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ARTICLE

LIQUIDATIONS BEFORE AND AFTER REPEAL OF *GENERAL UTILITIES*

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The principle of nonrecognition of gain or loss to a distributing corporation upon an in-kind distribution to its shareholders (the General Utilities *doctrine) has been described as one of seven fundamental principles of corporate tax law. This principle has been subject to substantial criticism, however, and its repeal now appears likely. In this Article, Professor Block analyzes pending proposals for the repeal of the* General Utilities *doctrine and the potential impact such a repeal would have on liquidating corporations and their shareholders under Subchapter C of the Internal Revenue Code. She notes that there is a growing consensus that some form of relief from a repeal of the nonrecognition principle should be provided for liquidating distributions. Professor Block then evaluates several relief proposals and advances her views as to the most viable. She warns that any relief measure adopted will result in new inconsistencies and complexities and urges that a deep and thorough examination of corporate tax policy be made before any major legislative action is taken.*

In 1935 the Supreme Court decided the now famous case of *General Utilities & Operating Co. v. Helvering.*[1] The holding of that opinion, now codified in sections 311 and 336 of the Internal Revenue Code of 1954,[2] allowed a corporation to recognize no gain[3] upon the distribution of appreciated property to its share-

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[1] 296 U.S. 200 (1935).

[2] Section 311(a) provides for nonrecognition with respect to distributions of ongoing corporations:

> GENERAL RULE — Except as provided in subsections (b), (c), and (d) of this section and section 453B, no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of —
> (1) its stock (or rights to acquire its stock), or
> (2) property.

I.R.C. § 311(a) (1982). Section 336(a) provides for similar nonrecognition with respect to liquidations:

> GENERAL RULE — Except as provided in subsection (b) of this section and in section 453B (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in complete liquidation.

I.R.C. § 336(a) (1982). Prior to the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), § 336 applied as well to partial liquidations. TEFRA amended § 336 so that it now applies only to *complete* liquidations. TEFRA, Pub. L. No. 97-248, § 222(b), 96 Stat. 324, 478 (codified at I.R.C. § 336 (1982)).

[3] The *General Utilities* nonrecognition rule as codified also applies to losses upon the distribution of depreciated property. *See supra* note 2. For a discussion of distributions of depreciated assets, *see infra* notes 214–219 and accompanying text.

holders.[4] Nonrecognition of gain or loss to the distributing corporation upon an in-kind distribution is a principle now firmly embedded in our corporate tax policy. In fact, the *General Utilities* nonrecognition rule has been described as one of seven fundamental principles of contemporary corporate tax law.[5]

Although the *General Utilities* principle is a central aspect of corporate tax law, it has been subject to substantial criticism. One commentator suggests that *General Utilities* and its statutory counterparts are the root of many troublesome questions and complexities facing students of taxation today.[6] Nevertheless, repeal of *General Utilities* is likely to create some discomfort within the organized tax bar[7] and the present administration.[8] It has been contended, however, that "[i]f the tax bar genuinely supports making the income tax system less complex, more rational, simpler in practice, it must be prepared to support . . . root changes of the sort exemplified by a curbing of the *General Utilities* doctrine even though, the result is an expansion of the tax base."[9]

Despite the tax bar's interest in avoiding an increase in the tax base, pressure has been growing in recent years to find

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[4] The *General Utilities* court simply held that: "Both tribunals below rightly decided that petitioner derived no taxable gain from the distribution among its stockholders of the Islands Edison shares as a dividend. This was no sale; assets were not used to discharge indebtedness." 296 U.S. at 206. The case has, however, frequently been cited by lower courts for the proposition that distributions of appreciated property do not result in taxable income to the distributing corporation. *See infra* notes 26–28 and accompanying text.

[5] Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90, 130 (1977).

[6] Blum, *Taxing Transfers of Incorporated Businesses: A Proposal For Improvement*, 52 TAXES 516, 519–20 (1974). Numerous other criticisms have been advanced as well. *See, e.g.*, Lewis, *A Proposed New Treatment for Corporate Distributions and Sales in Liquidation*, in TAX REVISION COMPENDIUM 1643 (Staff of House Comm. on Ways and Means, 86th Cong., 1st Sess. (Comm. Print 1959)) (*General Utilities* nonrecognition combined with availability of capital gain on sale or liquidation permits tax avoidance); Raum, *Dividends in Kind: Their Tax Aspects*, 63 HARV. L. REV. 593, 599–605 (1950) (tax avoidance problems).

[7] *See* Ginsburg, *Taxing Corporate Acquisitions*, 38 TAX L. REV. 171, 318–19 (1983); *Reform and Simplification of Corporate Taxation: Hearings Before the Senate Comm. on Finance*, 98th Cong., 1st Sess. 139 (1983) (statement of Donald C. Alexander of Morgan, Lewis & Bockius) [hereinafter cited as *1983 Senate Hearings*].

[8] *See Corporate Tax Upsets Reagan*, N.Y. Times, Jan. 27, 1982 at D1, col. 3 (city ed.) where it was reported that "President Reagan criticized the nation's corporate tax system as a 'myth' . . . and questioned whether it would be better to pass on profits directly to stockholders to be taxed in their individual incomes."

Despite these comments, the present administration has indicated its support for repeal of *General Utilities* as applied to ongoing distributions. *Hearings on H.R. 4170 Before the House Comm. on Ways and Means*, 98th Cong., 2d Sess. (in press) (1984) (statement of John E. Chapoton, Ass't Sec'y (Tax Policy), Dep't of the Treasury).

[9] Ginsburg, *supra* note 7, at 319.

additional sources of tax revenue. In October 1982, Senate Finance Committee Chairman Robert Dole (R-Kan.) asked the Finance Committee staff to undertake a comprehensive study of Subchapter C of the Internal Revenue Code, the corporate tax provisions.[10] Revenue raising was not, however, specifically listed as the goal of the Finance Committee staff's study.[11] Rather, its stated goals were simplification and prevention of unintended corporate tax benefits.[12]

The repeal of *General Utilities* now appears to be inevitable.[13] In fact, proposals generated by the Finance Committee staff have advocated a complete repeal of the *General Utilities* nonrecognition rule for both ongoing and liquidating distributions.[14] Such a firmly embedded doctrine cannot, however, be eliminated without creating shock waves. Opponents of a complete repeal of the nonrecognition principle have complained that such repeal as applied to liquidating corporations would be unduly harsh.[15] Consequently, there has been some debate over possible statutory relief from a repeal of *General Utilities* for liquidating corporations and their shareholders.[16]

The national legislature has chosen in the second session of the Ninety-eighth Congress not to grapple with the difficult questions regarding the repeal of *General Utilities* as applied to liquidating corporations. Rather, bills recently passed by the House and approved by the Senate would repeal the nonrecog-

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[10] STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 1ST SESS., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS 109 app. A (Comm. Print 1983) (press release) [hereinafter cited as STAFF REPORT].

The staff specifically was asked to review recent proposals for revision of major aspects of Subchapter C. The most important of these are proposals of the American Bar Association and the American Law Institute which call, in part, for the repeal of *General Utilities*. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: SUBCHAPTER C 116–17 (1982) [hereinafter cited as ALI PROPOSAL]; Committee on Corporate Stockholder Relationships, Section of Tax'n, American Bar Ass'n *Tax Section Recommendation No. 1981-5*, 34 TAX. LAW. 1386 (1981) [hereinafter cited as *Tax Section Recommendation No. 1981-5*].

[11] In fact, the staff report indicated that some of its proposals would result in revenue increase and others in revenue loss. The proposals were presented "not as revenue raising options, but as potentially meritorious changes in their own right." STAFF REPORT, *supra* note 10, at 2. Hearings on Finance Committee staff proposals which recommended, *inter alia*, the repeal of *General Utilities*, were held in October, 1983. *1983 Senate Hearings*, *supra* note 7.

[12] STAFF REPORT, *supra* note 10, at 109 app. A.

[13] This Article will not include a general critique of the *General Utilities* nonrecognition rule, for that has been done adequately elsewhere. *See supra* note 6.

[14] STAFF REPORT, *supra* note 10, at 76.

[15] *See infra* notes 136–142 and accompanying text.

[16] *See infra* notes 214–231 and accompanying text.

nition rule *only* for ongoing distributions.[17] This limited Congressional focus is unfortunate and represents yet another piecemeal effort at tax reform. At some time in the near future, Congress will again need to consider the repeal of *General Utilities* as applied to liquidating corporations and the broader Finance Committee staff and American Law Institute proposals.

Following some background and historical material, this Article will discuss pending proposals for the repeal of *General Utilities* and the potential impact such a repeal would have on liquidating corporations and their shareholders under Subchapter C. The impact of course will vary depending upon the precise form the repeal takes. With this in mind, the Article will criticize proposals for relief from repeal of *General Utilities* as applied to liquidating corporations. It is hoped that this discussion will lead to further careful examination of our tax policy prior to any final decision by Congress on this area of corporate tax.

I. HISTORY LEADING TO PROPOSALS FOR REPEAL OF *General Utilities*

A. *The* General Utilities *Case: A Nonliquidating Distribution*

In the *General Utilities* case,[18] the corporate taxpayer made an ongoing distribution of highly appreciated common stock of another corporation to its shareholders, for subsequent sale by the shareholders to a third party. The shareholders were, of course, required to pay a tax on the dividend received.[19] Little

[17] H.R. 2163, § 36, 98th Cong., 2d Sess. (Senate amendment in the nature of a substitute), *reprinted in* 2 SENATE COMM. ON FINANCE, 98TH CONG., 2D SESS., DEFICIT REDUCTION ACT OF 1984: STATUTORY LANGUAGE OF PROVISIONS APPROVED BY THE COMM. ON MARCH 21, 1984 at 147 (Comm. Print 1984). The Senate approved this bill on April 13, 1984. 23 TAX NOTES 229 (1984). H.R. 4170, § 54, 98th Cong., 2d Sess., 130 CONG. REC. 2643 (1984). The House of Representatives passed the Tax Reform Act of 1984 on April 11, 1984. 130 CONG. REC. 2741 [hereinafter cited as H.R. 2163 and H.R. 4170 respectively]. According to the House Report on this bill, the provision will increase fiscal year budget receipts as follows:

1984	$ 3 million
1985	18 million
1986	64 million
1987	114 million

H.R. REP. NO. 432, 98th Cong., 2d Sess. 1191 (1984). *See also* S. REP. NO. 169, 98th Cong., 2d Sess. 178 (1984).

[18] General Util. & Operating Co. v. Helvering, 29 B.T.A. 934 (1934), *rev'd*, 74 F.2d 972 (4th Cir.), *rev'd*, 296 U.S. 200 (1935).

[19] Revenue Act of 1928, ch. 852, § 22(a), 45 Stat. 791, 797 (current version at I.R.C. § 61 (1982)).

or no tax would be due on the subsequent sale, however, because the shareholders received a "step up" in basis to fair market value.[20] In this way the corporation hoped to avoid a tax at the corporate level on the appreciated value of the stock which would have been incurred had the corporation first sold the stock and then distributed proceeds to the shareholders.

The government argued in the Supreme Court that the sale of stock, although in form made by the shareholders, was in substance made by the corporation itself.[21] More generally the government argued that whenever a corporation distributes appreciated property to its shareholders, such distribution results in the realization of gain.[22] The court did not rule on these arguments which had not been properly raised at the trial level.[23] Rather, the only government argument upon which the Court specifically ruled was a dividend obligation theory. General Util-

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[20] The basis provision in effect at the time of *General Utilities* provided simply:

> SEC. 113. BASIS FOR DETERMINING GAIN OR LOSS.
>
> (a) *Property acquired after February 28, 1913.* — The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property . . . .

Revenue Act of 1928, ch. 852, § 113(a), 45 Stat. 791, 818 (1928).

Because the shareholders paid tax on the full value of the dividend received, *see supra* note 19 and accompanying text, their "cost" for the property received would be equivalent to the fair market value at the time of distribution. This concept, at least with regard to *individual* shareholders, has since been explicitly codified in I.R.C. § 301(d)(1) (1982). For a discussion of the different treatment of individual as opposed to corporate shareholders upon receipt of corporate distributions, *see infra* notes 91–92 and accompanying text.

[21] Brief for Respondent at 11–12.

[22] Brief for Respondent at 10–11, 18–19, 25. Unlike the imputed sale theory, the government's realization theory had not been raised at *either* tribunal below and appears for the first time in its brief to the Supreme Court. For further discussion of the government's argument, *see infra* notes 115–116 and accompanying text.

[23] The government's imputed sale theory had been raised for the first time on appeal before the Fourth Circuit and convinced that Circuit to reverse the Board of Appeals. 74 F.2d at 975. The Supreme Court in *General Utilities* concluded that the Fourth Circuit's review of this theory not properly raised before the Board of Tax Appeals was in error. 296 U.S. at 206. Ten years later, the Commissioner invoked the imputed sale theory where the corporate taxpayer negotiated for the sale of an apartment building and at the last minute distributed the building to its stockholders, who then actually executed the sale. In that case, the Supreme Court finally had its opportunity to rule on the imputed sale theory in the context of corporate distributions. With language that has since often been cited, the Court proclaimed:

> The incidence of taxation depends upon the substance of a transaction . . . . [T]he transaction must be viewed as a whole, and each step, from commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title.

Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945).

A detailed discussion of the "step transaction" or imputed sale doctrine is beyond the scope of this article. For a good recent discussion of these issues, see Leongard & Cobb, *Who Sold the Bush Brpthers' Beans?: The Commissioner's Power to Ignore the Transfer of an Asset Prior to Sale*, 35 TAX L. REV. 509 (1980).

ities had declared a dividend in the amount of $1,071,426.25, the fair market value of the property to be distributed. Pursuant to the dividend resolution adopted by the General Utilities Board of Directors, this amount was "payable in common stock."[24] Discharge of this approximately $1 million liability with property costing only $2,000, according to the government, resulted in a realization and required recognition of gain.[25]

Because the imputed sale and general realization theories were not considered by the Court, its holding was arguably limited to the satisfaction of dividend obligation theory. In its laconic holding, the Court stated only that: "[b]oth tribunals below rightly decided that petitioner derived no taxable gain from the distribution among its stockholders of the Islands Edison shares as a dividend. This was no sale; assets were not used to discharge indebtedness."[26] Although there has been some debate,[27] *General Utilities* is generally cited for the proposition that the distributing corporation realizes no gain upon the distribution of appreciated property as a dividend to its shareholders.[28]

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[24] In its resolution the Board referred specifically to the "Islands Edison" company stock which it planned to distribute. The precise language of the dividend resolution is quoted at 29 B.T.A. at 936.

[25] This dividend obligation theory was the *only* argument raised before the Board of Tax Appeals below. The Board in its opinion followed the rule developed in several earlier cases that "where the dividend resolution imposes only the obligation to distribute in kind and it is discharged in that way, no gain or loss results to the corporation." 29 B.T.A. at 939. The court here cited First Utah Sav. Bank v. Commissioner, 17 B.T.A. 804 (1929), *aff'd sub. nom.* First Sav. Bank of Ogden v. Burnet, 53 F.2d 919 (D.C. Cir. 1931); Bacon-McMillan Veneer Co. v. Commissioner, 20 B.T.A. 556 (1930); Callahan Road Improvement Co. v. Commissioner, 12 B.T.A. 1109 (1928), *acq.* 1928-2 C.B. 7. After examining the dividend resolution, the Board concluded that *General Utilities* was obliged thereby to distribute stock *in-kind.* Because there was no obligation to distribute a specified amount of money, the declaration and payment of the dividend resulted in no taxable income. 29 B.T.A. at 940. On Appeal, the Fourth Circuit agreed with the Board on this issue. 74 F.2d at 975.

