went Wrong at Franklin National,* 90 FORTUNE, Oct. 1974, at 225.

74 *See* Sinkey, *The Collapse of Franklin National Bank of New York,* 7 J. BANK RESEARCH 113, 115 & n.4 (1976).

75 *European-American Bank and Trust,* 66 BANKING, Nov. 1974, at 54-55.

76 *See, e.g.,* FOREIGN BANKING IN THE U.S., *supra* note 2, at F-23.

proposed acquisitions, weak holding company management and capital position have provided the basis for a number of rejections. Most frequently, the Board has denied applications when the holding companies were highly leveraged or when they planned to finance an acquisition with debt rather than equity capital: the Board has feared that such situations posed the danger of a future drain on the bank's resources.[77]

Less frequently, the Board has disapproved of acquisitions because of unsatisfactory past performance by the holding company management.[78] Very few of these cases involved foreign investors. However, in one case of a denied application, the central figure was a foreign individual investor with an especially unsavory record.[79] In another, the applicant was a small second-mortgage lender, based in London with deposits of only $94.7 million. The applicant sought to purchase majority control of a small national bank in New York state. The Board withdrew its initial approval after learning that the applicant was suffering financial difficulties.[80] These two cases are atypical, and they do not negate the general conclusion that foreign banks generally fare well under the criteria related to banking factors.[81]

In addition, the foreign-controlled institutions that successfully have purchased American banks have been strong financially and managerially. Accordingly, the Board consistently has found that proposed foreign acquisitions would benefit both the acquired banks and the local communities. Benefits usually have been found to derive from the foreign parents' infusion of new capital into the American banks and from the parents' managerial

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77 Austin & Hakala, *supra* note 61, at 237-38.

78 *Id.* at 234-35.

79 In this case, the proposed holding company would have been controlled by Adnan Khashoggi of Saudi Arabia, who was under investigation by the Department of Justice and the SEC in connection with alleged illegal payments by American companies. Security Bancorp, 64 Fed. Res. Bull. 405, 406-09 (1978).

80 Cedar Holdings, Ltd., 60 Fed. Res. Bull. 37 (1974). *See also* Gardner, *Foreign Investment in United States Banking,* in FOREIGN INVESTMENT IN THE UNITED STATES 396 & n.4 (P. Marans *et al.,* eds. 1978).

81 This case was unusual both because the foreign company was so small and because, under English law, it was not strictly a bank and it would have had to distribute most of the acquired bank's shares to its own institutional shareholders, a factor which complicated the decision. Cedar Holdings, Ltd., 60 Fed. Res. Bull. 37 (1974).

resources that are made available to the American banks.[82] The Board has stressed with monotonous regularity that the acquisitions would enhance the ability of the acquired American banks to compete in international banking, due to the greater expertise of the foreign banks' managements in this area.[83] Some acquisitions also have been found beneficial because of the foreign parents' ability and willingness to cater to the needs of particular ethnic groups served by the American targets.[84] The Board's positive findings concerning the financial and managerial resources of foreign banks, and the effects on the convenience and needs of the communities involved, may simply reflect a process of self-selection: the foreign banks with the desire and ability to enter the American market through acquisitions are the ones with the abundant financial resources, competent and aggressive managements, and experience in international trade.[85] Because the acquisitions have made these resources available to American banks, approval has been merely automatic.

However, one additional statutory limitation on acquisitions needs to be considered. Section 3(d) of the Bank Holding Company Act prohibits approval of any acquisition across state lines, unless expressly permitted by the law of the acquired bank's state.[86] This provision has the effect of prohibiting a bank in one state from acquiring a bank in any other state,[87] while permitting a foreign holding company to acquire its first American bank. Unlike the competitive factors that must be considered under sec-

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82 *See, e.g.*, National Westminster Bank, Ltd., 65 Fed. Res. Bull. 357, 358-59 (Board noted commitment to inject at least $25 million into the acquired bank, and stressed the competence of the foreign parent's management).

83 *E.g.*, Standard Chartered Bank, Ltd., *id.* at 350, 352; Lloyds Bank, Ltd., 60 Fed. Res. Bull. 125-26 (1974). On the greater expertise of foreign banks in international trade, *see* FOREIGN BANKING IN THE U.S., *supra* note 2, at F-3 to F-4. *But see* text accompanying notes 238 to 239 *infra*.

84 Banco Exterior de Espana, 63 Fed. Res. Bull. 1079 (1977). This reasoning by the Board is not necessarily inconsistent with the position taken in Part I, that foreign acquirers are also profit maximizers.

85 *Cf.* R. CAVES & R. JONES, WORLD TRADE AND PAYMENTS: AN INTRODUCTION 166 (2d ed. 1977) (foreign investment is seldom undertaken by a company before it becomes an established seller in its domestic market).

86 12 U.S.C. § 1842(d) (1976).

87 Maine allows acquisitions by out-of-state holding companies, but only if the law of the acquiring company's state would allow a Maine holding company to purchase a bank there. ME. REV. STAT., tit. 9-B § 1013(2) (Supp. 1978).

tion 3(c), the interstate prohibition cannot be overcome by a showing that an acquisition will serve the community's convenience and needs. Therefore, even in the case of a failing bank where acquisition may be necessary, an out-of-state holding company cannot come to the rescue. Acquisition by a foreign bank may be the only alternative to failure, especially if the troubled bank is too large for acquisition by an in-state bank.[88] When failure is not imminent, so that antitrust considerations are not tempered by the convenience and needs exception, the combined effect of sections 3(c) and 3(d) often is to prevent an acquisition by *any* American bank holding company. As a member of the Board has remarked concerning these two sections, "the implication is that a sizeable domestic bank seeking sale or merger (or perhaps a large injection of capital in a depressed stock market) may be forced to look abroad for a partner."[89]

The Board has stated that in evaluating proposed foreign acquisitions it has considered — presumably under the rubric of convenience and needs — the degree of foreign banking presence in the market affected by the acquisition.[90] However, the Board has not stated how much weight it has given to this consideration, or what the foreign market share must be in order to tip the balance against approval. Where the Board purportedly has considered this factor it has given the factor little weight. Indeed, the Board made such a statement in its decisions approving the applications of the National Westminster Bank to acquire the eleventh largest bank in the metropolitan New York market (with 1.9 percent of the commercial bank deposits), and the Hong Kong and Shanghai Banking Corporation to acquire the ninth largest bank in the same market (with 2.5 percent of the deposits).[91] Even prior to these acquisitions, New York had had the heaviest concentration of

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88 Holland, Statement before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Currency and Housing, July 16, 1975, *reprinted in* 61 Fed. Res. Bull. 419, 424 (1975) [hereinafter cited as Holland, Statement].

89 Address by Paul A. Volcker, 26th International Monetary Conference, June 1979, in *1979 Hearings, supra* note 20, at 293.

90 National Westminster Bank, Ltd., 65 Fed. Res. Bull. 357, 358 n.5 (1979); Hongkong and Shanghai Banking Corp., *id.* at 354, 355 n.4.

91 National Westminster Bank, Ltd., *id.* at 357, 358; Hongkong and Shanghai Banking Corp., *id.* at 354, 355.

foreign banks among the nation's cities.[92] Therefore, the degree of foreign concentration has been no more likely than the criteria in section 3(c) to lead the Board to disapprove a foreign acquisition.

The point of this discussion is not to imply that the Board has been mistaken in its favorable findings on foreign bank acquisitions. On the contrary, the undeniable strength of most of the acquiring banks, and the fact that foreign acquisitions are unlikely ever to pose significant antitrust problems all suggest that the Board's decisions have been both prudent and consistent with the concerns embodied in the Bank Holding Company Act. The point merely is to show that the statutory criteria almost inevitably lead to approval of foreign acquisitions. However, this conclusion suggests an additional question: whether different criteria should be used to measure the acceptability of foreign acquisitions of American banks.

In other words, because foreign acquisitions generally are consistent with the goals embodied in section 3 of the Bank Holding Company Act, the significant policy question is not whether foreign acquisitions undermine effective regulation of acquisitions under existing law, but whether the criteria which guide that regulation are appropriate. Since the existing criteria tend to favor foreign over domestic acquisitions, changing the criteria might slow the pace of foreign acquisitions. However, even assuming that this is a desirable goal, it does not justify repeal of any of the standards in section 3(c). While the antitrust criteria may be superfluous in light of the fact that the Sherman[93] and Clayton[94] Acts contain virtually identical language, and while the Justice Department may be better qualified than the Board to assess the competitive effects of an acquisition,[95] it would be difficult to argue that competitive factors should be ignored. And, even if antitrust enforcement were left to the Justice Department under the general antitrust laws, acquisitions by foreign persons still would be less

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92 *1979 Hearings, supra* note 20, at 52 (testimony of Muriel Siebert) (summarizing extent of foreign banking offices in New York); 125 CONG. REC. S8561 (daily ed. June 26, 1979) (remarks of Sen. Heinz) (proportion of loans made by foreign banks).

93 15 U.S.C. § 1 (1976).

94 *Id.* at § 18.

95 Clark, *The Regulation of Financing Holding Companies*, 92 HARV. L. REV. 787, 827 (1979).

likely to be anti-competitive than acquisitions by American persons. The convenience and needs test is vague, and its main utility is in meliorating the antitrust standards when the acquired bank is in danger of failing.[96] Abolishing this exception would put domestic holding companies at an even greater disadvantage than they now face, since more domestic acquisitions would be blocked under the antitrust criteria. Similarly, there is no reason to alter the criteria relating to the financial and managerial resources of the holding company. Because most bank failures apparently have been caused by managerial misconduct,[97] criteria that look to the holding company's management and resources are clearly important and they should not be discarded. It should be a source of comfort rather than concern that foreign holding companies usually can satisfy these criteria.

On the other hand, the prohibition of multistate acquisitions in section 3(d) cannot be justified so easily. In fact, its amendment has been urged repeatedly. For example, during and after the Franklin National Bank crisis, Franklin's management and the Board urged unsuccessfully that the section be amended to allow interstate acquisitions in emergency situations.[98] The Board has renewed the suggestion even more recently.[99] This proposal and the more radical step of repealing section 3(d) altogether merit more serious attention than they have been receiving. Repeal of the section would be responsive to the concerns expressed over the accelerating pace of foreign bank acquisitions, since such repeal would make possible many domestic acquisitions that now are flatly prohibited. Thus, repeal of the section might provide a means, short of direct restrictions or a permanent ban, of curtailing the number of foreign acquisitions. At the same time, repeal would be unlikely to have significant adverse consequences. The section's primary rationale is that it prevents undue concentration of bank ownership.[100] Not only is this danger more apparent than

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96 *See* text accompanying notes 71 to 76 *supra*.

97 Clark, *The Soundness of Financial Intermediaries*, 86 YALE L.J. 1, 12-14 (1976).

98 Barr, *The Last Days of Franklin National Bank*, 27 AD. L. REV. 301, 307-08 (1975); Holland, Statement, *supra* note 88, at 424-25.