[26] 296 U.S. at 206.

[27] As pointed out by Bittker and Eustice:

> It has been argued that in rejecting this [the general satisfaction] argument, the Court must have assumed (a fortiori) that the mere distribution of the appreciated property was not a taxable event; but there is a big difference between answering a question and assuming an answer in the absence of timely argument.

B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.21, at 7-51 n.126 (4th ed. 1979); *see also* Molloy, *Some Tax Aspects of Corporate Distributions in Kind,* 6 TAX L. REV. 57, 59–61 (1950); Raum, *Dividends in Kind: Their Tax Aspects,* 63 HARV. L. REV. 593, 599 (1950). *But see* Albrecht, *"Dividends" and "Earnings or Profits,"* 7 TAX L. REV. 157 (1952).

[28] *See, e.g.,* Commissioner v. Godley's Estate, 213 F.2d 529, 531 (3d Cir.) (footnotes omitted), *cert. denied,* 348 U.S. 862 (1954), where the court states:

> [T]he scope of the holding of the General Utilities case is uncertain. There is no doubt, however, that the case has received judicial and administrative

The *General Utilities* case itself involved a nonliquidating in-kind distribution. Its holding, however, has since been codified not only in section 311 for ongoing distributions, but also in section 336 for liquidating distributions.[29] Despite its first statutory appearance in Section 336, application of the nonrecognition rule to liquidating distributions was not novel when the provision was enacted in 1954. It can be traced as far back as 1919[30] predating even the *General Utilities* case itself.[31] The development of nonrecognition rules for liquidating as opposed to nonliquidating distributions at different times suggests that such distributions are qualitatively different and perhaps should be governed by different provisions. This concept will be discussed further below.[32]

B. *Legislative History of Nonrecognition*

1. *Codification in 1954.*

For the first time in 1954, the Code provided statutory rules governing the tax consequences of corporate in-kind distributions to shareholders.[33] Because a corporate in-kind distribution

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> acceptance as standing for the proposition that a corporation does not realize income from the distribution of property which has appreciated in value over its cost.

Accord United States v. General Geophysical Co., 296 F.2d 86, 88 n.3 (5th Cir. 1961), *cert. denied*, 369 U.S. 849 (1962); Natural Gasoline Corp. v. Commissioner, 219 F.2d 682, 683 n.3 (10th Cir. 1955).

For an impressive list of earlier cases reaching a similar conclusion, see Molloy, *supra* note 27, at 60 n.20. Further discussion of the "realization debate" appears below. *See infra* notes 107–128 and accompanying text.

29 *See supra* note 2.

30 *See* Treas. Reg. 45, art. 547 (1919) (promulgated under the Revenue Act of 1918), Internal Revenue Regulations, 1863-1938 vol. 8, 140; *see also* Watts, *Recognition of Gain or Loss to a Corporation on a Distribution of Property in Exchange for Its Own Stock*, 22 TAX LAW. 161, 163 n.8 (1968).

31 Treas. Reg. 74, Art. 71 (promulgated under the Revenue Act of 1928) was in effect at the time *General Utilities* was decided. It provided: "[N]o gain or loss is *realized* by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition." (emphasis added) *reprinted* in 138 U.S. REVENUE ACTS — 1909–1950 — THE LAWS, LEGISLATIVE HISTORIES & ADMIN. DOCUMENTS 20 (B. Reams ed. 1979).

32 *See infra* notes 136–147 and accompanying text.

33 Internal Revenue Code of 1954, ch. 736, §§ 311, 336, 68A Stat. 3, 94–95, 106 (codified as amended at I.R.C. §§ 311, 336 (1982)). Both House and Senate reports make it clear that these provisions were intended to be a codification of the *General Utilities* rule. H.R. REP. No. 1337, 83d Cong., 2d Sess., *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4017, 4227; S. REP. No. 1622, 83rd Cong., 2d Sess., *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4677. In addition to the general nonrecog-

may be viewed as a realization event and hence, a proper occasion for corporate taxation,[34] Congress' elimination of the corporate level tax on distributions through codification of the *General Utilities* doctrine should not be regarded as codification of a "nonrealization" rule. Its action might more appropriately be viewed as a response to pressures to mitigate the perceived harshness of the double tax nature of the corporate tax structure.[35]

Congress has, however, also been subject to pressures of an opposite nature because the broad nonrecognition provisions of sections 311 and 336 result in lost tax revenues.[36] For example,

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nition rule in each of these provisions, *see supra* note 2, limited statutory exceptions were enacted. These include distributions of:

(a) Installment obligations. See I.R.C. §§ 311(a), 336(a) (1982), which specifically list § 453B as an exception to the nonrecognition rule.
(b) Last in-first out (LIFO) inventory. *See id.* §§ 311(b) and 336(b).
(c) Assets with a liability in excess of basis. *See id.* § 311(c). There is no parallel exception to the nonrecognition rule for liquidations in § 336.

In addition to statutory exceptions, several judicial exceptions have been developed. Among these is the imputed sale doctrine. *See supra* note 23. Additional judicial exceptions include the assignment of income and tax benefit principles. The Supreme Court's most recent statement regarding the tax benefit rule as an exception to § 336 nonrecognition can be found in Hillsboro Nat'l Bank v. Commissioner, 103 S. Ct. 1134 (1983).

The Senate Finance Committee indicated in its report that it did not intend to change certain existing judicial exceptions to the nonrecognition rule, particularly the assignment of income doctrine. S. REP. No. 1622, 83d Cong., 2d Sess. 247, *reprinted* in 1954 U.S. CODE CONG. & AD. NEWS 4623, 4884.

At this juncture, it might be noted that the *General Utilities* holding in favor of the taxpayer can be attributed to the Commissioner's failure properly to raise all of his theories at the trial level. Had the imputed sale and general realization arguments been properly made, the case most likely would have been decided in favor of the government. Would Congress have enacted § 311 if *General Utilities* had been decided the other way? Were it not for this procedural twist, an entire chapter in our corporate tax history might have been written very differently.

[34] *See infra* notes 111–121 and accompanying text.

[35] This position has been taken by several commentators. *See, e.g.*, North, *Corporate Distributions of Appreciated Property--A Comment on Policy*, 36 NEB. L. REV. 528, 532 (1957). In discussing corporate distributions of appreciated capital assets, Professor North asserts:

> The pattern lacks symmetry. At the individual level the appreciation inhering in the distributed property is fully recognized (though not necessarily forthwith), while at the corporate level it is not recognized at all. The reason for this dichotomy may be tradition more than anything else. The elimination of tax at the corporate level results from Congress incorporating the Supreme Court's 1935 *General Utilities Company* decision into the 1954 Code. However, congressional continuation of this traditional approach is, in reality, a concession to those who view taxation of "earnings" at the corporate level and "dividends" at the shareholder level as "double taxation" of the same income. This concession, like the dividend exclusion and credit, represents a basic policy decision.

Id. (citations omitted).

[36] Projecting revenue increases that would be generated by repeal of *General Utilities* is difficult as revenue effect will vary based on the form that such a repeal takes. The

responding to the *General Utilities* nonrecognition doctrine as codified in sections 311 and 336, corporations quickly developed acquisition schemes which permitted an escape from the corporate level of taxation in what was in economic terms a simple sale of a business.[37] The conflicting pressures upon Congress to relieve the harshness of double taxation and at the same time increase revenue may provide an explanation for its history of schizophrenic behavior in relation to the *General Utilities* nonrecognition rule.

2. *Expansion of Nonrecognition to Include Sales in the Course of Liquidation.*

One early and obvious use of the *General Utilities* nonrecognition principle involved distribution of appreciated assets followed by immediate resale by the shareholder to an outside buyer. Based on the *General Utilities* opinion, taxpayers assumed that the distribution would not result in recognition to the distributing corporation. Moreover, the shareholders would recognize little or no gain on the resale because they would be entitled to a "step-up" in basis upon receipt of the assets in distribution. Corporations wishing to use this technique were dealt a severe blow, however, by the Supreme Court's decision in *Commissioner v. Court Holding Co.*[38] There, the Court held that the sale of assets by the shareholders immediately following receipt of those assets in distribution was *in substance* a sale made by the corporation itself.[39]

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present Finance Committee staff proposal would, according to its projections, result in a *loss* of revenue due to restructuring of transactions as "carryover basis" transactions that would not be subject to tax on the distribution of appreciated assets. Thus, without a relief measure for liquidations, repeal of *General Utilities* would, according to the Senate Staff, result in revenue loss in 1984 and 1985. By 1986, however, the Staff projects a revenue increase of $700,000,000. STAFF REPORT, *supra* note 10, at 108. For a discussion of "cost" versus "carryover" basis transfers under the Staff proposal, see *infra* notes 85–106 and accompanying text.

[37] A classic example is the Mobil-Esmark transaction. Mobil was interested in acquiring a subsidiary of Esmark which held highly appreciated assets. Instead of a direct acquisition, Mobil made a tender offer for the stock of Esmark (the parent corporation). Shortly thereafter, Esmark distributed the subsidiary stock to Mobil in redemption of the Mobil shares acquired. The redemption distribution qualified for nonrecognition to Esmark under pre-TEFRA § 311(d)(2)(B)(current version at TEFRA, Pub. L. No. 97-248, § 223(a)(1), 96 Stat. 324, 483), *see generally* Wall St. J., Aug. 27, 1980, at 4, col. 2.

For an analysis of the "Mobil-Esmark" transaction and similar transactions motivated by the *General Utilities* nonrecognition principle, see Ginsburg *supra* note 7, at 218–21.

[38] 324 U.S. 331 (1945) (Black, J.).

[39] *Id.* at 334. See *supra* note 23, for a brief discussion of the *Court Holding* case.

Whether a sale was *in substance* made by the shareholders or by the corporation itself was a factual question about which reasonable minds might differ.[40] The "shadowy and artificial" distinction[41] between the two very different situations thus made life uncertain for corporate taxpayers. To eliminate this uncertainty, Congress enacted section 337 expanding nonrecognition to certain sales of assets within a twelve-month period beginning upon the date of adoption of a plan of complete liquidation.[42]

This expansion of the scope of nonrecognition to certain asset sales exacerbated the pressure to close perceived loopholes and tax avoidance schemes generated by *General Utilities*. Hence, beginning in 1962 and continuing through 1982, Congress enacted a piecemeal series of amendments, each slowly whittling away at the *General Utilities* nonrecognition rule.

3. *Retraction of Nonrecognition for Distributions of Depreciable Property.*

In 1962, Congress dealt with a taxpayer "loophole" generated by dispositions of depreciable property: taxpayers could legitimately use depreciation deductions to reduce ordinary income[43] yet report gain on the sale of that property as capital gain.[44] As a result, before the enactment of the depreciation recapture rules found in sections 1245 and 1250,[45] property previously subject

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[40] In fact, just a few years after the decision in *Court Holding*, the Supreme Court upheld a lower court finding that a sale of assets by the shareholders shortly after receipt of those assets in a corporate distribution was in *substance* a sale by the shareholders. *See* United States v. Cumberland Serv. Co., 338 U.S. 451, 455–56 (1950) (Black, J.). The key factual distinction between the two cases concerned the contract negotiations which in *Cumberland* were conducted by the shareholders and in *Court Holding* by the corporation.

[41] 338 U.S. 451, 454–55.

[42] Section 337(a) provides:

> GENERAL RULE — If, within the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

I.R.C. § 337(a) (1982). For a good treatment of issues related to the history and operation of § 337, see generally B. BITTKER & J. EUSTICE, *supra* note 27, ¶¶ 11.64–.67. *See also* Galant, *The Enigmatic Section 337: A Current Sounding*, 34 INST. ON FED. TAX'N 493 (1976); Ratliff, *Equalizing Tax Treatment of Liquidations Under 337*, 54 TEX. L. REV. 151 (1975).

[43] I.R.C. § 167 (1982).

[44] *See id.* §§ 1001, 1201, 1221, 1231.

[45] Section 1245, first added by Pub. L. No. 87-834, § 13, 76 Stat. 960, 1032-1036 (1962), applies generally to "personal property." *See id.* § 1245(a)(3) (definition of "Section 1245 Property"). Section 1250, first added by Pub. L. No. 88-272, § 231, 78 Stat. 19, 100-105 (1964), on the other hand, generally applies to "real property." *See id.* § 1250(c) (definition of "Section 1250 Property").

to depreciation could be sold at capital gains rates, thus transmuting what, without depreciation deductions, would have been ordinary income into capital gain.

Rather than limit the recapture provisions to *sales* resulting in capital gain, Congress made sections 1245 and 1250 applicable to *dispositions* of section 1245 or section 1250 property.[46] The legislative history makes it clear that "disposition" for purposes of the recapture provisions includes a section 311 or 336 in-kind distribution as well as a section 337 sale in the course of liquidation.[47] Thus, although gain is generally not recognized under sections 311, 336, and 337, ordinary income may result from the distribution or sale of depreciable property pursuant to the terms of sections 1245 and 1250. The recapture provisions enacted in 1964 and 1984 thus were the first in a series of retrenchments from the *General Utilities* nonrecognition rule. Further retrenchment was forthcoming in 1969 with regard to redemption distributions.

4. *Retraction of Nonrecognition for Redemptions.*

Section 311(a) nonrecognition applies to a distribution by a corporation "with respect to its stock." Although the statute does not specifically refer to redemptions,[48] it was settled shortly after the enactment of section 311 that a distribution in redemption is governed by its terms.[49]

In 1969, Congress discovered that large insurance companies

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[46] *Id.* §§ 1245(a)(1); 1250(a)(1). (1962) Pub. L. No. 87-834, § 13(a)(1), 76 Stat. 960, 1032.

[47]

> In a series of situations your committee found it necessary to recognize ordinary income even though capital gain in such situations is not recognized under existing law. This was done primarily in those cases where the transferee receives another basis for the property than that of the transferor. This treatment is provided in three types of cases where a distribution is made by a corporation without the payment of a tax at the corporate level on unrealized appreciation in value: namely, where the property is distributed as a dividend (under sec. 311), where the property is distributed in a partial or complete liquidation by a corporation (sec. 336), and where in a plan of complete liquidation a corporation sells the depreciable personal property (and perhaps other assets) and within a 12-month period completes the liquidation of the corporation (sec. 337).

S. REP. No. 1881, 87th Cong., 2d Sess. 99, *reprinted in* 1962 U.S. CODE CONG. & AD. NEWS 3304, 3402–03.

[48] A "redemption" is defined as a corporate acquisition of its stock "from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock." I.R.C. § 317(b) (1982).