99 *1979 Hearings*, *supra* note 20, at 7-8 (statement of Henry C. Wallich); Wall St. J., April 9, 1980, at 7.

100 Holland, Statement, *supra* note 88, at 424.

real,[101] but it also may be controlled by application of the antitrust laws. Additionally, repeal of section 3(d) would remove an artificial geographic restraint on market entry which, together with restrictions on branching and similar barriers, can shield inefficient institutions from competition.[102] Thus, even if foreign acquisitions were not of concern, there would be good reasons for repealing section 3(d). Concern over foreign acquisitions simply provides an additional reason for repeal.

Concern over foreign acquisitions also has been fueled in the past by some evidence that foreign banks have not been so active as American banks in helping to finance state and local governments.[103] Even assuming that this is a desirable role for banks, foreign-owned subsidiary banks that are acquired may be more likely than foreign-owned branches or agencies to invest in state and municipal obligations.[104] Moreover, although some local authorities fear that foreign-owned banks might concentrate more than domestically owned banks on international transactions, to the detriment of local business, no evidence has been offered to substantiate that fear.[105] Assuming that foreign-owned banks are motivated by the same market forces that guide American banks in the quest for profit, then both foreign and domestically owned banks will direct their investments to where they will bring the greatest return per unit of risk. To the extent that either nonsupport of local government or participation in international transactions brings greater profits, it should be encouraged for all banks as a means of promoting more efficient capital markets.

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101 *See* Glassman & Eisenbeis, *Bank Holding Companies and Concentration of Banking and Financial Resources: A Review*, in STAFF OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE BANK HOLDING COMPANY MOVEMENT TO 1978: A COMPENDIUM, § 8, at 10-17 (1978) [hereinafter cited as FEDERAL RESERVE STAFF COMPENDIUM] (studies indicate long-term decline in banking concentration on national and state levels).

102 Clark, *The Soundness of Financial Intermediaries*, *supra* note 97, at 34-40 (costs of various types of anticompetitive regulation, including geographical restraints on entry).

103 *1979 Hearings*, *supra* note 20, at 59 (letter from Muriel Siebert).

104 *See* Terrell & Key, *Foreign Banking in the United States*, *supra* note 33, at 77-78 (assets of foreign-owned subsidiary banks resemble those of domestic banks more closely than do assets of foreign branches).

105 *See, e.g.*, New York Dep't of Banking, Statement on Proposed Acquisition of Marine Midland by the Hongkong and Shanghai Banking Corporation, June 29, 1979 [hereinafter cited as Statement on Marine Midland], in *1979 Hearings*, *supra* note 20, at 79-81.

Even if it is assumed that foreign banks' lack of civic responsibility might become a problem at some point, the problem can be handled without amending section 3(c) to include, for example, the degree of foreign presence[106] as a formal statutory criterion. The Board easily could promulgate a rule establishing a numerical test of the appropriate level of foreign presence in a market to implement the present section 3(c) convenience and needs test.[107] Here, the primary difficulty is that it is extremely difficult to formulate a meaningful litmus test for nationwide application. Any rigid numerical test necessarily would be arbitrary; and any imprecise, subjective test would be difficult to apply consistently and would generate significant costs due to uncertainty. An acceptable compromise might be for the Board to establish a numerical threshold which would create a presumption that a particular market had sufficient foreign presence; the presumption could be rebutted by showing that the acquired bank's investment policies would not be significantly altered.[108]

B. *State Regulation of Foreign Acquisitions*

Under the dual banking system that has evolved in the United States,[109] state banking authorities often regulate the acquisition of control, as well as the ongoing activity, of banks under their jurisdiction. In many instances, state laws are a greater barrier than federal law to foreign acquisitions. Although wide variations in the laws of different states make a comprehensive survey impossible here,[110] it is possible to identify and assess the consequences of several typical state regulated approaches to bank acquisition.

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106 The Board has suggested that this be an additional criterion. *See* National Westminster Bank, Ltd., 65 Fed. Res. Bull. 357, 358 n.5 (1979); Hongkong and Shanghai Banking Corp., *id.* at 354, 355 n.4.

107 12 U.S.C. § 1844(b) (1976) (grant of Board rulemaking authority).

108 Hongkong and Shanghai Banking Corporation agreed to provide such an undertaking to the New York banking department in connection with its proposal to acquire Marine Midland. N.Y. Banking Dep't, Statement on Marine Midland, in *1979 Hearings, supra* note 20, at 85-86.

109 For a defense of the dual banking system, *see* Scott, *The Dual Banking System: A Model of Competition in Regulation,* 30 STAN. L. REV. 1 (1977).

110 A somewhat dated survey of state laws relating to foreign acquisitions may be found in 5 DEP'T OF COM., FOREIGN DIRECT INVESTMENT IN THE UNITED STATES, App. K, K-166 to K-204 (1976).

On the one hand, bank holding company laws in some states are more favorable to foreign holding company acquisitions than to domestic ones. For example, it is unlawful in Illinois for anyone to form a bank holding company or for any existing bank holding company to acquire control of an additional bank.[111] Because "holding company" is defined as any company that controls 15 percent or more of the voting stock of each of two or more banks, the effect is to permit only one-bank holding companies.[112] Thus, it is legally impossible for an Illinois bank, through a holding company, to acquire another Illinois bank. The advantage for foreign holding companies arises from a definitional quirk: "bank" is defined to include only banks organized under the laws of the United States or of any state.[113] Since this definition excludes foreign banks, a British holding company affiliated with a British bank, for instance, would be allowed to acquire an Illinois bank without violating the multi-bank holding company prohibition. After the acquisition, the British company would control only one "bank" as defined in the statute. This definitional loophole has made it possible for foreign banks, through their foreign holding companies, either to establish a new banking subsidiary or to acquire an existing bank in Illinois.[114] That foreign holding companies may acquire local banks in states like Illinois is not necessarily bad. The purpose of prohibiting multi-bank holding companies is to prevent large aggregations of economic power within a state,[115] and acquisitions by foreign holding companies are in no way inconsistent with this goal. Yet, like some of the provisions and applications of the federal Bank Holding Company Act, such state laws encourage foreign rather than domestic acquisitions. On the other hand, some states explicitly forbid acquisitions of American banks by foreign holding companies. For

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111 ILL. ANN. STAT. ch. 16 1/2, § 73 (Smith-Hurd 1972). Statutory language varies considerably throughout the states, but Illinois is not the only state with the type of holding company statute described here. *See also* IND. CODE ANN. §§ 28-8-2-2 to -3 (Burns 1973).

112 *Id.*

113 *Id.* Illinois does *not* allow out-of-state domestic holding companies to acquire Illinois banks.

114 The Dai-Ichi Kangyo Bank, Ltd., 58 Fed. Res. Bull. 49 (1972) (new bank); Algemene Bank Nederland, 65 Fed. Res. Bull. 658 (1979) (acquisition).

115 Glassman & Eisenbeis, *Bank Holding Companies and Concentration of Banking and Financial Resources, supra* note 101, at 1.

example, a state of Washington statute prohibits an "alien bank" from acquiring any state or national bank located within the state.[116] Similarly, in Florida the pertinent statute makes it unlawful for any bank, trust company, or holding company, "the operations of which are principally conducted outside this state," to acquire the assets of or control over any similar institution within the state.[117] The only significant exception to this broad prohibition is a "grandfather" clause that has allowed one Canadian bank to acquire several Florida banks.[118]

Other states impose equally effective barriers to unfriendly bank acquisitions originating either inside or outside the state. For example, some states inhibit hostile takeovers by subjecting bank acquisitions as well as other acquisitions to the state corporate takeover statutes, most of which impose burdensome disclosure requirements and delays on potential acquirors.[119] In one notable instance, banker Bert Lance and a group of Middle Eastern investors attempted a hostile takeover of Financial General Bankshares, in which the incumbent management responded with a lawsuit alleging violations of both the Williams Act[120] and the Virginia Take-Over-Bid Disclosure Act.[121] Ultimately, the attempt to acquire the same holding company was thwarted by a Maryland statute that effectively prohibits hostile takeovers of banking institutions.[122] That law forbids any banking institution organized under state law to have an affiliate — defined to include a holding company — unless the banking institution "intends to have an affiliate."[123] Thus, when a Maryland banking subsidiary of Financial General Bankshares objected to acquisition by a Netherlands company, the

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116 WASH. REV. CODE ANN. § 30.42.050 (Supp. 1979). "Alien bank" is defined as a bank organized in a foreign country, controlled by citizens of foreign countries, and having its principal place of business in a foreign country. *Id.* at § 30.42.020(1).

117 FLA. STAT. ANN. § 659.141 (West Supp. 1979).

118 *See, e.g.,* The Royal Trust Co., 63 Fed. Res. Bull. 498 (1977).

119 On the effects of state corporate takeover statutes, *see* Note, *Securities Law and the Constitution: State Tender Offer Statutes Reconsidered,* 88 YALE L.J. 510, 527-29 (1978). The majority of states that have takeover statutes exempt bank acquisition. *E.g.,* ILL. ANN. STAT. ch. 121 1/2, § 137.69 (Smith-Hurd Supp. 1979).

120 15 U.S.C. §§ 781(i), 78m(d)-(e), 78n(d)-(f) (1976).

121 VA. CODE §§ 13.1-528 to -540 (1978 & Supp. 1979).

122 Financial General Bankshares, Inc. v. Lance, [1978] FED. SEC. L. REP. (CCH) ¶ 96,403 (D.D.C., April 27, 1978).

123 MD. ANN. CODE art. 11, § 72 (1976).

Maryland attorney general ruled that the acquisition would violate state law and the Federal Board accordingly denied the application for approval.[124] These cases are atypical, because the overwhelming majority of foreign acquisitions have taken place with the cooperation of the target bank's management.[125] However, these abortive attempts to acquire Financial General Bankshares do illustrate an additional impediment that states can create for foreign holding companies attempting to acquire American banks.

In addition, other states require administrative approval of all bank acquisitions, including those by foreign holding companies. For example, section 142(1) of New York's banking law requires prior approval by the state banking board whenever one bank holding company proposes to acquire another.[126] If a holding company acquires a single bank, no prior approval is necessary, but the holding company may not vote its shares in the acquired bank until the superintendent of banks either approves or fails for ninety days to disapprove the company's application to exercise control.[127] Similarly, in California, state administrative approval of acquisitions is also required.[128] However, in both New York and California, foreigners have been able to acquire important domestic banks.

Although the statutory criteria under which administrators are to evaluate proposed acquisitions vary from state to state, the standards generally are phrased broadly and are related primarily to bank soundness and depositor confidence. In New York, for example, the statute instructs banking authorities to consider "the character, responsibility and fitness" of the acquiring company, and to determine "whether the exercise of control may impair the safe and sound conduct of the business of such banking institution, the conservation of its resources or public confidence in its business."[129] In denying the application of the Hongkong and

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124 Credit & Commerce American Holdings, 65 Fed. Res. Bull. 254 (1979).