[49] Treas. Reg. § 1.311-1(a), T.D. 6152, 20 Fed. Reg. 8875, 8888, 1955-1 C.B. 61, 97; *see also* Watts, *supra* note 30, at 166–67.

were making heavy use of appreciated investment portfolios to redeem stock.[50] Gain on this appreciation was thus escaping tax under section 311(a). Responding to publicity surrounding this "loophole," Congress again amended section 311, adding section 311(d)(1).[51] This new subparagraph provided generally for the recognition of gain upon use of appreciated property to redeem stock.[52] More than any other exception to section 311(a), the 1969 amendments represented a general movement away from the *General Utilities* nonrecognition rule.[53] Each of the other statutory exceptions to the nonrecognition rule in section 311 involved a specific recapture of a prior tax benefit which in some sense was previously realized but not recognized.[54] In contrast,

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[50] An article in *Forbes* has been viewed as largely responsible for making Congress aware of the problem. *The Great Tax Free Cash In: The Insurance Companies Are Getting Imaginative About the Big Unrealized Capital Gains in Their Investment Portfolios*, FORBES, Nov. 1, 1969, at 52, *cited in* Emory, *Non-Liquidating In-Kind Corporate Distributions--Some New Problems for Old*, 24 TUL. TAX INST. 285, 304 n.80 (1975), *and in* Porter, *Redemptions of Stock With Appreciated Property: Section 311(d)*, 24 TAX LAW. 63, 64 (1970).

[51] Tax Reform Act of 1969, Pub. L. No. 91-172, § 905, 83 Stat. 487, 713 (codified as amended at I.R.C. § 311(d) (1982)).

[52] Section 311(d)(1) provides in pertinent part:

> (d) APPRECIATED PROPERTY USED TO REDEEM STOCK —
> (1)IN GENERAL. — If —
> (A) a corporation distributes property (other than an obligation of such corporation) to a shareholder in a redemption (to which subpart A applies) of part or all of his stock in such corporation, and
> (B) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),
> then a gain shall be recognized to the distributing corporation in an amount equal to such excess as if the property distributed had been sold at the time of the distribution . . . .

I.R.C. § 311(d)(1) (1982).

[53] Porter, *supra* note 50, at 65.

[54] For example, §§ 311(a) and 336(a) specifically list § 453B (Gain or Loss on Disposition of Installment Obligations), as an exception to the general nonrecognition rule. Section 453B serves to recapture upon "disposition" of an installment note, the excess of fair market value over the basis of the note. Income recaptured under § 453B was in fact *realized* at the time of the installment sale, but recognition was deferred by virtue of the § 453 installment reporting privilege.

Similarly, where a corporation exercises the privilege of accounting for inventory on a last in-first out (LIFO) as opposed to a first in-first out (FIFO) basis under § 472 and subsequently distributes inventory to its shareholders, §§ 311(b) and 336(b) will recapture the excess of the FIFO over LIFO inventory amount. Where one uses the privilege of LIFO accounting it might be argued that some gain was previously realized. For example, suppose Corporation X owns three inventory assets of equal value, purchased for $10, $20, and $30 respectively. If X sells or distributes one asset for $30, it will recognize no gain under the LIFO method since it is deemed to have first disposed of the last asset. Under FIFO, it would have been required to pay tax on a gain of $20. One might argue that the $20 of gain was realized but not recognized by virtue of the LIFO reporting privilege.

Finally, § 311(c) provides for recognition of gain to the distributing corporation where a liability to which the property distributed is subject, or which is assumed by the shareholder, exceeds the basis of the property. The corporation has previously been section 311(d) simply taxed the corporation upon its use of the appreciated value of its property in a redemption transaction.

Perhaps Congress in enacting section 311(d) was exhibiting second thoughts about the nonrecognition rule itself. Section 311(d), however, has not proved to be the appropriate mechanism for resolving these doubts. Instead, the redemption provision has created illogical and inconsistent tax policy.[55]

There are, of course, exceptions to the section 311(d) general recognition rule. In section 311(d)(2), Congress allowed continued use of the *General Utilities* nonrecognition principle for certain limited redemption distributions.[56] When Congress became aware of corporate acquisition schemes designed to take advantage of these special redemption nonrecognition rules,[57] it

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able to "use" the value of this excess for depreciation deductions on the assumption that it would repay the liability. By distribution of the asset to its shareholders subject to the liability, this assumption has proven invalid. Hence, it can be argued that the corporation realized income by using the liability from which it has now been relieved as part of its "cost basis" for depreciation purposes thus offsetting other income.

[55] For a critique of the § 311(d) provisions, *see* Porter, *supra* note 50. Congress has perhaps now perceived the illogical and inconsistent tax policy created by I.R.C. § 311(d). Bills recently passed by the House and approved by the Senate would amend § 311(d) so as to apply, with certain limited exceptions, to corporate dividend distributions of appreciated property, whether in redemption or not. H.R. 2163, *supra* note 17, § 36; H.R. 4170, *supra* note 17, § 54.

[56] Among the provisions in § 311(d)(2) more frequently used by corporate taxpayers to avoid recognition of gain were those in pre-TEFRA § 311(d)(2)(A), (B). Prior to TEFRA, § 311(d)(2)(A) read as follows:

> (2) EXCEPTIONS AND LIMITATIONS — Paragraph (1) shall not apply to —
>
> (A) a distribution in complete redemption of all of the stock of a shareholder who, at all times within the 12-month period ending on the date of such distribution, owns at least 10 percent in value of the outstanding stock of the distributing corporation, but only if the redemption qualifies under section 302(b)(3) (determined without the application of section 302(c)(2)(A)(ii)) . . . .

Tax Reform Act of 1969, Pub. L. No. 91-172, § 905, 83 Stat. 487, 713 (repealed by TEFRA Pub.L. No. 97-248. § 223(a)(1) 96 Stat. 324, 483 (1982)).

As pointed out by Porter, *supra* note 50, at 69: "The policy grounds for this exception [for a 10% shareholder] are obscure. There is no special hardship in taxing a corporation on such a redemption as compared with redemptions which do not so qualify." Section 311(d)(2)(B) (1976) provided before TEFRA that paragraph (1) would not apply to

> (B) a distribution of stock or an obligation of a corporation —
>
> (i) which is engaged in at least one trade or business,
>
> (ii) which has not received property constituting a substantial part of its assets from the distributing corporation, in a transaction to which section 351 applied or as a contribution to capital, within the 5-year period ending on the date of the distribution, and
>
> (iii) at least 50 percent in value of the outstanding stock of which is owned by the distributing corporation at any time within the 9-year period ending one year before the date of the distribution.

Tax Reform Act of 1969, Pub. L. No. 91-172, § 905, 83 Stat. 487, 713 (repealed by TEFRA, Pub.L. No. 97-248, § 1223 (a)(1), 96 Stat. 324, 483 (1982)).

[57] *See, e.g.*, Wall St. J., Aug. 27, 1980, at 4, col. 2; *see also* Ginsburg, *supra* note 7,

amended section 311(d), cutting back severely the scope of its nonrecognition exceptions. Several subparagraphs of section 311(d)(2) were repealed and replaced with more limited exceptions to the general rule that gain will be recognized on redemption distributions.[58]

Among the most important of the 1982 provisions added to section 311 is new section 311(d)(2)(A), which provides for nonrecognition to the corporation upon a distribution in redemption where a corporate shareholder receives property the basis of which is determined under section 301(d)(2); that is, where the corporate shareholder receives a dividend distribution with a carryover basis.[59] Through the use of a carryover basis, gain on appreciation of the assets is preserved at the shareholder level. Because the shareholder level of taxation on the appreciated value is preserved, Congress is willing to let the gain escape taxation at the distributing corporation level. Thus, Congress allowed the *General Utilities* nonrecognition principle to continue as long as tax on the gain was not avoided altogether. Concern here is not with preservation of the double tax structure but with preservation of any tax at all.[60]

TEFRA's revision of section 311(d), to provide for nonrecognition where the corporate shareholder receives property with a carryover basis from the distributing corporation, may foreshadow things to come.[61] This approach, which makes tax consequence to the distributing corporation dependent upon the type of basis received by the shareholder, has been proposed in the Senate Finance Committee staff and ALI proposals for the

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at 178; Ward, *The TEFRA Amendments to Subchapter C: Corporate Distributions and Acquisitions*, 8 J. CORP. L. 277, 283–86 (1983); *supra* note 37 and accompanying text.

[58] TEFRA, *supra* note 2, at § 223(a)(1) (amending I.R.C. § 311(d)(2) (1976)).

[59] Section 311(d)(2)(A) now provides:

> (2) Exceptions and Limitations —
> Paragraph (1) [general rule requiring recognition of gain when appreciated property is used to redeem stock] shall not apply to —
> (A) a distribution to a corporate shareholder if the basis of the property distributed is determined under section 301(d)(2) . . . .

I.R.C. § 311(d)(2)(A) (1982). For a good discussion of changes in corporate distribution rules made by TEFRA, see Steines, *Taxation of Corporate Distributions--Before and After TEFRA*, 68 IOWA L. REV. 937 (1983); Ward, *supra* note 57.

[60] Shareholders generally include the amount of dividends received in gross income. I.R.C. § 61(a)(7) (1982). *Corporate* shareholders receiving dividends from a domestic corporation, however, are generally entitled to a "dividends received" deduction. I.R.C. § 243 (1982). Where the distributing corporation is given nonrecognition treatment and the recipient corporate shareholder receives a "dividends received" credit, gain may forever escape taxation unless the recipient is given a carryover basis.

[61] *See infra* notes 64–65 and accompanying text.

reform and simplification of Subchapter C.[62] The proposals would expand the use of the distinction between cost and carryover basis distributions presently found for redemptions in section 311(d)(2)(A). They condition the continued availability of a nonrecognition rule on corporate transfers of assets on whether the corporation's basis in the assets is carried over to the transferee.[63]

Another chapter in the life of section 311(d) is about to unfold. Bills recently passed by the House and approved by the Senate would amend this provision so as to apply to *ongoing* distributions of appreciated property.[64] If these bills become law. the section 311(d) exception to the nonrecognition rule will no longer be limited to redemption distributions. Even under this amended version, however, there will continue to be exceptions. For example, the bills would exempt from recognition distributions to an 80 percent corporate shareholder where that shareholder receives a carryover basis under section 301(d)(2). In this limited context, the amended version would continue the approach of present section 311(d)(2)(A) which makes tax consequence to the distributing corporation dependent upon the type of basis received by the corporate shareholder.[65]

5. *Retraction of Nonrecognition for Partial Liquidations.*

In 1982, Congress repealed the section 336 nonrecognition rule for partial liquidations,[66] thereby eliminating nonrecognition

[62] *See infra* notes 85–105 and accompanying text.

[63] A detailed analysis of these proposals and their impact appears below. *See infra* notes 95–106 and 148–158 and accompanying text. It should be noted here, however, that the proposals differ somewhat from the approach used in § 311(d)(2)(A). Section 311(d)(2)(A) provides for nonrecognition to the distributing corporation upon *any* in-kind dividend distribution to a corporate shareholder if the recipient shareholder receives a carryover basis under § 301(d)(2). The Senate Staff and ALI proposals, in contrast, provide for a "carryover basis election" resulting in no gain to the distributing corporation *only* where there is a "substantial" transfer of assets. *See infra* notes 102–103 and accompanying text.

[64] If I.R.C. § 311(d) is amended as proposed in recently passed by the House and approved by the Senate legislation to provide generally for recognition of gain upon distributions of appreciated property, a *new* § 311(d)(2)(A) exception would be provided. The proposed provision would except from the new nonrecognition rule:

(A) a distribution to an 80 percent corporate shareholder if the basis of the property distributed is determined under § 301(d)(2). H.R. 2163, *supra* note 17, § 36(a)(2)(A); H.R. 4170, *supra* note 17, § 54(a)(2)(A).

[65] The bills passed by the House and approved by the Senate also include an exception for: "(B) A distribution which is made with respect to qualified stock if — (i) section 304(b)(4) applies to such distribution, or (ii) such distribution is a qualified dividend." *See infra* notes 67 and 74.

[66] TEFRA, *supra* note 2, § 222(b), (d). This put an end to the fine line drawing that

on partial liquidation at the distributing corporation level.[67] This represented another step in the slow process of whittling away at the *General Utilities* principle.[68]

6. *Collapsible Corporations.*

One tax-avoidance strategy developed by taxpayers in response to the *General Utilities* nonrecognition rule was the creation of "collapsible corporations."[69] The classic illustration of such a corporation involves the motion picture industry. Production of motion pictures frequently results in high costs in the early stages and substantial income in future years. A fairly

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was often necessary to distinguish between a distribution in partial liquidation (which was not taxable to the distributing corporation) and a redemption of part of a corporation's stock (which was taxable to the distributing corporation under § 311(d)). See Treas. Reg. § 1.311-1(a) (1954) (emphasis added), which provides that "the term 'distributions with respect to its stock' includes distributions made in redemption of stock (*other than distributions in complete or partial liquidations*)." For a discussion of the problems in distinguishing between partial liquidations and redemptions after the Tax Reform Act of 1969, *see* Bierman & Fuller, *Partial Liquidations under Section 346: Corporate Effects and Special Problems*, 42 J. TAX'N 286 (1975); Burke & Parker, *Partial Liquidations Under Section 346: Planning, Problems and Procedures*, 24 BAYLOR L. REV. 1, 60–63 (1972).

To complicate matters further, it was possible prior to TEFRA to combine a "partial liquidation" with a redemption. To the extent that stock was redeemed in excess of that necessary to accomplish a legitimate partial liquidation, the distribution was covered by § 311(d). *See* Rev. Rul. 74-465, 1974-2 C.B. 114. Despite this possibility, the corporate taxpayer in this ruling was treated as entirely within the partial liquidation provisions.

[67] The "partial liquidation" concept remains after TEFRA only in the limited context of determining tax consequences of a redemption to an individual, as opposed to a corporate, shareholder. What remains of "partial liquidations" can be found in I.R.C. § 302(b)(4), (e) (1982). Under those provisions, if a redemption distribution in "partial liquidation" is made to a shareholder who is not a corporation, that shareholder will be entitled to treat the distribution as part or full payment in exchange for stock under *id.* § 302(a).

[68] *See Legislation Relating to Tax-Motivated Corporate Mergers and Acquisitions, 1982: Hearings on H.R. 4562, 5517, 5719, 5855 and 6295 Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 97th Cong., 2d Sess. (1982) (statement of David G. Glickman, Deputy Ass't Sec'y (Tax Policy), Dep't of the Treasury).

[69] A "collapsible corporation" is defined as:

> a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of property which (in the hands of the corporation) is property described in paragraph (3), or for the holding of stock in a corporation so formed or availed of, with a view to —
>
> (A) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, before the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property, and
>
> (B) the realization by such shareholders of gain attributable to such property.

I.R.C. § 341(b)(1) (1982).

common arrangement in the industry was to set up a corporation which would finance production of a film through borrowing. Before release of the film, the corporation would liquidate, distributing all of its assets to the shareholders.

No tax resulted to the corporation upon the liquidating distribution pursuant to section 336. Moreover, the shareholders would have "sale or exchange" gain, as opposed to ordinary income, on the liquidation pursuant to section 331. In computing the "amount realized" on the liquidation "sale or exchange" the shareholders would include the full value of the completed film. If left in corporate solution, this value would be taxed to the corporation as ordinary income. Through such liquidation, the income from the successful film escaped taxation altogether at the corporate level. Moreover, income from the film, which should at least be treated as ordinary income to the shareholders, was transmuted into capital gains.[70]

To combat the collapsible corporation "loophole," Congress in 1950 enacted the provisions presently found in section 341.[71] Proponents of proposed Subchapter C reforms have argued that a repeal of *General Utilities* would eliminate the attractiveness of the collapsible corporation scheme. Thus, repeal of *General Utilities* should permit a simultaneous repeal of the complex provisions in Code section 341.[72] If *General Utilities* is only partially repealed, however, there may be some continuing need for a "collapsible corporation" provision.[73]

[70] For early cases involving motion picture industry collapsible corporations see Herbert v. Riddell, 103 F. Supp. 369 (S.D. Cal. 1952); O'Brien v. Commissioner, 25 T.C. 376 (1955), *acq.* 1954-1 C.B. 4. These cases arose in tax years prior to 1950. Thus, the collapsible corporation provisions were not directly applicable. Despite the clear tax avoidance motivation on the part of the taxpayer, the government lost in each case.