125 *See 1979 Hearings, supra* note 20, at 43 (testimony of Robert Carswell) (not aware of any hostile takeovers).

126 N.Y. BANKING LAW § 142(1) (McKinney 1971 & Supp. 1978-79).

127 *Id.* § 143-b.

128 CAL. FIN. CODE § 2058 (West Supp. 1979).

129 N.Y. BANKING LAW § 143-b (McKinney 1971 & Supp. 1978-79). *See also* N.Y. BANKING LAW § 10 (McKinney 1971) (setting forth general policies).

Shanghai Banking Corporation for prior authorization to exercise control of Marine Midland, the New York banking department interpreted these standards broadly enough to encompass a variety of specific factors, some of which had not been considered by the Federal Reserve Board.[130] The department agreed with the Board that the acquisition would not result in any significant lessening of existing or potential competition.[131] On the other hand, whereas the Board had found the benefits that could result from the additional capital and expertise which the foreign parent would make available to Marine Midland to be significant, the state authorities disagreed.[132] Finally, the department reached adverse conclusions on several issues that had not been mentioned at all in the Board's decision, including the implications of the acquisition on the structure of the upstate banking market, in which Marine Midland was dominant; the potential difficulty, due to different accounting and reporting standards abroad and in the United States, of overseeing the parent's activities and financial condition; and the fairness of the transaction to Marine Midland's public shareholders.[133] Although it is impossible to generalize on the basis of the interpretation of one state's statutory criteria in one important and controversial case, the Marine Midland decision does illustrate one obstacle that may be raised by the dual banking system against foreign acquisitions. The broad criteria for considering acquisitions in state holding company statutes may enable state administrators to reconsider and effectly reverse rulings on which the Board had ruled favorably. By doing so, or by attaching special importance to factors that the Board had not considered, state administrators may block acquisitions that could meet all the tests for approval under the Bank Holding Company Act.

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130 Despite the banking department's denial, the acquisition ultimately succeeded. *See* text accompanying notes 177 to 183 *infra*.

131 *Compare* N.Y. Banking Dep't, Statement on Marine Midland, in *1979 Hearings, supra* note 20, at 79-81, *with* Hongkong and Shanghai Banking Corp. 65 Fed. Res. Bull. 354, 355 (1979).

132 *Compare* N.Y. Banking Dep't, Statement on Marine Midland, in *1979 Hearings, supra* note 20, at 77-79, *with* Hongkong and Shanghai Banking Corp., 65 Fed. Res. Bull. 354, 355 (1979).

133 N.Y. Banking Dep't, Statement on Marine Midland, *1979 Hearings, supra* note 20, at 77-78, 96-99, 101-103.

Therefore, although it is difficult to assess precisely the overall impact of state regulation upon foreign acquisitions, the net effect of those state laws generally appears to have been to inhibit foreign acquisitions. If state laws tend to restrict foreign acquisitions, then two additional questions should be raised. The first question, which is explored next, is whether the federal regulatory scheme in fact allows states to approve or disapprove foreign acquisitions as they have already done. The second question, which is explored immediately thereafter, is whether, as a policy matter, the states should have the power to approve or disapprove foreign acquisitions of American banks.

In accord with the dual system of federal and state bank regulation, the Bank Holding Company Act defers to the states in several respects. Specifically, section 3(b) requires the Board to consider state regulators' recommendations whenever a holding company seeks approval of its acquisition of a state-chartered bank.[134] And, as already has been mentioned, the Act incorporates state restrictions on interstate holding companies.[135] Additionally, section 7 of the Act provides that its enactment "shall not be considered as preventing any state from exercising such powers and jurisdiction which [sic] it now has or may hereafter acquire with respect to banks, bank holding companies, and subsidiaries thereof."[136] Therefore, while the Act clearly contemplates some regulation by the states, the permissible extent of that regulation is uncertain.

The United States Supreme Court very recently has considered the extent of state power under the Bank Holding Company Act. In *Lewis v. BT Investment Managers, Inc.*,[137] an out-of-state bank holding company had proposed to provide trust and investment advisory services in Florida through a wholly-owned subsidiary. While the holding company's application to establish the Florida business was pending before the Federal Reserve Board, the Florida legislature had enacted a statute prohibiting out-of-state entities from acquiring or owning in-state banks, trust companies, or investment advisory companies.[138] Solely because the holding

134 12 U.S.C. § 1842(b) (Supp. II 1978).
135 *Id.* at § 1842(d).
136 *Id.* at § 1846.
137 48 U.S.L.W. 4638 (June 10, 1980).
138 FLA. STAT. ANN. § 659.141(1) (West Supp. 1979).

company's proposal would have contravened this law if it had been consummated, the Board had denied the application.[139] The company then had filed suit challenging the constitutionality of the Florida statute. A three-judge district court panel held on remand from the Fifth Circuit that the parts of the statutory sections relating to trust and investment advisory services were unconstitutional under the commerce clause.[140] The Supreme Court upheld the portion of the decision concerning investment advisory services and vacated the portion of the decision concerning trust services because, the Court decided, the statutory section dealing with trusts was not properly before it.

The threshold question in the case was whether the plaintiff's proposed investment advisory activities constituted interstate commerce. The state had argued in the district court that, as the statute merely prohibited out-of-state corporations from doing business in Florida and did not affect their operations elsewhere, only intrastate commerce was involved. The district court had rejected this argument.[141] The Supreme Court similarly dismissed the contention that the statute affected only matters of local character.[142] The Court noted that Congress had asserted its power to regulate the provision of banking services, the formation of banking organizations (such as bank holding companies under the Bank Holding Company Act), the rendering of investment advice, and the conduct of national investment markets.[143] Because no one had claimed that those laws were unconstitutional, the Court reasoned, the activities of holding companies affect interstate commerce and, therefore, fall within the scope of the Congress' commerce clause powers.[144]

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139 Bankers Trust New York Corp., 59 Fed. Res. Bull. 364, 366 (1973).

140 U.S. Const. art. I, § 8, cl. 2.

141 BT Investment Managers, Inc. v. Lewis, 461 F. Supp. 1187, 1194 (N.D. Fla. 1978).

142 48 U.S.L.W. at 4641. The Court suggested that the Bank Holding Company was based *primarily* upon the authority of the commerce clause, implying that congressional power in this area might also be considered a necessary incident to its power to lay and collect taxes and coin money, U.S. Const. art. I, § 8, cls. 1, 4, 18. *Cf.* McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819) (upholding constitutionality of the Bank of the United States). The Court also treated the scope of the commerce clause as the same in cases involving limits on states' power as in cases involving the permissible reach of federal power. Lewis v. BT Investment Managers, Inc., 48 U.S.L.W. at 4641.

143 48 U.S.L.W. at 4641.

144 *Id.*

The Court then addressed the more difficult question of whether the statute impermissibly burdened interstate commerce. Justice Blackmun, writing for a unanimous Court, declared that the statute displayed a local favoritism both on its face and in effect, a favoritism that could not be justified by alleged state interests in discouraging undue economic concentration in high finance, regulating financial practices, and maximizing local control over locally based financial activities.[145] However, the state argued next that Congress, through the Bank Holding Company Act, had conferred upon the states authority to place restrictions on the activities of bank holding companies.[146] The Court held that section 3(d) — which prohibits interstate acquisitions unless permitted by state law — if it authorized additional state regulation at all, permitted regulation only of the *banking* activities of bank holding companies.[147] Nor did the Court find that section 7, which provides that the Act does not deprive states of the power to regulate holding companies, grants any affirmative power to the states to exceed commerce clause limitations.[148] In short, none of the relevant provisions in the Act saved Florida's facially discriminatory statute.

State laws that restrict the power of foreign holding companies to acquire in-state banks pose somewhat different problems than those raised in *BT Investment Managers.* Such statutes affect the acquisition of banking rather than of non-banking subsidiaries, and they apply to foreign rather than interstate commerce. However, these differences should be unimportant. Section 3(d), concerning multistate banking subsidiaries, should be inapplicable as long as the foreign holding company seeking to acquire a bank in one state does not have an existing banking subsidiary in another state. In that case, the state's power to prevent an acquisition by a multi-state holding company should be entirely beside the point. Similarly, the court's holding that section 7 of the Act does not empower states to enact restrictions violative of the commerce clause should be at least as applicable to acquisitions by foreign

145 *Id.* at 4642.
146 *Id.* at 4643.
147 *Id.*
148 *Id.* at 4644.

holding companies as to acquisitions by domestic holding companies. Their activities, like those planned by the plaintiff in *BT Investment Managers,* would clearly fall within the scope of the commerce clause, and if section 7 does not authorize interference with interstate commerce, it could not authorize interference with international commerce either. Although the types of discriminatory or protectionist legislation challenged under the commerce clause usually are directed at competition from other states rather than from abroad,[149] the holdings in these cases have not been explicitly limited to discrimination against other states. Doctrinally, there is no reason why they should be, since the commerce clause applies to foreign as well as to interstate commerce.[150] The decision in *BT Investment Managers* thus has important implications for state laws affecting foreign bank acquisitions.

The most drastic implication of the decision is that state laws specifically prohibiting foreign acquisitions of banks might be unconstitutional. These laws single out foreign holding companies and hence are facially discriminatory. It might be said that the state interest in regulating and maintaining a sound banking system justifies this discrimination, but the Supreme Court, in *BT Investment Managers,* rejected similar arguments.[151] Opponents of foreign acquisition might argue that foreign ownership of in-state banks is itself contrary to the state's interest, and that a facially discriminatory statute is the only way to deal with the problem.[152] However, the burden would be on the defenders of the discriminatory statute to show that it actually produced local benefits and that nondiscriminatory alternatives were unavailable.[153] This would be a difficult burden to meet.[154]

Not all the state bank holding company statutes are facially discriminatory, but even those which even-handedly require admini-

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149 *See* Philadelphia v. New Jersey, 437 U.S. 617 (1978), and cases cited therein.

150 *See* Brown v. Maryland, 25 U.S. (12 Wheat.) 419 (1827) (commerce clause forbids states from taxing importers of foreign goods) (alternative basis for decision).

151 48 U.S.L.W. at 4642.

152 *See* FOREIGN INVESTMENT IN THE UNITED STATES, HEARINGS BEFORE THE SUBCOMM. ON FOREIGN ECONOMIC POLICY OF THE HOUSE COMM. ON FOREIGN RELATIONS, 93D CONG., 2D SESS. 160-64 (Comm. Print 1974) (remarks of Rep. Wolff).

153 Hunt v. Washington Apple Advertising Comm'n, 432 U.S. 333, 353 (1977).

154 *See* Philadelphia v. New Jersey, 437 U.S. 617, 624 (1978) (courts apply "a virtually *per se* rule of invalidity" to facially discriminatory statutes).

strative approval of all bank acquisitions might be applied to restrain unconstitutionally the flow of interstate or foreign commerce.[155] The test of constitutionality of such a law involves balancing the local benefits purportedly attained by the law against the burdens which the law apparently places on the freedom of commerce.[156] Here, too, proponents of laws that restrain commerce must show that no less restrictive alternatives are available.[157] The balance of benefits and burdens, as well as the efficacy of less restrictive alternatives, necessarily will vary from state to state and will depend upon conditions in the local banking market, language of the individual statute, and manner in which state authorities implement the statute. For example, disapproval of a foreign acquisition, on the ground that foreign banks already control a substantial enough share of the relevant market, might be justified if it can be shown that foreign banks are less likely than local ones to participate in the financing of state and local government and that no practical method exists to force them to participate proportionately. State restrictions might be justified in other situations as well, but the holding in *BT Investment Managers* at least makes such laws vulnerable to challenges based upon the commerce clause.

Laws giving state administrators discretion over acquisitions might also run afoul of the supremacy clause.[158] This is a question that neither court ever reached in *BT Investment Managers.*[159] In applying the supremacy clause, courts have developed three tests for determining whether a state law is preempted by federal legislation. Only one of these tests, the one which asks whether Congress has explicitly declared its intent to exclude state legislation,[160] need be considered here.[161] The Comptroller of the Currency reportedly

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155 *Cf.* H.P. Hood & Sons v. DuMond, 336 U.S. 525 (1949) (New York's Commission of Agriculture and Markets' denial of a license for an out-of-state milk distributor to open a processing plant in New York violated the commerce clause by favoring local over out-of-state interests).

156 Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).

157 Dean Milk Co. v. Madison, 340 U.S. 349, 354 (1951).

158 U.S. CONST. art. VI, § 2.

159 *See* BT Investment Managers, Inc. v. Lewis, 461 F. Supp. at 1191 n.4.

160 *See* Rice v. Santa Fe Elevator Corp., 331 U.S. 218 (1947) (express preemption).

161 The other tests are discussed in Note, *Securities Law and the Constitution, supra* note 120, at 518-19. The second test focuses on the pervasiveness of federal legislation in a particular field and is clearly inapplicable here because of the degree of state regulation

has taken the position that Congress has declared such an intent where acquisitions of national banks are concerned.[162] This position is based primarily upon the fact that federal laws[163] require the appropriate federal agencies to consult with the Comptroller — but not with state officials — before approving the acquisition of any national bank.[164] However, this argument misses the point. The Bank Holding Company Act gives the Federal Reserve Board ultimate discretion to approve or disapprove of the acquisition of any bank, whether chartered by a state or by the federal government.[165] Therefore, the real issue is the state role not in relation to the Comptroller, but in relation to the Board. To delineate that role, it is necessary to look carefully at the relevant sections of the Bank Holding Company Act.

On its face, the Act is somewhat contradictory. On the one hand, section 7 generally reserves power to the states to regulate bank holding companies.[166] The legislative history essentially restates the statutory language, adding cryptically that the states may exercise their power "in a manner more restrictive than the provisions of this bill."[167] Neither this legislative history, nor the few cases construing the section — most of which concern branching —[168] clearly delineate the areas of holding company activity over which the states have power. A careful reading of section 3(b), on the other hand, suggests that the Board's jurisdiction is exclusive. Besides requiring the Board to consider the views of the

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under the dual banking system. The third asks whether state regulation obstructs attainment of a congressional objective; as the initial focus is on congressional goals, which may be discovered only by reading the relevant statutes and legislative history, this test partially collapses into the first one.

162 *See* Message of New York Gov. Hugh Carey, vetoing S. 3333 (June 19, 1979) (citing Comptroller's position as a reason for vetoing a bill to prevent foreign bank acquisitions).

163 12 U.S.C. § 1842(b) (Supp. II 1978); 12 U.S.C.A. § 1817(j)(2) (Supp. II 1978).

164 Message of Gov. Hugh Carey, note 162 *supra*.

165 12 U.S.C. § 1842(b) (Supp. II 1978).

166 *Id.* at § 1846.

167 S. REP. No. 1095, 84th Cong., 2d Sess., *reprinted in* [1956] U.S. CODE CONG. & AD. NEWS 2482, 2504.

168 The most important of these decisions was Whitney Nat'l Bank in Jefferson Parish v. Bank of New Orleans & Trust Co., 379 U.S. 411 (1965), which held that the Board was the appropriate forum to consider the effect of a state law on a proposed acquisition by a holding company. The Board has interpreted the decision as meaning that it cannot approve an acquisition that conflicts with state law, but nothing in the decision gives a clue as to the outer boundaries of permissible state laws. For a discussion of the decision, *see* P. HELLER, HANDBOOK OF FEDERAL BANK HOLDING COMPANY LAW 147-53 (1976).

Comptroller or the state authorities before it approves the acquisition of a national or a state bank, respectively, the section provides that, if the appropriate regulator objects to the acquisition, the Board must hold a formal hearing, after which it will issue a final decision subject to judicial review.[169] By giving the Board final discretion over acquisitions, regardless of the views of state regulators, section 3(b) implies an intent to preempt the field concerning discretion over proposed bank acquisitions.[170] The legislative history is even more explicit. According to the Senate report that accompanied the original bill, section 3(b) represented a compromise between persons who thought state authorities should have only an informal, consultative role, and others who thought state authorities "ought to be given the right to decline such an application, regardless of the option of the Federal Reserve Board."[171] Because Congress explicitly rejected a proposal to allow state officials to block acquisitions which the Board approved, Congress clearly seems to have expressed an intent that federal regulation of acquisitions be exclusive, despite the general language in section 7.[172]

This result creates a serious anomaly. States undoubtedly are free to regulate bank holding companies in a variety of ways. They may prohibit multi-bank holding companies, or, if they wish, prohibit all bank holding companies from incorporating or doing business within their boundaries.[173] This being so, it makes little sense that states may not prohibit holding companies from acquiring new banking subsidiaries without first obtaining state regulatory approval. In practice, the Board has avoided the anomaly by declining to consider an application for approval of an acquisition if the state authorities oppose it.[174] While this posture by the Board

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169 12 U.S.C. § 1842(b) (Supp. II 1978).

170 In *Whitney,* the Court stated in dicta that the Board had exclusive jurisdiction vis-à-vis the Comptroller when the acquired bank was nationally chartered. 379 U.S. at 419. Logically, the same should apply to state authorities, when the acquired bank is state chartered.

171 S. REP. No. 1095, *supra* note 167, at 2490.

172 This interpretation, which in effect narrows the scope of section 7, receives some support from *BT Investment Managers,* in which the Court in a different context construed the section narrowly.

173 Commercial National Bank of Little Rock v. Board of Governors of the Federal Reserve System, 451 F.2d 86, 89 (8th Cir. 1971) (dictum).

174 37 Fed. Reg. 5084 (1972).

may be subject to challenge as an abuse of discretion, no one has made the challenge yet.[175] Even if challenged, the Board's approval might be upheld by a court that was determined to ignore the legislative history of section 3(b). However the preemption question might ultimately be decided, the fact that it exists at all calls attention to a broader question of policy: to what extent should state regulators have discretion over foreign acquisitions?

C. *Policy: What Should Be the Role of the States?*

Perhaps in no other area is the dual banking system as perverse as in the area of bank acquisitions.[176] The recent Marine Midland case illustrates the inherent irrationality in present law. When it received the application of the Hongkong and Shanghai Banking Corporation (HSBC) for approval of its proposed acquisition of Marine Midland Bank, the Federal Reserve Board, pursuant to statutory procedures, notified New York banking authorities and allowed the prescribed time for them to comment. Having received no objection from the state authorities, the Board approved the acquisition.[177] Later, however, when HSBC applied under New York law for prior approval of its exercise of control of Marine Midland, state authorities refused to give their approval, effectively nullifying the prior decision of the Board.[178] Marine Midland, in turn, then attempted to avoid the decision of the state authorities by applying to the Comptroller of the Currency for permission to convert from a state to a national charter.[179] The basis of this strategy was a provision in the New York law dispensing with the requirement of state approval when the acquired bank is nationally chartered and the acquisition is subject to federal approval.[180]

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175 *Cf.* Western Bancshares, Inc. v. Board of Governors of the Federal Reserve System, 480 F.2d 749 (10th Cir. 1973) (Board lacks discretion to disapprove an acquisition solely because of unfairness to minority shareholders).

176 For a critique of the system, *see* Robertson, *Federal Regulation of Banking: A Plea for Unification,* 31 LAW & CONTEMP. PROB. 673 (1966). *But see* Scott, *The Dual Banking System,* note 109 *supra,* which argues that the ability of banks to convert from a state to a national charter or vice versa is the key to a healthy and innovative banking system.

177 Hongkong and Shanghai Banking Corp., 65 Fed. Res. Bull. 354 (1979).

178 N.Y. Banking Dep't, Statement on Marine Midland, in *1979 Hearings, supra* note 20, at 63.

179 12 U.S.C. § 35 (1976) and N.Y. BANKING LAW § 137 (McKinney 1971) permit such a conversion.

180 N.Y. BANKING LAW § 143-b (McKinney 1971 & Supp. 1978-79).

Although the strategy was entirely proper under federal and state law, it had the effect of placing the power ultimately to permit or block the acquisition in the hands of the Comptroller, whose role in acquisitions under federal law is limited to advising the Board.[181] In other words, an application for conversion to a national charter, which normally is a routine matter,[182] became, in effect, a second application for federal approval of the acquisition. After the Comptroller approved the charter conversion, the Comptroller having scarcely acknowledged the extraordinary procedural setting of the case, the acquisition proceeded according to plan.[183] While Marine Midland and HSBC got what they wanted by exploiting the vagaries of jurisdictional lines under the dual banking system, ironically, the validity of their victory is open to question. Arguably, the parties to the acquisition should have applied for new approval from the Board *after* the Comptroller's approval of the charter conversion because HSBC's original application, and the Board's original approval, concerned the acquisition of a *state* bank, an acquisition that never was consummated. A national bank is not the same legal entity as a state bank, and the Board neither followed the statutory procedures regarding the acquisition of a national bank nor approved the acquisition of a national bank. In other words, the acquisition did not comply with the procedures set forth in section 3(b) of the Bank Holding Company Act. Although this is a procedural technicality, it is precisely the sort of technicality that Marine Midland and HSBC exploited to vitiate opposition to the acquisition by the state authorities. This also is the sort of technicality that is often exploitable in the jurisdictional morass created by the dual banking system. As a matter of policy, the success or failure of major bank acquisitions should not depend on such technicalities. Therefore, the jurisdictional lines should be more clearly drawn. The difficult question is just where those lines should be drawn.

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181 12 U.S.C. § 1842(b) (Supp. II 1978).

182 Scott, *The Dual Banking System, supra* note 109, at 9-12.

183 The Comptroller's opinion approving the conversion was disingenuous in suggesting that the timing, but not the substance, of the decision to convert was dictated by the position of the state authorities. *See* Opinion of the Comptroller of the Currency on Application of Marine Midland Bank, Buffalo, New York, to Convert from a Banking Institution Chartered under the New York Banking Law to a National Banking Association, Jan. 28, 1980, at 12 & n.8.