[71] Revenue Act of 1950, Pub. L. No. 81-814, ch. 994, § 212, 64 Stat. 906, 934 (1950). In essence, I.R.C. § 341(a) converts what would otherwise be capital gain upon liquidation or other disposition of a collapsible corporation to ordinary income. There are, however, numerous and complex exceptions to the general rule provided in subparagraphs (d) through (f) of § 341. For a general discussion of the complexities of the "collapsible corporation" provisions, see generally Ginsburg, *Collapsible Corporations--Revisiting an Old Misfortune*, 33 TAX L. REV. 309 (1978); Holden, *The Collapsible Corporation: What, Why, How; Understanding the Creature as Protection Against Unfortunate Tax Results*, 34 INST. ON FED. TAX'N 11 (1976); Comment, *The Structure of Collapsibility: A Policy Comparison of Section 341 and 751 of the Internal Revenue Code*, 21 HARV. J. ON LEGIS. 559 (1984).

[72] See, e.g., Ginsburg, *supra* note 7, at 213 n.114, where the author suggests that if *General Utilities* is repealed, "§ 341, a notoriously complex provision, would serve no function and thus disappear . . . ." *See also* Blum, *Taxing Transfers of Incorporated Businesses: A Proposal for Improvement*, 52 TAXES 516, 524 (1974); Lewis, *supra* note 6, at 1643.

[73] *See infra* text accompanying note 289.

C. *Summary*

Over the years since the 1954 codification of the *General Utilities* nonrecognition principle in sections 311, 336, and 337 of the Internal Revenue Code, Congress has enacted a piecemeal series of exceptions to that principle that has greatly increased the complexity of the Code and produced numerous inconsistencies in tax policy. Repeal of *General Utilities* for only ongoing distributions as provided in recent legislation passed by the House and approved by the Senate would be yet another step in the piecemeal amendment process.[74] As suggested by Senator Dole, the time is ripe for some overall revision and rethinking of Subchapter C.[75] The Senate Finance Committee Staff and the American Law Institute, in their proposals, have done much of this thinking to date.

II. Repeal Proposals

A. *Background*

1. *Focus on Acquisitions.*

Senator Dole instructed the Senate Finance Committee staff[76] to study the recent reform proposals of the American Bar Association Tax Section and the American Law Institute.[77] These proposals are not, however, limited to repeal of the *General*

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[74] H.R. 2163 and H.R. 4170, *supra* note 17, *do not* repeal I.R.C. § 311 outright. Rather, an *amendment* to § 311(d) is provided. This amendment provides generally for recognition of *gain* upon distributions of appreciated property. H.R. 2163, *supra* note 17, § 36(a)(1); H.R. 4170, *supra* note 17, § 54(a)(1). Two exceptions continue to be provided. These are:

> (A) a distribution to an 80 percent corporate shareholder if the basis of the property distributed is determined under § 301(d)(2);
> (B) a distribution which is made with respect to qualified stock . . . .

H.R. 4170, *supra* note 17, § 54(a)(2).
The latter provision generally continues the exception presently found in I.R.C. § 311(d)(2)(B) for "partial liquidation" distributions made to *individual* shareholders.
The bills would not change I.R.C. § 311(a)–(c). At least technically, then, the *General Utilities* rule is left in the Internal Revenue Code however emasculated by the revisions to I.R.C. § 311(d). This type of legislative change hardly qualifies as a "simplification" measure.

[75] *1983 Senate Hearings*, *supra* note 7 (opening remarks of Sen. Dole (R-Kan.)), *see also* Staff Report, *supra* note 10 at 109 app. A (Press Release).

[76] *See* Staff Report, *supra* note 10, at 909 app. A (Press Release).

[77] *See supra* note 10.

Utilities nonrecognition rule. They focus on the broader question of appropriate tax treatment for corporate stock or asset acquisitions. The Senate Finance Committee staff report, modeled in large part on the American Law Institute (ALI) proposal, has similarly focused on the "acquisition" issue in its proposal.[78]

Under present law, a corporate asset acquisition generally results in a tax to the selling corporation[79] and a cost basis in the assets to the purchaser.[80] If the transaction can be structured as a reorganization, however, the "selling" corporation generally will recognize no gain or loss[81] and the "purchaser" generally will receive the assets with a carryover basis.[82] Through use of a carryover basis, a gain on the appreciated value of the corporation's assets has been preserved. A stock acquisition, on the other hand, usually results in a tax to the selling shareholders[83] and a carryover basis in the underlying assets to the purchaser.[84]

2. *Escape from Taxation in a Cost-Basis Transfer--Importance of Distinguishing Between Cost and Carryover Basis Transactions.*

Ordinarily, a transaction which results in a cost basis to the "purchaser" has simultaneously resulted in recognition of gain or loss to the transferor.[85] There are numerous transactions that may be structured under the present Code, however, for which this is not the case. In these cases *General Utilities* becomes the culprit. Using the nonrecognition rules of sections 311, 336, and 337, a corporate transaction can be structured which results in nonrecognition to the transferor corporation and a cost basis to the transferee shareholders or purchasers.[86] Having received

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[78] *See* STAFF REPORT, *supra* note 10, at 55–67; ALI Proposal, *supra* note 10, at 22–50.

[79] I.R.C. § 1001 (1982).

[80] *Id.* § 1012.

[81] *Id.* §§ 361(a), 368. *But see id.* § 361(b) (taxation of boot).

[82] *Id.* § 358.

[83] *Id.* § 1001. The corporation itself will not, however, recognize any gain or loss when its shareholders sell stock.

[84] The purchaser will, of course, receive a cost basis in the *stock* purchased. *Id.* § 1012. Since only stock has changed hands, the corporation's basis in the underlying assets remains unchanged. *But see id.* § 338. For a discussion of § 338, *see infra* note 88 and accompanying text.

[85] I.R.C. §§ 1001, 1012 (1982).

[86] Should § 311(d) be amended as provided in H.R. 2163, *supra* note 17, § 36 and H.R. 4170, *supra* note 17, § 54, a § 311 ongoing distribution will no longer be available

a cost or "stepped-up" basis, the transferee will never be subject to tax on the corporation's gain due to the appreciated value of corporate assets. The transferor corporation similarly has avoided tax on the appreciation in value by virtue of the *General Utilities* nonrecognition rule. Thus, corporate level gain on the appreciation in the assets distributed never will be taxed.

a. *The Acquisition Context.* One "cost basis" transaction that uses the *General Utilities* nonrecognition principle to avoid tax on appreciation of corporate assets involves a corporate acquisition of stock in a subsidiary. Although a purchaser of stock ordinarily acquires a carryover basis in the underlying assets of the purchased subsidiary,[87] under Code section 338, a "qualified" purchaser of stock may elect to acquire a cost basis in assets owned by the new subsidiary.[88] As a result of this election, the purchaser receives a stepped-up basis in the assets of the "target" corporation with no tax cost to the target on the appreciation of its assets.[89]

b. *The Nonacquisition Context.* In the nonacquisition context, simple corporate distributions of appreciated assets may result in nonrecognition to the distributing corporation[90] and a

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as part of these planning strategies. Acquisition transactions which use the *liquidation* nonrecognition provisions in §§ 336 and 337 would, however, continue to be available.

[87] *See supra* note 84 and accompanying text. Even if the purchased subsidiary is liquidated, the recipient shareholder will ordinarily receive a carryover basis in assets received upon liquidation pursuant to I.R.C. § 334(b)(1) (1982).

[88] *Id.* § 338(a). A "qualified stock purchase" is defined to be:

> any transaction or series of transactions in which stock of 1 corporation possessing —
>
> (A) at least 80 percent of total combined voting power of all classes of stock entitled to vote, and
>
> (B) at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends),
>
> is acquired by another corporation by purchase during the 12-month acquisition period.

Id. § 338(d)(3).

I.R.C. § 338 was added to the Code by TEFRA § 224(a). Pub. L. No. 97-248, 96 Stat. 324, 485-490 (1982). Similar but not identical cost-basis stock acquisitions were previously available, however, under pre-TEFRA § 334(b)(2). Amended by TEFRA, Pub. L. No. 97-248, Title II, §§ 222(e)(1)(c), 224(b), 96 Stat. 324, 480, 488 (1982).

[89] I.R.C. § 338(a)–(b) (1982). For good discussions of § 338 see Ginsburg, *supra* note 7, 251–319; Ward, *supra* note 57, 308–36 (1983); Note, *Section 338: The Result of the Legal Evolution of the Tax Treatment of Two-Step Asset Acquisitions*, 61 TEX. L. REV. 1109 (1983).

[90] As to *ongoing* distributions, H.R. 2163, *supra* note 17, § 36 and H.R. 4170, *supra* note 17, § 54, would change this result. In fact, the House Report on the bill specifically states: "The committee believes that under a double-tax system the distributing corporation generally should be taxed on any appreciation in value of any property distrib-

cost basis to the recipient shareholders. For example, under section 301(d)(1)[91] an *individual* shareholder will receive a fair market value or cost basis in assets distributed as an in-kind dividend.[92] Similarly, a liquidating distribution resulting in recognition of sale or exchange gain to the shareholder under section 331 will result in a "step up" in basis to the recipient shareholder[93] without recognition of gain to the distributing corporation.[94]

B. *The ALI Proposal*

The ALI proposal,[95] upon which the Senate Finance Committee staff's recent proposals are modeled,[96] has responded to the problem of permanent avoidance of corporate taxation on appreciation in cost basis transfers by distinguishing such transfers from those in which carryover basis rules apply.[97] Proposal C1 provides as a general rule that, "[e]xcept as specifically otherwise provided, gain or loss shall be recognized on any corporate transfer of assets, by distribution in kind to shareholders or sale in the course of liquidation or otherwise, in which basis does not carryover."[98] The ALI, in its comments to this proposal, states that its "main import" is the rejection of *General Utilities*.[99] Moreover, "[t]he main reason for Proposal C1 is to assure that unrealized gains do not escape tax altogether, and

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uted in a nonliquidating distribution." H.R. REP. No. 432, 98th Cong., 2d Sess. 1190 (1984); *see also* S. REP. No. 169, 98th Cong. 2d Sess. 177 (1984).

[91] Section 301(d)(1) provides:

> [T]he basis of property received in a distribution shall be —
> (1) NONCORPORATE DISTRIBUTEES. —
> If the shareholder is not a corporation, the fair market value of such property.

I.R.C. § 301(d)(1) (1982).

[92] Such cost-basis distributions to individual shareholders should be contrasted with carryover basis distributions to corporate shareholders. Under *id.* § 301(d)(2), a *corporate* shareholder, unlike an individual, will generally receive the asset with a basis equal to that of the distributing corporation; that is, a carryover basis.

[93] *Id.* § 334(a).

[94] *Id.* § 336.

[95] For a good general analysis of early drafts of the ALI proposals, *see* Beghe, *The American Law Institute Subchapter C Study: Acquisitions and Distributions,* 33 TAX LAW. 743 (1980).

[96] Because the ALI proposals are far more detailed than those of the Finance Committee staff, attention here is focused on the former. References will of course be made to points upon which the Finance Committee staff differs with the ALI.

[97] *See* ALI PROPOSAL, *supra* note 10 at 22.

[98] *Id.* at 116.

[99] *Id.* at 117. (Comments to Proposal Cl).

no such escape will result from a transfer in which corporate basis carries over."[100] Although the overall ALI proposal is focused on acquisition transactions, Proposal C1 clearly extends as well to liquidating and nonliquidating distributions in kind.[101]

With regard to corporate acquisitions, the ALI and Senate staff proposals would make classification as a "cost" or "carryover" basis transaction *explicitly* elective.[102] Election to treat a transaction as a cost basis acquisition to the purchaser would subject the corporate transferor or seller to recognition of gain or loss on the transfer.[103] The decision to elect a cost basis acquisition can result in significantly higher tax cost to the transferor. Purchase negotiations will include a discussion of these issues. Indeed, the price and terms of the acquisition will be affected by a decision to take the cost basis route.

This change is not as dramatic as it may appear at first glance. With sophisticated tax planning, parties to corporate acquisitions under present law can choose either a cost or carryover basis transaction. By fitting within the reorganization provisions of the Code, an acquisition may thus receive carryover basis treatment even under present law. Complexities in the reorganization rules, however, may create numerous traps for the unwary.[104] In making the classification explicitly elective, the ALI concedes that its proposals are "based on ideas implicit in many provisions of existing law; . . . the proposal is to articulate the idea more explicitly, and implement it more comprehensively."[105]

While parties to the sale of substantially all of the assets or stock of a corporation have the option to select either a cost or

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[100] *Id.*

[101] *Id.* at 114–15.

[102] *Id.* at 43 (Proposal Al-Classification of Acquisition Transactions); STAFF REPORT, *supra* note 10, at 60–61. It should be noted here that the term "acquisition" for purposes of the ALI Proposal "refers primarily to acquisitions of *all* of the stock or *all* of the assets of an acquired corporation which was not previously a subsidiary of any other corporation." ALI PROPOSAL, *supra* note 10, at 43.

Similarly, under the Finance Committee staff proposal a *stock* acquisition would require a purchase "of at least 80 percent of the voting power of all voting stock and at least 80 percent of all other stock" to qualify for elective treatment. STAFF REPORT, *supra* note 10, at 55. This is parallel to the present requirement for a cost-basis election under I.R.C. § 338. An *asset* acquisition would qualify for elective treatment under the Senate proposal where "one corporation acquires *substantially all* of the assets of another corporation." *Id.* at 56 (emphasis added).

[103] ALI PROPOSAL, *supra* note 10, at 116; STAFF REPORT, *supra* note 10, at 60–61.

[104] See STAFF REPORT, *supra* note 10, at 27–32, where complexities and traps related to the reorganization provisions are discussed. *See also*, J. PECHMAN, FEDERAL TAX POLICY 159–60 (1977).

[105] ALI PROPOSAL, *supra* note 10, at 22.

a carryover basis, no such election is provided for simple liquidating distributions not connected in any way with a corporate acquisition. The liquidation will automatically be classified as a "cost basis" transfer because the shareholders receive a "step-up" in basis under section 331. The implications of this electivity distinction will be discussed further below.[106]

III. Impact of Proposed Repeal of *General Utilities* on the Liquidating Corporation

A. *Unresolved Debate: Is a Corporate Distribution in Kind a Realization Event?*[107]

1. *Revival of the Debate.*

Under section 1001, "gain from the sale or other disposition of property" must be recognized except as otherwise provided in Subtitle A of the Internal Revenue Code.[108] To the extent that a corporation has disposed of property by distribution to its shareholders, it would appear that such "disposition" should result in recognition of gain under this provision. Unfortunately, the issue does not lend itself to such simple solution. Before such a "disposition" can be taxed, it must be determined as a constitutional matter that income has been realized under the Sixteenth Amendment.[109]

Given the sparse language in the Supreme Court's opinion in *General Utilities*, it is not clear whether the Court there held that a corporation realizes, as opposed to recognizes, no gain upon a distribution of appreciated property.[110] The debate on the "realization" question was quieted by the codification of the nonrecognition rule in sections 311 and 336 of the Code. If these

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[106] *See infra* notes 148–158 and accompanying text.