In approaching this question, it is useful to ask whether state officials can contribute any additional expertise to an acquisition decision. One area in which they can contribute involves the financial and managerial condition of the state-chartered banks about to be acquired. Since state-chartered banks are subject to ongoing state inspection and regulation, state officials should be better informed than federal officials as to the target bank's financial condition and the quality of its management. Present law, which gives state authorities only an advisory role when the bank to be acquired is state-chartered, already may take account of this facet of state expertise.

State authorities also may be in a better position to assess the local impacts of a proposed bank acquisition. For example, in the Marine Midland case, one of the primary reasons for the state regulators' objection to the acquisition was that it might have a deleterious effect on the structure of the up-state banking market. Marine Midland was dominant in that market, largely because of the state's policy of restricting the major New York City banks to toehold or *de novo* expansion in the up-state area.[184] Because of HSBC's size, international focus, and existing New York City operations, the state authorities considered HSBC to be substantially equivalent to a major New York City bank and feared that approval of the acquisition would require, as a matter of fairness, that those banks also be allowed to expand through the acquisition of major up-state banks.[185] Therefore, consummation of the acquisition would have set an important precedent, as better understood by state authorities. In fact, the Bank Holding Company Act does not adequately account for this aspect of state expertise. Section 3(b) does not even require the Board to consult state authorities when the bank is nationally chartered, even though the Board almost certainly does so in practice.[186] The local impacts of a bank acquisition are the same, whether the bank is state-chartered or nationally-chartered, and state officials can play an important role in pointing out what those impacts are likely to be.

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184 N.Y. Banking Dep't, Statement on Marine Midland, in *1979 Hearings, supra* note 20, at 67-71.

185 *Id.* at 99, 104.

186 As indicated at text accompanying note 174 *supra,* the Board in practice regards an application for approval of any bank acquisition as moot whenever it is opposed by state officials.

However, to concede that state regulators have valid concerns is not to suggest that they should have veto power over proposed acquisitions, especially when foreign holding companies are involved. Indeed, countervailing considerations emerge from the net economic benefits of foreign acquisitions of American banks as enumerated in Part I.[187] Moreover, the focus of state regulators may be on local economic impacts rather than on broader economic effects or on national foreign policy.[188] For example, restrictions on foreign acquisitions could evoke economic or political retaliation abroad,[189] and even if retaliation is not likely, restrictions on foreign acquisitions still would contradict this nation's longstanding policy of encouraging foreign investment in the United States.[190] While federal law does restrict the power of non-citizens to invest in certain industries,[191] whether to depart from the general policy of free trade is a decision that should be made at the national rather than the state level.[192] In other words, federal regulators should have exclusive jurisdiction over proposed foreign acquisitions. Although the Federal Reserve Board should give careful consideration to the views of state regulators, the Board's decision should be final, subject only to judicial review. Of course, any recommendation to vest exclusive jurisdiction in the Board necessarily implies exclusivity as to all bank acquisi-

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187 *See* text accompanying notes 11 to 54 *supra*.

188 American treaties generally except banking from the general requirements of national treatment in commercial and financial activities. *E.g.*, Treaty with the Netherlands on Friendship, Commerce and Navigation, March 27, 1956, art. VII, para. 2, 8 U.S.T. 2043, T.I.A.S. No. 3942 (effective Dec. 5, 1957). The fact that such an exception is necessary, however, merely points up the fact that bank regulation may implicate foreign policy and thus that some aspects of it should be reserved to the federal government.

189 *See* text accompanying notes 25 to 29 *supra*.

190 *See, e.g., 1979 Hearings, supra* note 20, at 28 (statement of John G. Heimann).

191 *See, e.g.*, 47 U.S.C. § 310(b) (1976) (FCC may not grant operating licenses for radio stations to aliens).

192 State restrictions on alien ownership of certain forms of property have generally been regarded as proper. The best example is land, an immovable resource that arguably is not even an object of interstate or foreign commerce, the ownership of which has traditionally and most efficiently been controlled exclusively by the states. Morrison, *Limitations on Alien Investment in American Real Estate*, 60 MINN. L. REV. 621, 650-52 (1976). Banking is inherently an industry that affects interstate commerce, and not since the early days of the republic have the states had exclusive authority to regulate banking.

tions. One procedure should apply regardless of whether the acquiring holding company is foreign-owned or domestically-owned, and regardless of whether the acquired bank is state-chartered or nationally-chartered.

This should not be a startling recommendation, since the Bank Holding Company Act already appears to give the Board such exclusive jurisdiction. The Board should simply stop deferring automatically to opposing views of state regulators on questions of approval of bank acquisitions. However, if the Board is unwilling to take this step, Congress should consider a clarifying amendment to the Bank Holding Company Act, to remove any doubt that the state's role in bank acquisition procedure is intended to be other than purely advisory. Exercise of exclusive federal jurisdiction by the Board would be an important step toward a more coherent policy concerning foreign bank acquisition.

III. Foreign Acquisitions and Regulation of Holding Company Activities

Whether they are controlled by domestic or foreign holding companies, American banks are subject to a wide range of regulations aimed at assuring bank soundness and protecting depositors. Ideally, acquisition of such banks by foreign holding companies would have no effect on the implementation or the effectiveness of any of the major regulatory goals that are applied to banks themselves.[193] However, holding company affiliation raises additional regulatory concerns which are also addressed by federal law. The current law regulates three types of holding company activities: transactions among affiliates, nonbanking activities of bank holding companies, and managerial overlaps.[194] The effectiveness of these regulations as they are applied to foreign holding companies is one of the central questions underlying the issue of foreign bank acquisition.

193 *See* Clark, *The Soundness of Financial Intermediaries,* note 97 *supra.*

194 These categories are taken from Clark, *The Regulation of Financial Holding Companies, supra* note 95, at 792-803. Clark includes another category, nonbanking activities of banks, which is not included here because acquisition by a foreign holding company would not affect regulation aimed at banks themselves, as opposed to their holding companies.

A. *Transactions Among Affiliates*

One way in which American law attempts to promote bank soundness is by regulating transactions among bank holding company affiliates. For example, federal law restricts the dividends that a bank may pay to its parent holding company without prior regulatory approval[195] and limits the amount a bank may loan to its affiliates.[196] While other means by which a bank's resources may be transferred to its parent or affiliates — such as payment by the bank of management fees or service charges to an affiliate, prepayment of debt owed by the bank to a holding company, or transfer of successful operations from the bank to the holding company's other subsidiaries (or the reverse if an operation is unsuccessful) — are not directly subject to regulation,[197] the federal banking authorities have the power to stop serious abuses that constitute unsound banking practices.[198]

Regulation of intercompany transactions is essential because, as has been noted previously, fraud and self-dealing have been prime causes of bank failure.[199] Therefore, it is appropriate to consider whether an American bank affiliated with a foreign holding company will be exposed, either to a greater or to a lesser extent than one affiliated with a domestic holding company, to abuse by the holding company's management. This entails two distinct inquiries — whether acquisition by a foreign holding company affects the likelihood of insider misconduct, and whether acquisition by a foreign holding company affects the ability of banking authorities to monitor transactions among affiliates and to put a stop to misconduct when it occurs.

As far as the likelihood of abuse is concerned, it is important to bear in mind that the laws regulating dividend payments, limiting the amounts of loans that may be made to affiliates, and giving regulators the power to interdict unsound banking practices apply

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195 12 U.S.C. §§ 60, 324 (1976) (national and state member banks).

196 *Id.* at § 371c (member banks); 12 U.S.C. § 1828(j) (Supp. II 1978) (nonmember insured banks).

197 Clark, *The Regulation of Financial Holding Companies, supra* note 95, at 803.

198 *E.g.,* 12 U.S.C. §§ 1818(b), (e) (1976) (power to issue cease and desist orders and remove culpable bank officers).

199 *See* text accompanying note 97 *supra.*

equally whether the parent is domestic or foreign. Although existing regulation in this area has been criticized as weak and sometimes misdirected,[200] this is not a reason to restrict foreign acquisitions, but to strengthen the law concerning all holding companies. There is no evidence that foreign holding companies are more likely to siphon the resources of their American banking subsidiaries than are domestic holding companies.[201] In fact, the large capital contributions that foreign banks often make to the American banks they acquire, the consistency with which the Board makes favorable findings regarding the acquiring companies' managements, and the general opposition of federal banking authorities to restrictions on foreign acquisitions all suggest that the contrary is true.[202] A member of the Board once suggested that holding companies generally are committed to the health of their foreign subsidiary banks.[203] Moreover, in the one formal opinion in which a member of the Board opposed establishment of domestic subsidiaries by foreign holding companies because of the possibility of a form of self-dealing, his opposition had nothing to do with bank soundness, but rather with the possibility that the banks' loan policies might favor foreign commercial enterprises with which the banks' parents were closely associated, to the detriment of American competitors.[204]

On the other hand, monitoring transactions among affiliates is a matter of serious concern when the holding company is foreign.

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200 Clark, *The Regulation of Financial Holding Companies, supra* note 95, at 838-48.

201 *Cf.* N.Y. Banking Dep't, Statement on Marine Midland, in *1979 Hearings, supra* note 20, at 197, 197-98 (department, though opposing the acquisition, explicitly refused to impugn the integrity of Hongkong and Shanghai's management).

202 *See* text accompanying notes 41, 47, 79-81 *supra.* It is true that some foreign individuals recently have been implicated in questionable practices. The most spectacular incident involved Michel Sindona, who assumed control of Franklin National Bank shortly before its collapse and who was largely responsible for its ill-fated venture into foreign exchange speculation. However, Sindona cannot be blamed entirely for the collapse, since Franklin was suffering from poor management well before he arrived. *See* Rose, *What Really Went Wrong at Franklin National, supra* note 73, at 225. The other incident has involved Adnan Khashoggi, *see* note 79 *supra.* These *individual* cases, however, indicate nothing about the quality of management of the foreign *banks* that have acquired American banks.

203 Wallich, *Central Banks as Regulators and Lenders of Last Resort in an International Context: The View from the United States,* in FEDERAL RESERVE BANK OF BOSTON, KEY ISSUES IN INTERNATIONAL BANKING 91, 96-97 (1977).