[107] For an excellent treatment of the "realization" concept, see generally Del Cotto, *Sales and Other Dispositions of Property Under Section 1001: The Taxable Event, Amount Realized and Related Problems of Basis*, 26 Buffalo L. Rev. 219 (1977).

[108] I.R.C. § 1001(a), (c) (1982).

[109] U.S. Const. amend. XVI provides: "The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration." *See generally* Eisner v. Macomber, 252 U.S. 189 (1920). Moreover, § 1001(a) includes as gain from the sale or other disposition of property, "the excess of the *amount realized* . . . over the adjusted basis." I.R.C. § 1001(a) (1982) (emphasis added).

[110] *See supra* notes 27–28 and accompanying text.

provisions are in fact repealed the debate may be renewed and it will become necessary to resolve the realization issue.

2. *The "Realization" Question.*

As an initial matter, it is clear that one need not actually receive tangible property to have realized income; an economic benefit equivalent to receipt will suffice.[111] Moreover, in *Helvering v. Horst*,[112] the Court indicated that income is "realized" when one "controls the source of the income" and "controls the disposition of that which he could have received himself."[113] The Court also stated that "[t]he power to dispose of income [is] the equivalent of ownership of it."[114]

As the government argued in its brief to the Supreme Court in *General Utilities*, the corporation used its appreciated assets to satisfy its general obligation to make dividend payments to its shareholders.[115] Although not a tangible receipt, this satisfaction can be viewed as an economic benefit to the corporation.[116] Following *Helvering v. Horst*, it can also be argued that the corporation "controls the disposition of that which it could have received itself." A corporation has power over its assets and would clearly have recognized income had it disposed of the asset through a sale.

A stronger argument for "realization" to the corporation upon distribution of appreciated assets can be made if one looks to the theoretical underpinnings of the concept itself. Gross income is defined under section 61 as including "all income from what-

[111] Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929) (employer's payment of employee's federal income tax liability held to be a realization of income to employee).

[112] 311 U.S. 112 (1940). Helvering v. Horst involved interest coupons which the taxpayer had detached from negotiable bonds and transferred as a gift to his son. Although the opinion includes substantial discussion of the "realization" concept, the case was really an "assignment of income" case. The real issue in *Horst* concerned the identity of the taxpayer (father or son) liable for tax on receipt of the interest rather than the realization of income.

[113] *Id.* at 116–17.

[114] *Id.* at 118.

[115] Brief for Respondent at 18–19, General Util. & Operating Co. v. Helvering, 296 U.S. 200 (1935).

[116] It has been held that income is realized upon the cancellation of indebtedness. United States v. Kirby Lumber Co. 284 U.S. 1 (1931). To the extent that a corporation has a "general" debt to its shareholders, the use of appreciated property to satisfy that debt can be said to result in the realization of income.

At least one commentator has suggested that even "emotional satisfaction" may be a sufficient "benefit" to justify an imposition of tax on "gain," under the realization concepts of Eisner v. Macomber. Lowndes, *Current Conceptions of Taxable Income*, 25 OHIO ST. L.J. 151, 162 (1964).

ever source derived."[117] There are, however, some limitations. Although appreciation in value can be viewed as "income" under this broad language, our system of taxation has generally required a "sale or other disposition" prior to taxation of such appreciation.[118] Specifically, although appreciation is taxable, one should not be taxed upon appreciated value prior to the ending of one's investment in the asset.[119]

Under this theory, if the corporation and its shareholders are in fact distinct entities,[120] then the distributed property has left the "corporate solution" upon distribution. The appropriate time to tax the corporation upon the previously unrealized appreciation of its assets is upon distribution to its shareholders, because something of value has left the corporation permanently and has been acquired by the shareholders. This author contends that when appreciated property is disposed of in such a way as to end the transferor's investment, income is realized to the extent of previously unrealized appreciation accruing during the term of the transferor's ownership.[121]

B. *Nonliquidating Versus Liquidating Distributions—Should Liquidations Be Treated Differently?*

1. *The "Realization Debate" As Applied To Liquidations.*

As argued above, a corporate distribution of appreciated property can be viewed as a realization event. This remains true for both liquidating and nonliquidating distributions. If realization is the issue, repeal of section 311 would suggest a simultaneous repeal of section 336. This is in fact what the ALI and Senate Finance Committee Staff have proposed.[122]

From the shareholder perspective, it may be conceded that a

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[117] I.R.C. § 61(a) (1982).

[118] I.R.C. § 1001(a) (1982).

[119] *See* Del Cotto, *supra* note 107, at 225.

[120] The Supreme Court has found them to be so in Lynch v. Hornby, 247 U.S. 339, 344 (1918).

[121] The author recognizes that this interpretation would result as well in taxation to the donor upon gifts of appreciated property. *Contra* Cambell v. Prothro, 209 F.2d 331 (5th Cir. 1954).

[122] ALI PROPOSAL, *supra* note 10 at 116; STAFF REPORT, *supra* note 10, at 66. Bills recently passed by the House and approved by the Senate would not repeal I.R.C. § 336 but would virtually eliminate the § 311(a) nonrecognition rule by providing generally for the recognition of gain upon dividend distributions of appreciated property. H.R. 2163, *supra* note 17, § 36 and H.R. 4170, *supra* note 17, § 54.

liquidating distribution is different from an ongoing distribution. Where the corporation is terminating its existence, the shareholders will no longer hold shares of stock reflecting their investment interest. This would appear to be an appropriate time to allow the shareholder to recoup his or her capital investment and to treat the distribution as a sale or exchange.[123]

For the corporation, however, it is difficult to view liquidating and nonliquidating distributions as different in nature. Each results in a disposition and an ending of the corporation's investment in its assets. The former distribution is simply a disposition of all rather than some of the corporation's assets.[124] Historically, however, the Treasury Department has viewed liquidating and nonliquidating distributions differently. As noted above, nonrecognition to the corporation upon liquidating distributions was Treasury Department policy as far back as 1919.[125] In fact, the language used in the early regulations was to the effect that "no gain or loss is *realized* by a corporation from the mere distribution of its assets in kind upon dissolution."[126]

Having taken the position that no gain or loss is "realized" upon liquidating distributions, the government found itself in an awkward position in the *General Utilities* case making the "realization" argument with respect to ongoing distributions. In a weak effort to distinguish the situations, the government's brief stated in a footnote: "The reason why no gain is recognized upon even a partial liquidation is that the stock is surrendered and it is a capital transaction, from the standpoint of both the corporation and the stockholders."[127]

It can be conceded that a liquidating distribution is a capital transaction from the shareholder's viewpoint; his or her invest-

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[123] This is, in fact, what the Internal Revenue Code provides. *See* I.R.C. § 331(a) (1982).

[124] This position was taken by the District of Columbia Court of Appeals in First Sav. Bank of Ogden v. Burnet, 53 F.2d 919, 921 (D.C. Cir. 1931), where the court stated: "No difference exists in principle between mere distributions of assets by corporations in dissolution, and by those not in dissolution. In both instances alike such assets are merely distributed among the stockholders of the corporation . . . ." The court in that case appeared to take the position that no gain or loss is realized in either case. While the "question is not free from doubt," *id.* at 920, the court concluded that a corporate distribution is not equivalent to the "sale or other disposition" of property.

[125] *See supra* notes 30–31 and accompanying text.

[126] Treas. Reg. 45, Art. 547, *supra* note 31 (emphasis added). The language of the regulation was changed only slightly in later years to refer to distribution of assets "in partial or complete liquidation." *See* Treas. Reg. 74, Art. 71, *supra* note 30.

[127] Brief for Respondent at 16 n.1, General Util. and Operating Co. v. Helvering, 296 U.S. 200 (1935).

ment in the corporation is ended. The government's argument is of questionable merit, however, when viewed from the corporation's standpoint.[128]

2. *The Policy Debate.*

a. *The Double Taxation Issue.* Early government arguments notwithstanding, if any corporate distributions are to be treated as realization events, all corporate distributions should be treated as such. The more difficult question is whether, as a matter of tax policy, corporations *should* recognize gain upon any distributions in kind to their shareholders.[129] This debate goes to the heart of the integration or "double taxation" question. Should income be taxed once to the corporation and again to the shareholders upon receipt of distributions?[130] The repeal proposals fail to consider this basic question. The Finance Committee staff and the ALI proposals provide for recognition only upon cost basis transfers. A repeal of *General Utilities* only for cost basis transfers would increase but not complete the integrity of our double tax system. In general, it assures one level of taxation in situations where tax had been avoided entirely in the past.[131] Confrontation with the "integration" question is avoided in the present proposals.[132]

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[128] The only case cited in the government's footnote, *id.*, is Hellmich v. Hellman, 276 U.S. 233 (1928). That case, however, dealt, not with tax consequences to the corporation on dissolution, but rather with tax consequences to the recipient shareholders.

[129] One proponent of relief from repeal of *General Utilities* in the liquidation context summed it up nicely in recent testimony before the Senate Finance Committee: "I appreciate that there is no theoretical reason compelling this approach . . . . Yet, the history here is so compelling that taxing this gain just seems wrong." *1983 Senate Hearings, supra* note 7 at 142–143 (statement of Robert A. Jacobs, of Milgrim Thomajan Jacobs & Lee), *see also* Blum, *supra* note 6, at 521.

[130] The "integration issue" is one which has generated great controversy and will not be discussed at length here. For an interesting discussion of the issues, *see generally* C. McLure, Must Corporate Income Be Taxed Twice? (1979).

[131] This will not be true for all cost-basis transfers. For example, upon an in-kind distribution to an individual shareholder, the full fair market value of the property distributed will be treated as ordinary income to the extent of the corporation's earnings and profits. I.R.C. §§ 61(a)(7); 301(b)(1), (c)(1); 316 (1982). Thus, repeal of *General Utilities* in this context would result in two levels of taxation where only one had been imposed before.

[132] The Staff Report states its assumption that the corporate income tax will continue to be imposed and that repeal of such tax is not imminent. Staff Report at 4. *See also 1983 Senate Hearings, supra* note 7, at 2 where Sen. Dole (R-Kan.) remarked: "Many of us — including the President, apparently have substantial doubts about the ultimate desirability of imposing a corporate level tax. But it is pretty clear to this Senator that politics and economics will prevent any radical change in the near future." (opening remarks of Sen. Dole).

If we truly are operating under a double tax system, why not recognize income on all transfers? This is, of course, not likely to be a popular argument, given the pressure to mitigate rather than increase double taxation. Complete repeal of *General Utilities* regardless of whether or not basis carries over would be a dramatic step. As pointed out by the Treasury Department in its testimony on TEFRA, such repeal "would mean that we have a true double tax at the corporate and shareholder levels. To eliminate or mitigate this double tax, some integration of the corporate and shareholder taxes would be required."[133]

Integration would of course be "a highly complex and far reaching change in the tax laws."[134] There is little indication that Congress or the present administration is prepared to grapple with this question in the foreseeable future.[135]

b. *Relief for the Liquidating Corporation?* Where a corporation is terminating its existence, as in a complete liquidation, there is an argument for allowing it to die a peaceful death without subjecting the corporation and its shareholders to the hardship of double taxation on the appreciated value of its assets. If the corporation is liquidating because of financial difficulty, it may not have the funds necessary to pay taxes. Shareholders wishing to continue the business as sole proprietors or partners may find themselves forced to sell assets in order to satisfy tax liabilities. Moreover, if the corporation is not a collapsible corporation, there is less likely to be an "evil" tax avoidance motive behind its distribution of appreciated assets to the shareholders.

Many who generally support the repeal of *General Utilities* are concerned about the effects of such repeal on the liquidating business. It has been argued that repeal of the *General Utilities* nonrecognition rule as applied to liquidations will discourage incorporation in the first place.[136] Moreover, to impose double

[133] *Tax Treatment of Corporate Mergers and Acquisitions: Hearings Before the Senate Comm. on Finance*, 97th Cong., 2d Sess. 70 (1982) (statement of David G. Glickman, Deputy Ass't Sec'y (Tax Policy) Dep't of the Treasury).

[134] *Id.*

[135] *See supra* note 132. Even with regard to the present Finance Committee staff proposals, the Treasury Department has responded that: "Congress should not embark upon such a fundamental strengthening of this two tier tax system without at least giving serious consideration to whether integration of the corporate and shareholder taxes is a more desirable long term objective." *1983 Senate Hearings*, *supra* note 7, at 5 (statement of Ronald A. Pearlman, Deputy Ass't Sec'y (Tax Policy) Dep't of Treas.).

[136] This argument was raised at the recent Senate Finance Committee hearings. *See*

taxation at a time when the corporation's "life" is ending strikes many as simply too harsh. There is, consequently, a growing consensus that some relief from a repeal of the nonrecognition principle should be provided for liquidating distributions.[137]

c. *Specific Objections to Repeal of* General Utilities *for the Liquidating Corporation.* Among the many specific objections to a repeal of *General Utilities* in the liquidation context is that such repeal may disproportionately affect small closely held corporations.[138] Faced with a tax upon liquidation, closely-held corporations may be forced to "sell out" rather than liquidate and continue to operate the business in some other form. An informed purchaser looking at the potential tax on a possible future liquidation may offer to pay less for the corporation.[139]

Concerns have been expressed that much of the gain which would be taxed twice upon liquidation may be inflationary, as opposed to "real" gain.[140] Similarly, some are concerned that gain that now would be taxed to both the corporation and its shareholders upon a liquidating distribution may reflect appreciation in the value of assets which took place before those assets were contributed to the corporation.[141] Repeal of *General*

1983 Senate Hearings, supra note 7, at 1–2 (statement of Edwin S. Cohen, for the Chamber of Commerce of the United States at 1–2) *id.* at 2 (Statement of John S. Nolan, Miller & Chevalier).

[137] Many of the proposals would provide such relief not to the corporation itself, but to the shareholders. *See, e.g.*, ALI Proposal, *supra* note 10, at 134–41 (shareholder credit); Blum, *supra* note 6, at 521, 526–27 (shareholder credit); *1983 Senate Hearings, supra* note 7, at 18 (statement of Ronald A. Pearlman) (discussing nonrecognition for shareholders upon receipts in liquidation); Lewis, *supra* note 6 at 1646 (nonrecognition for shareholders). *But see 1983 Senate Hearings, supra* note 7 at 7, (Statement of Edward N. Delaney, chairman, section of Tax'n of the A.B.A.) where the ABA states its preference for a corporate exemption from recognition of gain for certain historic assets or even a special exemption from recognition for closely held corporations. These issues will be discussed below. *See infra* notes 261–287 and accompanying text.

[138] *See supra* note 136. There is some evidence that small corporations tend to undergo liquidation more frequently than large corporations. For example, the United States Small Business Administration reports that the dissolution rate of businesses for 1978–1980 was 10.52 % for corporations with less than 5 employees as opposed to 5.13 % for those with 500 or more employees. U.S. SMALL BUSINESS ADMINISTRATION, THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT 150, Table 6.6 (1983). Moreover, in comparing dissolutions of small as opposed to large establishments, it reports that 97.8 percent of business dissolutions in 1978–1980 were of corporations with 100 or fewer employees. *Id.* at 152, Table 6.7. According to this report, approximately 90 percent of business dissolutions are voluntary and not based on financial reasons. *Id.* at 148.