204 The Dai-Ichi Kangho Bank, Ltd., 58 Fed. Res. Bull. 49, 53 (1972) (dissenting statement of Gov. Brimmer).

This is due, in part, to the fact that American regulators' physical access to holding company records is more difficult when the records are located abroad, and, in part, to the fact that accounting standards are much different in foreign countries than in the United States. For example, when the HSBC proposed to acquire Marine Midland, it could not provide consolidated balance sheets for itself and its affiliates which conformed to accepted American accounting standards.[205]

While such problems should not be dismissed lightly, they should not be considered to be insurmountable. Indeed, the Board recently has undertaken measures that should improve its ability to supervise foreign holding companies' transactions with American subsidiaries, including a requirement that financial information that has been prepared according to foreign practices be reconciled with and explained in terms of American accounting principles, that foreign holding companies submit quarterly reports on transactions between the American subsidiary and the foreign holding company or its affiliates, and that foreign holding companies submit annual reports containing information sufficient for the Board to assess the parent's financial condition.[206] Additionally, representatives of the Board have been meeting regularly with foreign authorities to discuss the regulatory problems involved in the internationalization of banking. Therefore, a forum already exists for facilitating cooperation between American and foreign central bankers in the supervision of activities of multinational holding companies.[207] Finally, American banking regulators have ample power under domestic[208] and international[209] law to compel pro-

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205 N.Y. Banking Dep't, Statement on Marine Midland, in *1979 Hearings, supra* note 20, at 97. Even within the relatively cohesive European Economic Community, accounting differences trouble bank regulators. Blunden, *International Cooperation in Banking Supervision,* 17 BANK OF ENGLAND Q. BULL. 325, 328-29 (1977).

206 Board of Governors of the Federal Reserve System, Statement of Policy on Supervision and Regulation of Foreign Bank Holding Companies, Feb. 23, 1979, [1979] FED. BANKING L. REP. (CCH) ¶ 97,725. The Board has subsequently proposed a new form (F.R. Y-8f) for reports of intercompany transactions for foreign holding companies and their American bank subsidiaries. 44 Fed. Reg. 62,947 (1979).

207 Wallich, *Central Bankers as Regulators and Lenders of Last Resort, supra* note 203, at 96.

208 *See, e.g.,* 12 U.S.C. § 1844(f) (Supp. II 1978) (Board may, in connection with any application or proceeding under the Bank Holding Company Act, issue subpoenas and subpoenas duces tecum).

209 *See* U.S. v. Aluminum Co. of America, 148 F.2d 416, 443 (2d Cir. 1945) (". . . any state may impose liabilities, even upon persons not within its allegiance, for conduct outside its borders that has consequences within its borders which the state reprehends. . . .").

duction of a foreign holding company's records, if necessary. Therefore, while policing intercompany transactions may be more difficult when the parent is foreign, recent steps by the Board have gone far in assuring accountability by foreign bank holding companies.

B. *Nonbanking Activities of Foreign Holding Companies*

One of the cornerstones of bank regulation in the United States is the separation of banking from other business activities. The National Bank Act,[210] for example, empowers national banks to engage in strictly limited types of activities, and the Glass-Steagall Act[211] makes it unlawful for any bank to act as broker, dealer, or underwriter of securities. The separation of banking from other activities extends also to bank holding companies. Section 4(a) of the Bank Holding Company Act [212] broadly prohibits holding companies from owning or controlling stock in nonbanking companies. However, section 4(c) enumerates several exceptions, the most important of which, for domestic holding companies, permits holding companies to own shares in any company that the Board by order or regulation has found to be engaged in an activity "so closely related to banking or managing or controlling banks as to be a proper incident thereto."[213] Using this exemptive power, the Board has listed a number of activities that it deems to meet the "closely related" test, such as those involving credit extension, financial management, data processing, and specialized courier services.[214]

The laws of most foreign countries, by contrast, permit their banks far greater freedom to invest in nonbanking companies. In fact, few major countries other than the United States enforce a rigid separation of commercial and investment banking,[215] and a number of major countries even permit their banks to maintain

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210 12 U.S.C. § 24 (1976).

211 *Id.* at § 378.

212 *Id.* at § 1843(a).

213 *Id.* at § 1843(c)(8).

214 12 C.F.R. § 225.4(a) (1979). The categories are taken from Clark, *The Regulation of Financial Holding Companies, supra* note 94, at 797.

215 *See generally* J. MAYCOCK, EUROPEAN BANKING: STRUCTURES AND PROSPECTS (1977). Japan, where banks may underwrite no securities other than government bonds, is an exception. F. LEES & M. ENG, INTERNATIONAL FINANCIAL MARKETS: DEVELOPMENT OF THE PRESENT SYSTEM AND FUTURE PROSPECTS 253 (1975).

very close ties to industrial or commercial businesses. Japan provides the clearest example of this with its tradition of powerful financial conglomerates. The tradition began well before World War II, with the formation of a network of *zaibatsu* conglomerates, which were controlled by banks which virtually dominated the Japanese economy.[216] Although *zaibatsu* conglomerates have been illegal since the end of the War, they have been partially replaced by the less formal *keiretsu* associations, which bring together a variety of financial, commercial, and industrial companies, united by interlocking directorates, close financial ties and gentlemen's agreements and centered around a bank.[217] The interconnections between banks and nonfinancial firms were sufficiently strong (even though the banks did not have formal control of the nonbank firms) in 1972 to lead one member of the Board to dissent from the Board's decision approving the applications of three Japanese bank holding companies to establish *de novo* subsidiary banks in this country.[218] Yet, Japan is unique only in its degree and tradition of agglomeration. In fact, the leading banks in some European countries not only cooperate closely with industrial and commercial firms, but also own majority interests in and sometimes even supply the management for such companies.[219] A final example is provided by the HSBC, which had subsidiaries in the shipping, trading, airlines, and publishing fields when it acquired Marine Midland.[220]

This raises a difficult question of policy: whether acquisition of an American bank by a foreign one, which may be heavily engaged in nonbanking activities, presents significant dangers either to this country's policy of separation or to the soundness of American banks. Consideration of this problem must begin with a further look at the American regulatory scheme.

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216 The history of the *zaibatsu* conglomerates is recounted succinctly in Note, *Regulating the One-Bank Holding Companies — Precluding Zaibatsu?,* 46 ST. JOHN'S L. REV. 320 (1971).

217 F. LEES & M. ENG, INTERNATIONAL FINANCIAL MARKETS, *supra* note 215, at 242.

218 The Dai-Ichi Kangyo Bank, Ltd., 58 Fed. Res. Bull. 49, 53 (1972) (dissenting statement of Gov. Brimmer).

219 J. MAYCOCK, EUROPEAN BANKING, *supra* note 215, at 5 (France), 45 (West Germany).

220 N.Y. Banking Dep't, Statement on Marine Midland, in *1979 Hearings, supra* note 20, at 64, 68.

Specifically, the Bank Holding Company Act contains two additional exceptions, both of which are contingent upon Board approval and both of which apply only to foreign holding companies. First, there is an exemption for a holding company's ownership of shares of a company that is organized under the laws of a foreign country and that conducts the "greater part" of its business outside the United States.[221] Second, there is an exemption for ownership of shares of a company "which does no business in the United States except as an incident to its international or foreign business."[222] The Board has implemented these statutory exemptions in a section of its Regulation Y.[223] For present purposes, the most important provisions of the regulation are those that permit a foreign holding company to "[e]ngage in direct activities of any kind outside the United States"[224] and to own noncontrolling shares in any foreign company engaged in activities in the United States if over half of the company's revenues are derived outside the United States and if the company does not engage in the underwriting, selling or distribution of securities in the United States.[225] In essence, the statute and regulation strictly limit the permissible United States activities of foreign holding companies with American subsidiary banks, but scarcely limit the foreign activities of such holding companies. Therefore the Act seems adequate to accomplish the goals of separation and prevention of the development of *zaibatsu* conglomerates in the United States. No matter how powerful or diversified a foreign holding company might be elsewhere, its operations in the United States are sharply curtailed. A foreign holding company's acquisition of a large American bank might, by increasing the holding company's overall financial power, heighten *zaibatsu* risks in its home country. However, this should be a concern for banking regulators abroad, not for those in the United States.

The other important goal of separation policy is preserving bank soundness in order to protect depositors from the risk of bank fail-

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221 12 U.S.C. § 1843(c)(9) (1976). *See also* 12 U.S.C. § 1841(h)(2) (Supp. II 1978) (granting a general exemption from § 1843 for foreign holding companies "principally engaged in the banking business outside the United States. . . .").

222 12 U.S.C. § 1843(c)(13) (1976).

223 12 C.F.R. § 225.4(g) (1979).

224 *Id.* at § 225.4(g)(2)(i).

225 *Id.* at § 225.4(g)(2)(v).

ure.[226] Separation for soundness has been justified on the ground that it simplifies the banking authorities' job of regulating and monitoring bank operations, and on the ground that it removes the temptation to managerial fraud and self-dealing that might be presented if a nonbanking enterprise needed large injections of capital that could be supplied most readily by an affiliated bank.[227] Both of these concerns already have been considered in the context of transactions among affiliates; it is necessary only to reiterate that there is no evidence that foreign holding companies, despite their diversification, are more likely than domestic ones to engage in self-dealing. However, to the extent that diversification renders the task of monitoring bank soundness more difficult, foreign acquisitions of American banks do impose some costs.

Two other reasons have been given in support of the separation policy. One is that the public might confuse the identities of the affiliated companies, and that the failure of a nonfinancial company, therefore, could lead either to a run on its banking affiliate or to an attempt by the failed company's creditors to pierce the corporate veil and obtain a judgment against the banking affiliate.[228] Piercing the corporate veil to get at a bank's resources is unlikely under existing corporate and banking law, and it is doubtful whether a run on the bank in such circumstances would occur.[229] The other reason given for separation is that the management of a diverse holding company may be prone to take inordinate risks or may not be able to manage its various enterprises. However, this suggestion lacks evidentiary support,[230] and in any case, neither danger is likely to be any greater when the holding company is foreign than when it is domestic.[231]

Therefore, of all the reasons given to support the policy of separation, only the concern that affiliation with a diversified

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226 Clark, *The Regulation of Financial Holding Companies, supra* note 95, at 815-16.
227 *Id.* at 815.
228 *Id.* at 833-35.
229 *Id.*
230 *Id.*
231 Clark suggests that one way to avoid confusion of identities is to require that the names of the holding company and the subsidiary bank not be misleadingly similar. *Id.* at 838. In fact, similar names almost always are used when a foreign holding company acquires an American bank, probably reflecting an attempt to take advantage of the acquired bank's good will. On the ability of foreign holding companies' managements, *see* text accompanying notes 79 to 81 and 85 *supra.*

holding company will increase the cost of regulation seems important in the context of foreign acquisitions. Although the Board's actions discussed in the preceding section have facilitated such supervision, the cost factor remains poignant. Yet, against the increased costs of supervision, it is necessary to balance the benefits that can be expected to accrue to American banks due to the diversification of their foreign parents. The primary benefit is the reduction of "affiliation risk," or the risk to which a bank is subject because of its affiliation with a holding company.[232] Limited empirical studies, based upon the experience of American holding companies, suggest that diversification into nonbanking activities reduces the overall risk of the holding company.[233] A bank's acquisition by a foreign holding company may reduce the bank's affiliation risk simply because the typical foreign parent is more highly diversified than the typical American parent. Furthermore, geographical diversification, which acquisition by a foreign holding company necessarily entails, tends to smooth out the holding company's earnings from its various affiliated banks. This smoothing may further reduce the holding company's level of risk and the bank's affiliation risk below the levels attainable by domestic holding companies.[234] These gains in bank soundness resulting from the foreign holding company's product and geographic diversification appear at least to balance the increased regulatory costs that may result from acquisition of American banks by foreign conglomerates.

In summary, the policy of separating banking from nonbanking lines of business does not provide a reason for restricting bank acquisitions permanently. *Zaibatsu* risks do not exist in this country. The dangers that bank ownership by diversified foreign holding companies will enhance the likelihood of self-dealing, increase the risks due to possible confusion of identities, or result in poor holding company management are slight. And the increased costs of monitoring a diversified foreign holding company are at least

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232 Rose, *The Effect of the Bank Holding Company Movement on Bank Safety and Soundness: A Literature Review*, in FEDERAL RESERVE BOARD STAFF COMPENDIUM, *supra* note 101, § VI, at 13.

233 *Id.* at 14-17.

234 *Id.* at 18.

balanced by the reduced affiliation risk that results from the holding company's product and geographic diversification.

C. *Managerial Overlaps*

Federal law restricts managerial overlaps involving banks in several ways. The Clayton Act prohibits interlocking directorates among large competing business corporations, generally, and between any Federal Reserve member bank and any other bank, specifically.[235] Similarly, the Financial Institutions Regulatory and Interest Rate Control Act of 1978 prohibits interlocking directorates among non-affiliated banks, except for small banks or those in different geographic markets.[236] These prohibitions apply equally to subsidiaries of foreign and domestic holding companies, so foreign acquisitions pose no additional risks of undermining this aspect of bank regulation.

In one respect, however, foreign acquisitions may reduce the dangers posed by managerial overlaps. Existing laws governing interlocking directorates have been criticized because their concern is with antitrust policy rather than with self-dealing, which can be facilitated by managerial overlaps; the fact that existing law permits interlocks between a bank and a nonbanking affiliate illustrates the lack of concern with self-dealing.[237] Such interlocks are less likely to occur if the holding company is foreign because its directors and those of its foreign affiliates are likely to be citizens of their respective foreign countries; the American citizenship requirements for bank directors, which are imposed by the National Bank Act[238] and many state banking laws,[239] in effect, prevent significant directorate interlocks. Thus, foreign acquisitions of American banks not only do not undermine regulation of

235 12 U.S.C. § 19 (1976).

236 12 U.S.C. §§ 3202-3204 (Supp. II 1978).

237 Clark, *The Regulation of Financial Holding Companies, supra* note 95, at 803.

238 12 U.S.C. § 72 (Supp. II 1978). If a national bank is affiliated with a foreign holding company, however, the Comptroller may waive citizenship requirements for a minority of the directors.

239 *E.g.*, ILL. ANN. STAT. ch. 16 1/2, § 116(2) (Smith-Hurd 1972) (domicile requirement).

managerial overlaps, but tend to improve the results of such regulations when citizenship requirements exist.

D. *Summary*

Effective regulation of holding company activities other than bank acquisitions does not call for legislative change. The only significant regulatory problem that results from foreign acquisitions is that monitoring transactions among affiliates become somewhat more difficult and costly, a problem that is exacerbated by the fact that foreign bank holding companies tend to be more highly diversified than American ones. However, the Board has recognized this problem and has taken steps to deal with it. Furthermore, any increased regulatory costs resulting from the diversification of foreign holding companies are probably offset by the reduced affiliation risks that come from a bank's affiliation with a typically more diversified foreign holding company. In none of the major areas of holding company regulation are the problems sufficient to warrant the imposition of permanent restrictions or a permanent ban on foreign bank acquisitions.

Conclusion

The temporary moratorium imposed by Congress was itself a moderate measure, but the fact that Congress ever considered a moratorium necessary is troubling. Enactment of the moratorium indicates a fear that foreign acquisitions of American banks are inherently dangerous, and it implies that permanent restrictions might well be imposed since the moratorium has expired. However, permanent restrictions would impair market efficiency and would contribute little to bank soundness or regulatory efficacy.

Foreign acquisitions do call for some changes in the present approach to holding company regulation, but these changes do not suggest permanent statutory restrictions. The most important of these changes — repeal of section 3(d) of the Bank Holding Company Act — might slow the rate of foreign acquisitions, but it would do so by easing restrictions on domestic acquisitions rather than by imposing artificial constraints on transnational market

positions. Other desirable changes could be implemented simply through administrative action by the Federal Reserve Board. The Board should promulgate a rule establishing a threshold test for determining when foreign presence in a particular banking market has reached a desirable limit, and it should begin exercising the exclusive jurisdiction which it has over proposed acquisitions under the Bank Holding Company Act. It is, perhaps, ironic that recommendations for improvement in American policy concerning foreign acquisitions suggest improvement fundamentally in the treatment of domestic acquisitions. However, this apparent irony merely underscores the central theme developed in this Note, that foreign acquisitions pose no significant dangers to the American banking system.

BOOK REVIEW

REGULATION, ECONOMICS, AND THE LAW. By *Bernard H. Siegan,* ed. Lexington, Ma.: D. C. Heath & Co., 1979. Pp. viii, 127, index. $14.50.

*Reviewed by Allen Early**

In six debates during a Law and Economics course at the University of San Diego Law School, business persons, lawyers, and economists considered whether certain economic activities were better regulated by the government or market forces. These debates, as well as a speech, "The Economics of Free Speech," by Milton Friedman are preserved in *Regulation, Economics, and the Law,* edited by Bernard Siegan, director of Law and Economic Studies at the school.

Some may question whether a series of debates on economic issues is a proper use of time for students training for a career in law. Professor Siegan feels that it is.

> . . . I do not believe that a line exists clearly demarking the concerns of the law. Future lawyers, judges, and legislators will be better prepared to serve their professional interests by having greater familiarity with and understanding of contemporary approaches to solving society's economic and social problems (p. vii).

The issues discussed revolved around a few key questions:

> Will the private market better provide the wants, desires, and aspirations of the people in the presence or in the absence of regulation? Which model serves us more efficiently and effectively? Will government supervision of private activity allocate resources more efficiently and equitably? (p. vii).

Answers to those questions will not come from the field of economics, and certainly will come from outside the legal field. Each individual's answer will depend on whether he or she agrees with a statement by Alan B. Morrison, Director of the Public Citizen Litigation Group, that: "[S]omebody has got to look out for people when they are not looking out for themselves" (p. 75).

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In reply, Milton Friedman would assert that society has no such obligation. In his speech, he compares public response to and acceptance of restrictions placed on the exercise of First Amendment rights and those placed on exercise of economic rights. His purpose is to "demonstrate that there is a basic and fundamental inconsistency in the attitude of intellectuals in general, and the judiciary in particular, to the two areas of freedom" (p. 117). He believes it is schizophrenic to impose severe costs on third parties to protect free speech, but to restrict economic freedom on the basis of almost any third-party effect, however trivial (p. 117). Those who are familiar with his writings, will know that he is consistent in favoring the regulation by the free market over any sort of government regulation of human activity. For example, he would favor freedom to enter any profession — including medicine and law — without any sort of licensing. Those practitioners who performed well would be rewarded by the market system, and thus would continue in their chosen professions. Those whose services were not satisfactory, and so not financially rewarding, would have to get into some other sort of activity. This would presumably assure us of having only capable professionals. The spirit of Professor Friedman seems present throughout the debates.

For example, the debate "Private Corporations and Social Responsibility," covers an area in which Nobel Laureate Friedman has spoken out most forcefully. Friedman argues, in effect, that the *only* obligation of a corporation is to make money for its stockholders. Henry G. Manne, Director of the Center for Studies in Law and Economics at the University of Miami, uses a different approach for his "opposition" to corporate responsibility. He says the question is a trick question, based on ". . . an epistemological error, the notion that a corporation is something that exists in and of itself, [and] if there is no such thing as a real corporate entity, then of course it cannot have a moral responsibility" (p. 29). He believes we are confused by the convenience of legal vocabulary and the reality of the world around us.

The fact that corporations have certain rights under the Constitution does not mean they are people. We recognize that most people in government — despite what is taught in civics classes — are trying to maximize their own political power. They are *not* trying to maximize the interest of everybody else. Business persons

are trying to maximize the return on their investment. There is no corporate purpose apart from their own.

An opposing view is taken by Louis B. Lundborg, retired chairman of the board, Bank of America. Several years ago he countered Alvin Toffler's widely-read *Future Shock* with *Future Without Shock.*[1] There he set out his attempts to understand, for example, those young people who had burned down the branch of the Bank of America at Isla Vista during the 1960's. He felt that only by understanding those who were "anti-establishment" could the establishment survive. He believes strongly in corporate social responsibility.

> The corporation not only should but must pursue a course of social responsibility — I might say a course of social responsiveness — because the public demands it as the price of its franchise, because the corporation's own self-interest demands it, and because the cause of a free society demands it. [The Corporation] has an obligation . . . to be aware of the consequences of its acts . . . and so govern those acts that they will be beneficial, not harmful, to the community and to the broader society (p. 28).

Professor Manne feels such responsibility rests on all of us as individuals, but recognizes that no individual gains anything from practice of such behavior if everyone else is a free rider. He confesses that this belief does not leave him very optimistic about the survival of the free market system (p. 39).

The debates about the specific areas of government regulation — energy, communications, consumer protection, land use and national health insurance — are centered around similar issues. The opposing speakers differ fundamentally on questions of efficiency and equity. Which goal is more important? As mentioned above, the answer will not be found in economics or in law. In the energy field, for example, we cannot decide whether it is more important to produce more oil and gas, or to keep the oil companies from "making too much money." And so we have regulations which seek to protect poor people but which do nothing to encourage more production of the needed energy sources.

In general, the debaters express themselves forcefully, but are fairly genteel in their criticism. Ronald Coase and Nicholas Johnson, in discussing the abolition of the Federal Communica-

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1 L. B. LUNDBORG, FUTURE WITHOUT SHOCK (1974).

tions Commission, seem to stray farther from this genteel posture than the others. Coase, professor of economics at the University of Chicago Law School (and a disciple of Friedman) states, "We all know that the FCC is inefficient, slow-moving and poorly, if not basely, motivated" (p. 41). Johnson, a former FCC Commissioner states, "My radical friend, Ronald Coase, seeks to destroy that which has been created and offers, I must say, very little in return for it" (p. 47). They do not deal in trivialities, however, and go to the heart of what they believe should be done about the use of the radio frequency spectrum.

The debate concerning government regulation and the consumer mentions several specific agencies. Arthur A. Shenfield, British barrister, and professor of economics at the University of California at Davis, cites a number of situations, considered horrible examples of the way regulation works. Alan B. Morrison, director of the Public Citizen Litigation Group, presents cases of the evils which would arise without regulation, especially in the drug field. He says we should ask whether the marketplace has worked, and, if not, see if regulation would be better (p. 65).