[139] *See, e.g.*, *1983 Senate Hearings supra* note 7, at 2 (statement of Edwin S. Cohen).

[140] *See 1983 Senate Hearings, supra* note 7, at 4–5 (statement of John S. Nolan).

[141] This argument was made by the New York City Bar. *See* New York City Bar, *Comments on Subchapter C Reform,* 20 TAX NOTES 821, 822 (1983); *see also* Blum,

Utilities might also result in the double taxation of intangibles such as "goodwill" that are distributed to shareholders in liquidation.[142]

d. *The Senate Staff Position.* The Senate staff proposal takes a strong stand on distributions in liquidation. It proposes that *General Utilities* be fully repealed for liquidating as well as nonliquidating distributions.[143] The Senate staff argues that liquidation is frequently a formality without economic substance and often driven by tax avoidance motivation.[144] Recognizing, however, that the Finance Committee might conclude that complete repeal of *General Utilities* is too harsh,[145] the Senate staff proposal has listed and briefly described several "relief" options.[146] The proposed relief measures will be discussed further below.[147]

C. *The Concept of Electivity*

1. *Cost Versus Carryover Basis Election.*

a. *Acquisitions.* Under the Senate staff and ALI proposals, parties to a corporate acquisition will be entitled to elect cost or carryover basis treatment.[148] Absent an election, certain presumptions will be applied. For example, a "qualified stock acquisition"[149] would be treated as a carryover basis transaction

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supra note 6, at 528. For further discussion of the pre-incorporation appreciation issue see *infra* notes 186–196 and accompanying text.

[142] *See* Lewis, *supra* note 6, at 1648; *1983 Senate Hearings*, *supra* note 7, at 5–6 (statement of John S. Nolan). Further discussion regarding the distribution of "goodwill" in liquidation can be found at *infra* notes 197–213.

[143] STAFF REPORT, *supra* note 10, at 66. This is in contrast to the ALI proposal which has recommended a "shareholder credit" as relief to shareholders of liquidating corporations. ALI PROPOSAL, *supra* note 10, at 134–37. Further discussion can be found at *infra* notes 263–270 and accompanying text.

[144] STAFF REPORT, *supra* note 10, at 92.

[145] *Id.* at 65.

[146] *Id.* at 93–94.

[147] *See infra* notes 261–287 and accompanying text.

[148] ALI PROPOSAL, *supra* note 10, at 43 (Proposal AI — Classification of Acquisition Transactions); STAFF REPORT, *supra* note 10, at 55–57. *See supra* notes 102–106 and accompanying text.

[149] The Senate staff proposal describes a "qualified stock acquisition" as an acquisition in which "stock possessing at least 80 percent of the voting power of all voting stock and at least 80 percent of all other stock (except nonvoting, nonparticipating preferred stock) is acquired within a 12-month period beginning on the date of the first purchase of stock." STAFF REPORT, *supra* note 10, at 55. Thus, an acquisition of controlling stock in a subsidiary followed by a liquidation of the subsidiary would be a "qualified stock

unless a cost basis election is made.[150] A "qualified asset acquisition,"[151] on the other hand, would be treated as a cost basis transaction unless a carryover basis election is made.[152] By limiting the availability of this election to "qualified" acquisitions, the proposal is intended to apply "primarily to acquisitions of *all* the stock or *all* the assets of an acquired corporation which was not previously a subsidiary of any other corporation."[153]

b. *Complete Liquidations.* Under present law, when a corporation distributes assets in complete liquidation the shareholders are treated under section 331(a) as if they had "sold or exchanged" their stock for the assets received.[154] If gain or loss is recognized on the exchange, section 334(a) provides that each shareholder will take the property with a basis equal to its fair market value upon liquidation.[155] The corporation recognizes no gain or loss on the distribution under section 336.

The Senate staff and ALI proposals for the repeal of *General Utilities* would not alter the tax treatment of shareholders who have received assets in liquidation. The proposals would, however, require recognition of gain to the corporation upon distribution of appreciated assets in complete liquidation, since the liquidation will virtually always be a cost basis transfer to the

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acquisition" which will receive carryover basis treatment unless a cost basis election is made. This is a continuation of the cost basis election provisions presently found in I.R.C. § 338 (1982). Even under present law, such a "qualified stock purchase" would be eligible for a cost basis election under *id.* § 338(a). *Id.* § 338(d)(3).

[150] STAFF REPORT, *supra* note 10, at 57.

[151] A "qualified asset acquisition" is less precisely defined. An asset acquisition may qualify, according to the Senate staff proposal, "if [it is] a statutory merger or consolidation, or a transaction or a series of transactions in which one corporation acquires *substantially all* of the assets of another corporation." STAFF REPORT, *supra* note 10, at 56 (emphasis added).

[152] *Id.* at 57.

[153] ALI PROPOSAL, *supra* note 10, at 43 (emphasis added). The ALI proposal, however, is less explicit than the Senate staff proposal as to which acquisitions will qualify. The extent to which acquisitions of less than all of the assets will qualify is left by the ALI for a later proposal. *Id.* Nor is the ALI proposal explicit concerning the treatment of a sale of stock. *Id.* at 62–66.

[154] That section provides: "DISTRIBUTIONS IN COMPLETE LIQUIDATION TREATED AS EXCHANGES — Amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock." I.R.C. § 331(a) (1982). A parent corporation receiving assets in liquidation of a subsidiary, however, generally will receive nonrecognition treatment pursuant to *id.* § 332.

[155] Section 334(a) provides: "If property is received in a distribution in complete liquidation . . . and if gain or loss is recognized on receipt of such property, then the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution." *Id.* § 334(a) (1982).

shareholders pursuant to section 334(a). In contrast to a qualified acquisition, no carryover basis election is made available for the simple distribution of assets upon a complete liquidation that is unconnected with any "acquisition." A simple liquidation in which the shareholder receives a "stepped-up" or cost basis would automatically be classified as a cost basis transaction under the proposal, thus subjecting the distributing corporation to gain on the transfer.[156]

c. *Problems with Electivity Distinction.* The availability of a carryover basis election for "acquisitions" but not for simple liquidations poses several problems. First, the availability of the election maximizes flexibility for large corporations which are frequently involved in acquisitions. Similar flexibility is not available to the smaller closely held corporation liquidating in a "non-acquisition" context. This distinction might result in greater complexity. For example, liquidation of a subsidiary following a "qualified stock acquisition" is an elective transaction whereas a simple liquidation is not. Corporations may attempt to fit within the "acquisition" model simply to create more flexibility.[157]

Even worse, a target corporation in a hostile takeover situation might be compelled to sell rather than liquidate and allow its shareholders to continue the business. Under the proposals, a purchaser of the target may elect carryover basis treatment for a "qualified stock acquisition," while the shareholders of the target may not. As a result, the tax cost of an acquisition followed by liquidation may be less than that of a simple liquidation distribution to the shareholders. This situation may hurt the target in its negotiations during a takeover attempt.[158]

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[156] STAFF REPORT, *supra* note 10, at 66.

[157] Reacting to this potential problem, the Treasury Department, in response to the staff report, has suggested that an election be provided for certain in-kind liquidations as well. *See 1983 Senate Hearings, supra* note 7, at 19 (statement of Ronald A. Pearlman).

[158] This critique of the Senate staff proposal was articulated by the New York City Bar:

> [R]epeal of *General Utilities* without shareholder election for carryover basis may put target corporations at an artificial tax disadvantage in a hostile takeover situation. An acquiring corporation could afford to make a carryover basis election and save the corporate tax, whereas the target could not distribute the assets to its shareholders . . . without paying the corporate tax.

Handler, *New York City Bar Comments on Subchapter C Reform*, 20 TAX NOTES 821, 822 (1983) [hereinafter cited as *New York City Bar Comments*].

2. *What Will Remain of the Section 333 Election?*

a. *Background.*[159] As indicated above, a liquidating distribution to a shareholder other than a parent corporation will ordinarily be treated as a "sale or exchange" by the recipient shareholder under section 331(a).[160] An exception to the recognition of gain on the sale or exchange is provided, however, for a qualified shareholder who elects to be treated under section 333.[161] Several issues regarding the section 333 election are raised by the Senate staff and ALI proposals, but unfortunately they are left unanswered. Although the proposals are not entirely clear on this point, it appears that a repeal of section 333 is included as part of the proposed reform package.[162]

One issue which arises is whether a repeal of section 333 is appropriate. Even if section 333 is not repealed, another issue is whether a liquidation in which the shareholders elect section 333 treatment should be classified as a cost or carryover basis transfer. Finally, another issue which arises is whether, if section 333 is repealed as part of a reform package, some alternative form of shareholder election regarding the treatment of liquidating distributions should be added.

b. *Operation of Section 333.* Under section 333 a "qualified" shareholder may elect to limit the recognition of gain which would otherwise be imposed by section 331 upon receipt of certain liquidating distributions.[163] It is possible under this pro-

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[159] For a good comprehensive treatment of the history behind and operation of § 333, see generally Horwood & Hindin, *Section 333: When Is It a Safe Exit?*, 2 J. CORP. TAX 23 (1975); McGaffey, *The Deferral of Gain in One-Month Liquidations*, 19 TAX L. REV. 327 (1964).

[160] *See supra* notes 154–155 and accompanying text.

[161] I.R.C. § 333 (1982).

[162] There is no specific mention of a repeal of § 333 in the Senate staff proposal. On the other hand, the proposal outlines a fairly rigid rule for liquidations: "Shareholders other than controlling corporations would receive property at fair market value and the corporation would recognize gain on property sold pursuant to a plan of liquidation or distributed in kind to shareholders." STAFF REPORT, *supra* note 10, at 66. No § 333 nonrecognition election for recipient shareholders is mentioned. Elsewhere in the report, the Finance Committee staff critiques the use of § 333 under present law. *Id.* at 36. See also Beghe, *supra* note 95, at 748 n.29, where he indicates that the future status of § 333 is similarly unclear under the ALI proposal.

Others have assumed that § 333 would be repealed along with a repeal of *General Utilities*. *See, e.g.*, *New York City Bar Comments*, *supra* note 158, at 821, 822; *see also* Lewis, *supra* note 6, at 1649 (proposing a repeal of § 333).

[163] Several conditions must be met before § 333 will be applicable. First, the liquidation must be made in pursuance of an adopted plan of complete liquidation. I.R.C. § 333(a)(1) (1982). Second, the transfer of property must occur within one calendar month. *Id.*

vision to achieve nonrecognition at the time of liquidation. It may be misleading, though, to refer to section 333 as a "nonrecognition" provision. In fact, through the use of a substituted basis,[164] the shareholder's section 331 "sale or exchange" gain is merely deferred until later disposition of the assets. Moreover, a section 333 election will not always operate to the shareholder's advantage. Despite the election, gain will be recognized to the extent of the shareholder's ratable share of earnings and profits[165] and to the extent that the shareholder receives money, stock, or securities in the liquidating distribution.[166] Shareholders electing section 333 treatment may have ordinary income to the extent of earnings and profits, whereas the same gain would have been given "sale or exchange" treatment under section 331. Many an unhappy shareholder has fallen into this trap for the unwary.[167] Once made, a section 333 election is irrevocable.[168]

c. *Section 333 Liquidation: Cost or Carryover?* One important issue which must be dealt with if section 333 is to survive

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§ 333(a)(2). For any shareholder to be a "qualified electing shareholder" he or she must file a written election along with a specified percentage of other shareholders in the corporation. *Id.* § 333(c). Elections must be filed within 30 days after adoption of the plan of liquidation. *Id.* § 333(d).

[164] Pursuant to *id.* § 334(c), the shareholder will substitute his or her basis for the stock in the assets received upon liquidation. That section provides:

> (c) PROPERTY RECEIVED IN LIQUIDATION UNDER SECTION 333. — If —
>
> (1) property was acquired by a shareholder in the liquidation of a corporation in cancellation or redemption of stock, and
>
> (2) with respect to such acquisition —
>
> (A) gain was realized, but
>
> (B) as the result of an election made by the shareholder under section 333, the extent to which the gain was recognized was determined under section 333, then the basis shall be the same as the basis of such stock cancelled or redeemed in the liquidation, decreased in the amount of any money received by the shareholder, and increased in the amount of gain recognized to him.

Id. § 334(c).

[165] This portion of the gain will be treated as a dividend pursuant to § 333(e)(1), which is applicable to noncorporate shareholders. It provides that "there shall be recognized and treated as a dividend, so much of the gain as is not in excess of [the electing shareholder's] ratable share of the earnings and profits . . . ." *Id.* § 333(e)(1).

[166] In addition to the § 333(e)(1) dividend income, capital gain will be recognized to the extent that the excess over earnings and profits consists of money, stock, or securities. *Id.* § 333(e)(2). I.R.C. § 333(f) provides for similar, but not identical, treatment for corporate shareholders.

[167] For a classic case in which the taxpayers belatedly found that they had made a disadvantageous election under § 333, see Cohen v. Commissioner, 63 T.C. 527 (1975), *aff'd mem.*, 532 F.2d 745 (3d Cir. 1976).

[168] Treas. Reg. § 1.333-2(b)(1) (1960).

the repeal of *General Utilities* is the classification of an elective liquidation under section 333 as a cost or carryover basis transaction. The carryover basis transaction envisioned by the Senate staff and ALI proposal is one in which the *corporation's* basis in the transferred assets is carried over. If this occurs, and if certain other conditions are met, no gain or loss will be recognized to the corporation on the transfer.[169] In a section 333 liquidation, however, it is not the *corporation's* basis which carries over. Instead, section 334(c) preserves the *shareholder's* basis in the stock canceled or redeemed upon liquidation. Technically, a section 333 liquidation would not therefore be classified as a carryover basis transaction.[170] Like the ordinary section 331 liquidation, a section 333 liquidation, if it continues to be available, automatically would be classified as one in which corporate gain must be recognized.[171]

d. *Legislative History: Why Postpone the Gain upon a Section 333 Election?* To determine whether a "section 333-like" nonrecognition provision should survive the repeal of *General Utilities*, it is helpful to briefly examine the legislative history of the "one-month liquidation rule." The predecessor[172] of section 333 was enacted in response to a growing concern regarding the proliferation of closely held companies formed to retain earnings and take advantage of the lower tax rates available to corporations.[173] Congress wanted to encourage the liquidation

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[169] ALI Proposal Bl provides that

> no gain or loss shall be recognized on a carryover-basis transfer of substantially all the assets of a nonsubsidiary corporate transferor if any of the following conditions are met —
>
> (A) within the taxable year of such transfer and the next succeeding taxable year all the assets of such transferor are distributed to shareholders or creditors in complete liquidation, less assets retained to meet claims.

ALI PROPOSAL, *supra* note 10, at 73.

[170] Nor is a § 333 liquidation truly a cost basis transfer, as the shareholders will receive a substituted basis. I.R.C. § 334(c) (1982).

[171] The ALI proposal for repeal of *General Utilities* would require corporate recognition of gain or loss for any transaction "in which basis does *not carryover.*" ALI PROPOSAL, *supra* note 10, at 116 (emphasis added). Because the corporation's basis does not carry over in a § 333 election, corporate recognition of gain or loss would presumably be required under the proposal.

[172] Revenue Act of 1938, ch. 289, § 112(b)(7), 52 Stat. 447, 487. The general terms of this provision have not changed substantially since that time. *See* I.R.C. § 333 (1982).

[173] The maximum corporate tax rate in 1938 was 19%. Revenue Act of 1938, ch. 289, § 13, 52 Stat. 447, 455 (repealed Pub. L. No. 76-1, 53 Stat. 1 (1939)). Individuals, in contrast, were subject to a maximum tax rate of 75%. *Id.* § 11, 52 Stat. at 452–54 (*repealed by* Pub. L. No. 76-1, 53 Stat. 1 (1939)). The spread between corporate and individual tax rates has been narrowing. The present maximum tax rates for corporations and individuals are 50% and 46%, respectively. I.R.C. §§ 1, 11 (1982).

of such "personal holding companies."[174] Where such liquidations involved corporations without cash or earnings, an immediate tax on the shareholder might have imposed a serious hardship, forcing shareholders to sell assets to satisfy tax liabilities. In response to this hardship, Congress enacted a "one-month liquidation rule" in section 112(b)(7) of the Revenue Act of 1938.[175]

Section 112(b)(7) originally was intended as only a temporary measure. It provided that to qualify, the shareholder nonrecognition election had to take place within the month of December, 1938.[176] Despite its limited purpose and time frame when originally enacted, the special one-month liquidation rule survives to the present day.[177] While the provision was originally intended to facilitate the liquidation of personal holding companies, the statute by its terms has never been so limited.

From early on, Congress appeared to be aware that the coverage of this provision was far broader than originally intended. For example, in the process of re-enacting the one-month liquidation rule in 1943, the Senate Finance Committee stated in its report that the provision "permits a corporation to liquidate property which is not reflected in its earnings and profits account, because the increase in value has not been realized without recognition of gain or loss to the shareholder."[178] The report went on to concede that "[t]he effect of the section is in general to postpone the recognition of that portion of a qualified electing shareholder's gain on the liquidation which would otherwise be recognized and which is attributable to appreciation in the

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[174] *See* 83 CONG. REC. 5171 (1938) (statement of Sen. George (D-Ga.)). Congress first promulgated special rules for "personal holding companies" in 1934. Revenue Act of 1934, ch. 277, § 351, 48 Stat. 680, 751. Today, the Code contains a series of complex provisions dealing with "personal holding companies." I.R.C. §§ 541–547 (1982). The definition of a "personal holding company" is in two parts. First, a personal holding company is one in which "[a]t any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned directly or indirectly, by or for not more than 5 individuals." *Id.* § 542(a)(2). In addition, to be classified as a personal holding company, "[a]t least 60 percent of its adjusted ordinary gross income . . . for the taxable year [must be] personal holding company income." *Id.* § 542(a)(1). "Personal holding company income" includes such items as dividends, rents, mineral oil and gas royalties, copyright royalties, produced film rents, use of corporate property by shareholders, and personal service contracts. *Id.* § 543(a).

[175] Revenue Act of 1938, ch. 289, § 112(b)(7), 52 Stat. 447, 487.

[176] *Id.* § 112(b)(7)(A)(ii).

[177] For an excellent analysis of the early history behind the "one-month liquidation rule" and its continued re-enactments, see Eaton, *Liquidation Under Section 112(b)(7)*, 38 VA. L. REV. 1 (1952).

[178] S. REP. No. 627, 78th Cong., 1st Sess. 22 (1943).

value of certain corporate assets distributed in complete liquidation."[179]

Thus, over many years, Congress has expressed particular concern for the hardship imposed upon shareholders in certain complete liquidations where assets are distributed in kind. This hardship is particularly acute when the value of the in-kind distribution to the shareholders in liquidation reflects, in large part, unrealized appreciation of the distributed assets, and when the corporation has distributed no earnings and profits or cash or its equivalent. Because an additional tax burden on liquidation would be imposed by the repeal of *General Utilities*, such repeal would elevate rather than eliminate the concern for these hardships.[180] As a result, in considering the repeal of *General Utilities*, Congress should as a policy matter consider simultaneously the advisability of continuing a shareholder nonrecognition rule in some form.

e. *Should Some Shareholder Nonrecognition Rule Be Retained for Complete Liquidations?* As an initial matter, it should be noted that a complete liquidation theoretically involves two different kinds of gain or loss: (1) the corporation's gain or loss from the distribution of appreciated or depreciated assets; and (2) the shareholder's gain or loss from the "sale or exchange" of stock.[181] A section 333 election operates as a recognition deferral for the latter.[182]

Because the two gain or loss questions are distinct, it is theoretically possible to retain the section 333 shareholder nonrecognition provision even if section 336 is repealed. Repealing *General Utilities* while retaining section 333, in fact, would

[179] *Id.* at 48. It might here be noted that this precise language, with one additional phrase, is presently found in Treas. Reg. § 1.333-1(a) (1960). The language there explains § 333 as postponing gain "attributable to appreciation in the value of certain corporate assets *unrealized by the corporation at the time such assets are distributed* in complete liquidation" (additional phrase emphasized).

[180] *See New York City Bar Comments*, *supra* note 158, at 821, 822, suggesting that the § 333 nonrecognition provision be expanded rather than eliminated if *General Utilities* is repealed.

[181] Since the corporation and its shareholders are distinct entities, these issues should be distinct, albeit somewhat intertwined. The amount realized to the shareholders on the liquidation will be the fair market value of property received. I.R.C. §§ 331(a), 1001(b) (1982). As such it will reflect the appreciation in value of corporate assets. Each shareholder's basis in his or her stock, however, does not reflect a proportionate share of the corporation's basis in its assets, but rather reflects his or her cost for the stock. There is no reason to expect that the shareholder gain will be equivalent to the appreciation of corporate assets.

[182] *See supra* notes 163–166 and accompanying text.

result in double taxation on liquidation; the shareholder level of taxation merely would be deferred until a subsequent shareholder disposition of the assets. It has even been suggested that the nonrecognition concept in section 333 be expanded as a form of relief from the complete repeal of *General Utilities*, so that shareholders in any complete liquidation would be entitled to defer recognition of gain.[183] Other relief proponents have gone further still and suggested the possibility of a tax-free unwinding of the corporation, one parallel to the tax-free incorporation now provided under section 351.[184]

Several different forms of relief from the repeal of *General Utilities* for liquidating corporations can be fashioned by using some kind of shareholder nonrecognition rule along with either a substituted or a carryover basis for the shareholders. Each of these variations presents practical as well as policy problems. These problems will be explored below in the discussion of relief measures.[185]

D. *Pre-Incorporation Appreciation*

1. *Possibility of Double Taxation.*

One specific argument that has been raised in support of relief from repeal of *General Utilities* for liquidating distributions is the potential double taxation of pre-incorporation appreciation.[186] That this double taxation is a possibility can be simply illustrated as follows.

When appreciated property is contributed to a corporation by shareholders who have control of the corporation immediately after the exchange, neither the shareholders nor the corporation will recognize gain.[187] Under section 362(a), however, the corporation will receive a carryover basis from the shareholders in the assets received in the section 351 exchange.[188] In addition,

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[183] *See New York City Bar Comments*, *supra* note 158, at 822.

[184] *See 1983 Senate Hearings*, *supra* note 7, at 18 (statement of Ronald A. Pearlman); Lewis, *supra* note 6, at 1646.

[185] *See infra* notes 274–285 and accompanying text.

[186] *See* Blum, *supra* note 6, at 528; *1983 Senate Hearings*, *supra* note 7, at 1 (statement of John S. Nolan); *New York City Bar Comments*, *supra* note 158, at 822.

[187] I.R.C. §§ 351(a), 1032 (1982).

[188]

> If property was acquired on or after June 22, 1954, by a corporation —
> (1) in connection with a transaction to which section 351 (relating to transfer

because the shareholders received their stock without recognition of gain under section 351, their basis in the stock received will be the same as that in the property exchanged.[189]

Under present law, when the corporation distributes the assets back to the shareholders in complete liquidation, it will again recognize no gain, this time under section 336. The tax treatment of the shareholders will be governed by section 331. Under this provision, the amount the shareholders receive upon liquidation will be treated as full payment in exchange for stock.[190] For purposes of determining gain upon this sale or exchange, the shareholders' basis in their stock will be governed by section 358.

If section 336 is repealed as proposed, and if assets are distributed in complete liquidation without further appreciation during the period in which they were held by the corporation, the corporation nevertheless will have a taxable gain. This recognized gain is entirely due to pre-incorporation appreciation. Moreover, because the shareholders received a substituted basis in their stock, they too will be taxed upon liquidation. Both the shareholders and the corporation are being taxed on the appreciation, all of which took place before the corporation was even in existence. In this context, the double taxation results appear to be particularly harsh.

> of property to corporation controlled by transferor) applies, . . .
> then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

Id. § 362(a).

[189]

> GENERAL RULE — In the case of an exchange to which section 351 . . . applies —
> (1) NONRECOGNITION PROPERTY — The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged —
> (A) decreased by —
> (i) the fair market value of any other property (except money) received by the taxpayer,
> (ii) the amount of any money received by the taxpayer, and
> (iii) the amount of loss to the taxpayer which was recognized on such exchange, and
> (B)increased by —
> (i) the amount which was treated as a dividend, and
> (ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

Id. § 358(a).

[190] *See supra* notes 154–155 and accompanying text.

2. *Relief from Double Taxation of Pre-Incorporation Appreciation.*

Arguments for relief from these harsh results of the repeal of *General Utilities* in the liquidation context do not hold up, however, when examined more closely. First, the double taxation of pre-incorporation appreciation is not unique to liquidations. Because of the carryover basis rule provided in section 362, the transferee corporation in a section 351 exchange will be taxed on pre-incorporation appreciation whenever it sells or disposes of the assets received in the exchange, whether or not in liquidation. In the example above, if a few days after receipt from the shareholders, the corporation sold the property received in the section 351 exchange, the corporation would still be subject to a tax on a gain resulting entirely from pre-incorporation appreciation. If the shareholders shortly thereafter sold their stock, they would similarly be subject to tax on a gain reflecting the same appreciation in value. Double taxation simply is one of the costs which must be considered when one incorporates.

The particular harshness of double taxation on pre-incorporation appreciation has been troubling taxpayers for some time. In fact, constitutional challenges to such taxation have been raised. In *Perthur Holding Corp. v. Commissioner*,[191] a constitutional challenge was made under the Revenue Act of 1926, which contained nonrecognition and basis rules paralleling sections 351, 358, and 362.[192]

According to the court in *Perthur Holding Corp.*, the only possible constitutional objection was a Fifth Amendment due process argument. Because the statutory provisions in question were fully in effect at the time of incorporation, though, the court found that the taxpayer had notice of the provisions and rejected this argument.[193]

Learned Hand did recognize the double taxation problem, but wrote for the Second Circuit Court of Appeals: "[It] may be unfair, but it is not unconstitutional; again it was a matter for

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[191] 61 F.2d 785 (2d Cir. 1932) (L. Hand, J.), *cert. denied*, 288 U.S. 616 (1933).

[192] Revenue Act of 1926, ch. 27, §§ 203(b)(4), 204(a)(6), 204(a)(8), 44 Stat. 9, 12, 15 (*repealed by* Pub. L. No. 76-1, 53 Stat. 1 (1939)).

[193] 61 F.2d at 786. Later cases permitted even a retroactive application of these provisions. *See, e.g.*, Edward Securities Corp. v. Commissioner, 32 B.T.A. 375 (1935).

[the shareholder] to consider when he put on a corporate dress."[194] Congress, he continued, is generally free,

> to depress one kind of activity and promote another, for the incidence of taxation inevitably has indirect social and economic effects . . . . If these sections unduly discourage incorporation of such enterprises, Congress may have intended it, and was within its powers if it did. It is hard to conceive greater chaos than if judges were to upset fiscal policies of which they disapprove.[195]

Subsequent taxpayers similarly have challenged the double tax on pre-incorporation appreciation, but these efforts have been rebuked with a citation to Learned Hand's opinion in *Perthur Holding Corp.*[196]

Any response to this hardship must come from Congress. Perhaps the time has come for Congress to consider as a policy matter the question of double taxation of pre-incorporation appreciation. If so, this should not be done in the limited context of liquidation transactions but in all situations in which the problem arises. This potential for double taxation is not sufficient reason to reject a repeal of *General Utilities* with regard to liquidations. A relief measure dealing with pre-incorporation appreciation which is limited to the liquidation context will generate further inconsistencies in tax policy. No such relief should be enacted without a thorough and general examination of issues related to the taxation of pre-incorporation appreciation.

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[194] 61 F.2d at 786.

[195] *Id.*

[196] *See, e.g.*, King v. United States, 79 F.2d 453, 456 (4th Cir. 1935); Phillips v. Commissioner, 63 F.2d 101, 102 (3d Cir. 1933).

For similar cases decided prior to Perthur Holding see Osburn Cal. Corp. v. Welch, 39 F.2d 41 (9th Cir.), *cert. denied*, 282 U.S. 850 (1930); Newman, Saunders & Co. v. United States, 36 F.2d 1009 (Ct. Cl. 1929), *cert. denied*, 281 U.S. 760 (1930).

Attempts to challenge carryover basis under the provisions used for the calculation of depreciation deductions similarly have been unsuccessful. *See, e.g.*, Manhattan Gen. Equip. Co. v. Commissioner, 76 F.2d 892 (2d Cir. 1935); Edward Securities Corp. v. Commissioner, 32 B.T.A. 375 (1935).

The constitutionality of the incorporation exchange provisions and carryover basis rules connected with them is now well-settled law. The potential hardship of double taxation of pre-incorporation appreciation, however, has been discussed in recent legal literature. *See* Keller, *The Midstream Incorporation of a Cash-Basis Taxpayer: An Update*, 38 MD. L. REV. 480, 484–85 (1979); Thompson, *Tax Policy Implications of Contributions of Appreciated and Depreciated Property to Partnerships, Subchapter C Corporations and Subchapter S Corporations in Exchange for Ownership Interests*, 31 TAX L. REV. 31, 92–96 (1975).

The double taxation potential of the basis provisions in §§ 358 and 362 will not necessarily be detrimental. Thus, in the case of depreciated property, there is the beneficial potential for double losses. *See* Keller, *supra*, at 484 n.30.

E. *Distributions of Goodwill*[197]

1. *Background.*

After a complete liquidation, the shareholders may continue the business enterprise as partners, or, in the case of a sole shareholder, as a sole proprietor. If the shareholders intend to continue business operations, a complete liquidation raises questions about the taxation of any goodwill distributed as part of the going concern to the shareholders. Critics of the present repeal proposals are concerned that without some relief from repeal of *General Utilities* for liquidating corporations, the value of goodwill will be subject to a double tax upon liquidation. The argument here is similar to the pre-incorporation appreciation argument discussed above.[198] It is feared that shareholders may be forced to sell tangible assets to satisfy tax burdens and thus will be unable to continue the business. Moreover, double taxation of goodwill upon liquidation is particularly harsh because, unlike tangible assets, goodwill is not subject to depreciation.[199]

2. *Treatment of Distributions of Goodwill upon Liquidation.*

An initial question that arises if goodwill is distributed in liquidation is whether the shareholders must include its value as part of their amount realized under section 331. This issue has not arisen as often as might be expected because most distributions in liquidation to shareholders who intend to continue the business are to controlling corporate or "parent" shareholders. Such distributions are tax-free to the recipient corporate shareholders under section 332.[200]

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[197] A comprehensive discussion of the concept of "goodwill" is beyond the scope of this article. For a general discussion of issues related to the taxation of transfers of "goodwill," see McDonald, *Goodwill and the Federal Income Tax*, 45 VA. L. REV. 645 (1959); Weiss, *The Tax Treatment of a Disposition of Professional Goodwill*, 73 YALE L.J. 1158 (1964); Note, *Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill*, 81 HARV. L. REV. 859 (1968). For a more recent treatment, see Dubin, *Allocation of Costs to, and Amortization of, Intangibles in Business Acquisitions*, 57 TAXES 930 (1979).