The debates concerning land use regulation and national health insurance are in a similar vein. Each side embodies a philosophical statement of belief more than a specific position on an issue. Are such statements helpful to those training to be lawyers? This reviewer believes they are. Court decisions are not made in a vacuum any more than are business decisions. Professor Siegan obviously would not have gone to the effort of bringing these proponents of widely differing viewpoints together for his classes if he had not believed this process would be helpful to his students. "[These] debates should help provide an understanding of the operation of the market and of government regulation and eliminate at least some conjecture about the final impact of a decision affecting the marketplace" (p. viii).

At the present time there is a great deal of criticism directed to too much regulation of the marketplace by government. By contrast, in former times there was widespread feeling that there was too little.

It is important that lawyers know what effect government actions have on the private sector. To do this they must have some understanding of business practices and purposes. It is appropriate to study these matters when they are training to be lawyers.

REGULATORY BUREAUCRACY: THE FEDERAL TRADE COMMISSION AND ANTITRUST POLICY. By *Robert A. Katzmann*. Cambridge, Ma: The MIT Press, 1980. Pp. xiii, 223, appendices, index. $17.50.

*Reviewed by Randall Bartlett**

Robert Katzmann has written a very interesting and readable book about the case selection — and attendant policy adoption — processes of the Federal Trade Commission. The book attempts to do two things. First, it attempts to study and describe the internal and external forces which influence final policy choices, and it is largely successful in doing so. Secondly, and somewhat less successfully, it challenges the validity and usefulness of some of the contemporary theories of bureaucratic behavior, in his terms, "the conventional wisdom."

Katzmann conducted interviews with over one hundred persons who had been involved with the Federal Trade Commission, either as commissioners or staff, or as actors external to it. He is particularly concerned with the Commission's resolution of an internal debate between two basic philosophies of antitrust enforcement — the reactive and the proactive. In the former, the Commission is seen as fulfilling its mission most effectively when it responds to case initiatives from the outside — the mail bag approach. Such an orientation leads to smaller, behavioral cases that generate little evolution of legal principles, but provide relatively rapid (if the term is at all applicable to FTC proceedings) resolution and substantial opportunities for litigative experience.

The alternate proactive approach entails actively seeking cases based upon structural data in various markets. It often involves extensions of the law and the allocation of substantial resources for extended periods of time.

Katzmann concludes that the conflict between these two approaches is resolved by the complex interaction of Commission actors with widely varying goals. Staff attorneys use the Commission as a short-term career stop and demand litigative experience. Economists decry the waste of resources on trivia and focus on the probable quantitative impacts of structural cases on consumer

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benefits. Commissioners need to balance staff morale with congressional pressures and Bureau directors need to balance the needs of staff with the demands of the Commission. In short,

> Organizational arrangements have much to do with determining how power is distributed among participants in the decision-making process, the manner in which information is gathered, the types of data that are collected, the kinds of policy issues that are discussed, the choices that are made, and the ways in which decisions are implemented. The various professional norms and personal objectives of the actors — executives, managers, and operators — also affect the decisions of organizations. Moreover, external actors (for example, the president, congressional committees, and interest groups) may also influence agency behavior (p. 7).

He has successfully captured the internal tensions of the agency and the way in which different actors and groups play various roles in case selection. Economists do perceive staff attorneys as crusaders more concerned with legal process than with economic substance. Attorneys do view economists as professional naysayers and obstructionists. Various groups are extremely protective of "turf." The book thus presents an accurate and useful picture of the internal dynamics of this agency.

Having drawn the lines of tension between the reactive and proactive approaches to case selection, Katzmann concludes that internal organizational pressures dictate a middle ground. Some resources will have to be allocated to simple behavioral cases in order to meet professional demands of attorneys and to permit continued recruitment of high quality staff. Structural cases will also be undertaken for internal reasons, although Katzmann questions, and rightly so, the ability of the Commission to pursue such extensive cases successfully. The enormous scope of the cases and the continual disenchantment and resignation of young staff attorneys make such cases very difficult to complete.

It is a bit frustrating that Katzmann draws the battle lines between the two approaches in terms of their content, *i.e.,* the "social" advantages of each, but is content to resolve the issue on seemingly positive grounds, *i.e.,* the Commission will *have* to reach the existing accommodation. It would have been interesting to attempt to resolve the normative issues as well. However, it

would be unfair to focus too much attention on the book he did not write rather than the one he did.

More important is Katzmann's actual attempt to refute "conventional wisdom" and its "sweeping generalization." He sets out to "show that these accounts [contemporary theories of bureaucratic behavior] do not fully explain FTC behavior," (p. 6) and he adequately meets that goal. They are not *complete* explanations of all specific policy choices. On the other hand, specific instances of incompleteness do not, as Katzmann seems to imply, negate the usefulness of those approaches.

Thomas Kuhn[1] has argued most powerfully that science progresses when an accepted theory of the world is so challenged by anomaly that it becomes untenable. It does not fall of its own weight, nor is it replaced by a return to "random fact gathering." Rather, it is replaced by a more powerful competing *theory.* Until such a new theory is developed, the existing paradigm is always preferable to an arbitrary collection of examples.

Katzmann performs a valuable service in identifying many failures of existing theory to account for FTC policymaking. He seems to want to deny the validity of Kuhn's theory of knowledge, however, by implying that his presentation of a counterexample is sufficient to reject those theories, without providing a general substitute theory.

Indeed, Katzmann's whole argument could easily be viewed as an extension of at least some of those theories rather than an attack on their basic principles. Economic methodology seeks to provide general theories aimed at answering some range of important questions. The models are not intended to be comprehensive or to be perfect descriptions of all situations. Providing a counterexample is a useful critique of the conclusions of some of the approaches, but is not sufficient to reject their general principles.

Furthermore, many aspects of Katzmann's example really reinforce principles in the economic models he pretends to attack. Those principles rest on the important presumption that bureaucrats behave "economically," *i.e.,* that individuals respond to the personal incentive structures which they face. That very behavioral

1 T. KUHN, THE STRUCTURE OF SCIENTIFIC REVOLUTIONS (1962).

assumption seems to be the heart of Katzmann's argument. In his view, attorneys in the FTC are using it for personal career development purposes and want policies which serve that end (Chs. 5, 6). Economists have longer time horizons and different professional payoffs and hence seek different agency policies (Ch. 4). The entire description of the FTC is based upon an analysis of varying individual strategies for personal gain and the institutional balancing of those strategies. That *is* the basic economic approach.

Consequently, when he challenges that approach, he, at times, seems to be doing battle with a straw man. For example, he criticizes Niskanen[2] for claiming that bureaucrats only wish to maximize their budgets, when instead their purposes are more complex. He is correct, but he also is unfair to Niskanen, who uses a different definition of a "bureaucrat," *i.e.,* only the "senior official of any bureau with a separate identifiable budget."[3] He was not purporting to deal with staff attorney motivations. Niskanen also assumes that

> Among the several variables that may enter the bureaucrat's utility function are the following: salary, perquisites of the office, public reputation, power, patronage, output of the bureau, ease of making changes, and ease of managing the bureau.[4]

Katzmann is right to point out that, in the case of the FTC, using a single proxy variable of "budget" to measure gain is inappropriate. He has amply justified that conclusion; but he goes too far when he implies that he has therefore proven the inappropriateness of such models in general. Niskanen is implicitly dealing with traditional executive department agencies, and demonstration of excessive oversimplification relative to the FTC is not proof of similar problems in those more traditional cases.

Katzmann also categorically rejects the institutional theories of agency capture on the basis of his study of the FTC. Noting that the Commission is obviously not controlled by any given industry is a valuable counterexample to those general theories. It is again, however, not sufficient totally to invalidate them as he implies.

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2 W. Niskanen, Bureaucracy and Representative Government (1971).
3 *Id.* at 22.
4 *Id.* at 38.

Theory needs to be replaced by more powerful theory — not rejected by the presentation of counterexamples.

Others such as Weaver[5] have previously noted that capture models are perhaps only appropriate for specific types of regulatory agencies, such as those which deal with what are in effect the management decisions of a particular industry. The FTC clearly performs a different category of function, more analogous to the Consumer Product Safety Commission than the Interstate Commerce Commission. It is important to see that the nature of the regulation is a key variable in determining the applicability of those models. The presentation of the FTC situation is, therefore, insufficient to demonstrate the inappropriateness of such theory for the regulation of price and service levels.

The book, in short, is a fascinating case study of how a single regulatory body balances competing interests. In that regard it is well researched, well written and well argued. It is not, however, a general theory of bureaücratic decisionmaking. It does raise several issues which such a theory should answer. I look forward to attempts by this author or others to provide those answers.

5 Weaver, *Regulation, Social Policy, and Class Conflict*, 50 PUBLIC INTEREST 45 (1978).

RECENT PUBLICATIONS

IN THE ABSENCE OF POWER: GOVERNING AMERICA. By *Haynes Johnson.* New York: The Viking Press, 1980. Pp. 339, index. $12.95.

Haynes Johnson is one of the luminaries of the Washington press corps. He has won the Pulitzer Prize, taught journalism at Princeton University, and authored several books. His latest work is a straight-forward, anecdotal account of the Carter presidency.

Johnson's point is simple: Jimmy Carter has failed to provide effective leadership, but it is probably more the fault of the office than of the man.

Beginning with the historic forces that propelled Carter into office in 1976, Johnson explains how these same circumstances created the post-Vietnam, post-Watergate disillusionment with government that has served to weaken the presidency. The "Me Generation" spawned a new breed of legislator, less wedded to party ideology. The era of the political power broker, the Sam Rayburns and Lyndon Johnsons, was gone. Stricter congressional controls, in the form of legislative vetoes and denials of executive privilege, further lessened presidential influence. But, beyond these factors, it was the sheer size of the federal government itself that handicapped Carter's efforts to lead the country.

The tune is familiar — Carter's first budget was five times greater than John Kennedy's and five hundred times that of Woodrow Wilson (p. 51). The HEW regulations published in one week contain twice as many words as Tolstoy's *War and Peace* (p. 69).

Johnson's blunt reportorial style may be the only distinguishing feature of the book, for *In the Absence of Power* tells us little that we have not read and heard countless times before. Indeed, it is Johnson's well-written presentation of the cold, hard facts that gives weight to his ultimate question: Is governing America beyond any one individual's capacity? While Johnson does not attempt to answer his question, one senses that he believes an affirmative response is an all too real prospect for the future.

Thomas G. Hamerlinck

BOOKS RECEIVED

AGAINST THE CURRENT: ESSAYS IN THE HISTORY OF IDEAS. By *Isaiah Berlin and Henry Hardy*, eds. New York: The Viking Press, 1980. Pp. liii, 394, bibliography, index. $16.95.

AMERICA REVISED. By *Frances Fitzgerald*. Boston: Little, Brown Company, 1979. Pp. 240, notes, bibliography. $9.95.

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