[198] *See supra* note 186 and accompanying text.

[199] Treas. Reg. § 1.167(a)-3, T.D. 6182, 1956-1 C.B. 101. In contrast, certain other intangible assets may be depreciated if known "to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy . . . ." *Id.*

[200] I.R.C. § 332(a) (1982) operates as an exception to § 331 and provides for nonrecognition to a parent corporation upon liquidation of a subsidiary.

Because the distribution in these cases receives nonrecognition treatment, the ques-

Although this issue has not arisen much in recent litigation, it is still a potential weapon in the Commissioner's arsenal. In cases where the Commissioner has raised the issue, several taxpayers have persuaded the court, as a factual matter, that no goodwill was distributed. This is particularly true for small family-held businesses.[201] If a determination is made that goodwill has been distributed, however, the shareholders may be taxed on the value of goodwill under section 331. Present proposals for repeal of *General Utilities* do not contain any simultaneous proposal for revision of section 331. Thus, if *General Utilities* is repealed, double taxation on the value of goodwill may result.

Like pre-incorporation appreciation, however, the potential for double taxation of goodwill is not unique to the liquidating business. It exists under present law even for the ongoing business. Suppose, for example, that A is the sole shareholder of X Corporation. A sells all of his stock in X to a single buyer, B. Part of the purchase price is allocable to goodwill. A is taxable on gain from the sale to B, including any gain attributable to goodwill.[202] Assume further that X Corporation shortly thereafter sells all of its assets as an ongoing operation to Y Corporation in an exchange in which B receives some Y stock and other property. If the exchange does not qualify for reorganization treatment, X will pay tax on gain[203] attributable to the same goodwill on its sale to Y which was previously taxed to A on his sale to B.

This result can be avoided if the transaction is designed so as to fit within the tax-free reorganization provisions. Nevertheless, the double taxation potential will not be a new problem if

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tion of taxability of "goodwill" received by the shareholder does not arise. Where the stock was recently acquired in a transaction to be treated as a cost basis "asset acquisition" under § 338, however, the value of "goodwill" may become an issue. When such an election is made, it becomes necessary to allocate the "cost" or purchase price between tangible and intangible assets such as goodwill for purposes of determining amounts subject to depreciation or amortization. Since § 338 was not enacted until 1982, the cases on this issue arose under the predecessor to that provision; pre-TEFRA § 334(b)(2) (1976). *See, e.g.*, VGS Corp. v. Commissioner, 68 T.C. 563 (1977); North Am. Serv. Co. v. Commissioner, 33 T.C. 677 (1960).

[201] *See, e.g.*, D.A. Carty v. Commissioner, 38 T.C. 46 (1962), *acq.* 1964-1 C.B. 4; Cullen v. Commissioner, 14 T.C. 368 (1950), *acq.* 1950-2 C.B. 1; Mittelman v. Commissioner, 7 T.C. 1162 (1946), *acq.* 1947-1 C.B. 3; *see also* Lawton v. Commissioner, 6 T.C. 1093, *rev'd on other grounds*, 164 F.2d 380 (6th Cir. 1946); MacDonald v. Commissioner, 3 T.C. 720, 726 (1944), *acq.* 1944-1 C.B. 18. For a discussion of early cases on this issue, see Shelton, *Stockholder's Gain on the Liquidation of a Corporation When There Is Goodwill*, 7 INST. ON FED. TAX'N 349 (1949).

[202] I.R.C. § 1001(c) (1982).

[203] *Id.*

General Utilities is repealed. As with pre-incorporation appreciation, perhaps the time is ripe for a more general examination of the tax consequences of the transfer of goodwill.

3. *The ALI and Senate Staff Response to the Goodwill Problem.*

As previously discussed, the ALI and Senate staff proposals would repeal *General Utilities* only for those transactions in which the basis does not carry over.[204] One major concern with the "stepped-up" basis in such transactions is the acquisition by the transferee of a new basis for depreciation purposes. Given a higher cost basis, the transferee would have greater depreciation deductions and, thus, lower income from the assets acquired in the transfer. This concern is not present with respect to the acquisition of goodwill, because it is not a depreciable asset.[205]

Recognizing this unique aspect of goodwill, the ALI and Senate staff proposals create a special rule for cost basis acquisitions involving the transfer of goodwill or other similar intangibles.[206] In corporate acquisitions, an "acquisition premium" that represents the purchase of goodwill frequently is paid over and above the aggregate fair market value of the assets.[207] Under the Senate staff and ALI proposals, amounts attributable to goodwill and similar intangibles may receive carryover basis treatment even though the parties have elected to treat the overall transaction as a cost basis acquisition.[208] As a result, the transferor corporation may not be required to recognize gain,

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[204] *See supra* notes 97–99 and accompanying text.

[205] Treas. Reg. § 1.167(a)-3, T.D. 6182, 1956-1 C.B. 101.

[206] STAFF REPORT, *supra* note 10, at 58, 61; ALI PROPOSAL, *supra* note 10, at 120–33. ALI Proposal C2, *id.* at 124, specifically refers to "transfer of goodwill or going-concern value or any similar intangible"; it is not limited to goodwill. For purposes of discussion, however, this provision will hereinafter be referred to as the "goodwill rule." The goodwill rule appears to apply, however, only to corporate acquisitions. It is not clear whether it would apply to a simple liquidation. The Senate staff proposal's only reference to the goodwill provision is found in the acquisition proposals. STAFF REPORT, *supra* note 10, at 58. The report does state, however, that "the liquidation proposal should conform to the enactment of the acquisition proposal." *Id.*

The ALI proposal regarding goodwill is much more specific on this point and suggests that a "distribution in kind to old shareholders *could* be treated the same way so long as shareholders are required to take goodwill fully into account, as under present law, on a liquidating distribution." ALI PROPOSAL, *supra* note 10, at 127 (emphasis added).

[207] The ALI proposal provides some examples of acquisitions involving "unallocated purchase premium." *See* ALI PROPOSAL, *supra* note 10, at 120–21.

[208] STAFF REPORT, *supra* note 10, at 58, 61; ALI PROPOSAL, *supra* note 10, at 120–33.

even in a cost basis acquisition, to the extent of the premium representing the purchase of goodwill.[209]

This goodwill provision is anything but a simplification of present law. Under the proposal, a cost basis transaction will not necessarily be entirely so; there will be transactions which are part cost and part carryover. Parties to an acquisition must agree on amounts to be allocated to goodwill. Moreover, the transferee must consent to treat the amount allocated as "unallocated premium"; that is, not to depreciate or amortize.[210]

In addition to these complexities, problems would be generated by a subsequent transfer of the goodwill by the purchaser. Although the "stepped-up" or cost basis for goodwill would not generate depreciation deductions, it would result in a lower gain on subsequent sale by the purchaser. There remains a risk, then, that the gain from appreciation attributable to goodwill which accrued while the seller owned the business will escape taxation forever. To avoid this result, provision must be made to handle tax treatment of later transfers by the purchaser.[211]

A special goodwill rule, then, would add further complexity to a proposal advertised as a "simplification" measure. This, however, should not be sufficient reason for its rejection. Simultaneous reform and simplification may not be possible. Consistency and neutrality are also important goals.[212]

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[209] For example, ALI Proposal C2 (Unallocated Premium in Cost-Basis Transfers) provides:

> GENERAL RULE — No gain shall be recognized on any transfer of goodwill or going-concern value or any similar intangible by a corporation if the purchaser identifies the amount attributable to such intangible and consents to treat it as unallocated premium and if the consideration for such intangible (or the intangible itself) is distributed to shareholders or creditors as part of a distribution in complete or partial liquidation of the transferor corporation carried out during the taxable year of such transfer or the next succeeding taxable year . . . .

ALI PROPOSAL, *supra* note 10, at 124.

[210] *Id.*

[211] These provisions may be quite complex. The ALI, for example, has proposed the following:

> TREATMENT OF PURCHASER — A purchaser shall not be allowed any deduction on account of any unallocated premium in computing income or gain or loss on any subsequent use or transfer of property except —
>
> (A) in computing gain or loss on a carryover-basis disposition of assets as provided in Proposal B2, or
>
> (B) as an offset to an amount which a subsequent purchaser consents to treat as unallocated premium under this proposal on a resale of the intangible in question.
>
> In either case the amount allowable shall be subject to any adjustments or limitations that may be prescribed for a purchase premium in Proposal B2.

ALI PROPOSAL, *supra* note 10, at 125.

[212] *See* STAFF REPORT, *supra* note 10, at 1.

If a special goodwill rule is to be provided, however, it should extend to cover complete liquidations as well as acquisitions. It would be inappropriate to deny such a provision in the case of simple in-kind liquidations where the hardship of double taxation and unavailability of depreciation deductions may be greater. The details of such a provision remain to be worked out.[213]

F. *Distributions of Depreciated Property: Can the Corporation Recognize the Loss?*

1. *Background.*

The *General Utilities* case involved the distribution of securities which had appreciated in value.[214] In fact, the focus of much discussion concerning distributions in kind has been on appreciated assets.[215] Early case law established, however, that the *General Utilities* nonrecognition principle should apply equally to losses upon the distribution of depreciated property,[216] and sections 311(a) and 336(a) do so provide.[217]

Gain or loss, of course, is recognized upon a sale to an unrelated third party.[218] Corporations can, therefore, avoid recognition of gain and at the same time take advantage of loss deductions by simply *distributing* appreciated assets under sec-

[213] Another possible approach in the liquidation context would be to exempt the receipt of goodwill from taxation at the shareholder level under § 331. *See* ALI PROPOSAL, *supra* note 10, at 127, 322–24. This exception would not be necessary if the Code is amended to provide for a tax-free unwinding of the corporation paralleling the tax-free incorporation presently provided in § 351. *See supra* note 184 and accompanying text. *See also infra* notes 281–285 and accompanying text.

Even if a liquidation goodwill exemption is adopted, though, the subsequent transfer of goodwill by the shareholders may present problems. Unless some tax is collected on resale, tax avoidance strategies may be developed whereby shareholders immediately transfer the business to an outsider. The ALI has, in fact, proposed an excise tax if the business is resold within ten years after receipt in a liquidating distribution, in the event that a liquidation goodwill exception is adopted. *See* ALI PROPOSAL, *supra* note 10, at 323.

[214] In that case, the stock distributed had appreciated from approximately $2,000 to $1,122,500 in 15 months. 29 B.T.A. 934, 935 (1934) (findings of fact).

[215] *See, e.g.*, Mastry, *Corporate Distributions of Appreciated Property*, 56 A.B.A. J. 1210 (1970); North, *Corporate Distributions of Appreciated Property--A Comment on Policy*, 36 NEB. L. REV. 528 (1957); Roberts, *"Dividend in Kind" of Appreciated Property--Tax Trap to Shareholders*, 40 A.B.A. J. 790 (1954).

[216] *See, e.g.*, Natural Gasoline Corp. v. Commissioner, 219 F.2d 682 (10th Cir. 1955); Corporate Inv. Co. v. Commissioner, 40 B.T.A. 1156, 1168 (1939), *nonacq.* 1940-1 C.B. 6.

[217] See *supra* note 2 for the text of §§ 311(a) and 336(a).

[218] I.R.C. § 1001 (1982).

tion 311(a) or section 336(a) and *selling* depreciated assets to third parties. Losses on the sale are recognized for tax purposes and the cash received from the outside buyer can subsequently be distributed to the shareholders.

If the *General Utilities* nonrecognition principle for both gains and losses is fully repealed, this "straddle" technique would disappear. Distribution of any asset, whether appreciated or depreciated, would subject the corporation to recognition of gain and allow the corporation to recognize loss.

Given past legislative history, however, it is not entirely clear that Congress would repeal the nonrecognition rules for both gains and losses.[219] As an initial policy matter it must be determined whether the repeal of the section 311 and section 336 nonrecognition provisions should apply to loss transactions at all.

2. *Should Repeal of* General Utilities *Apply to Loss Transactions?*

If raising tax revenue is a major objective, it can be argued that allowing corporations to recognize loss upon distributions in kind is unwise. Under present law, on the other hand, corporations have been able to recognize these losses through the use of the "straddle" technique described above. As a result, repealing the *General Utilities* principle vis-a-vis losses would arguably have a neutral effect on tax revenue.[220]

The Senate staff and the ALI propose repealing the *General Utilities* nonrecognition rule for both gains and losses.[221] This approach has substantial appeal based on notions of consistency, logic, and integrity of the corporate tax structure. Whether the distribution results in gain or loss, the event of distribution has the same characteristics from the "realization"

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[219] In fact, H.R. 2163 and H.R. 4170, *supra* note 17, would amend § 311(d) to provide in general for recognition of "gain (but not loss)" upon in-kind distributions. H.R. REP. No. 432, 98th Cong., 2d Sess. 1190 (1984); S. REP. No. 169, 98th Cong., 2d Sess. 177 (1984).

[220] The revenue projections regarding the Senate staff proposals unfortunately do not distinguish between a full repeal of *General Utilities* and a repeal only for appreciated assets. *See* STAFF REPORT, *supra* note 10, at 107–08.

[221] ALI PROPOSAL, *supra* note 10, at 116. The Senate staff proposal is not as explicit on this point as it might be, however. Its focus is clearly on the recognition of gains. The section of the report dealing with cost basis acquisitions, for example, begins with the heading "Recognition of Gain." Nevertheless, the report does indicate that the recognition of gain or loss, with certain exceptions, is proposed. *See* STAFF REPORT, *supra* note 10, at 61, 66.

standpoint.[222] This approach, however, is inconsistent with other recent congressional revisions of the tax law.

For example, in the Subchapter S Revision Act of 1982,[223] Congress addressed the *General Utilities* problem in the limited context of small business corporations permitted to elect "pass-through" status under Subchapter S of the Code.[224] Recognizing that the Subchapter C distribution rules, including sections 311 and 336, are applicable to Subchapter S corporations, the Senate, in its report on the 1982 revisions to Subchapter S,[225] expressed a concern that "assets could be distributed tax-free (except for recapture in certain instances) and subsequently sold without income recognition to the selling shareholder because of the stepped-up fair market value basis."[226] As a result of this concern, Congress provided in new section 1363(d) that an S Corporation will recognize *gain* upon distribution of appreciated property "in the same manner as if it had sold such property to the distributee at its fair market value."[227]

In thus repealing *General Utilities* in the S Corporation context, Congress limited the repeal to provide for recognition of

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[222] *See supra* notes 122–128 and accompanying text.

[223] Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669.

[224] The Subchapter S corporation itself will generally not be subject to taxation upon making a proper election. I.R.C. § 1363(a) (1982). Each shareholder will take into account his or her pro rata share of the corporation's income. *Id.* § 1366.

Although the electing Subchapter S corporation will not itself be taxed, the corporation's income must be determined for the purposes of calculating each shareholder's pro rata share of income and deductions. In that regard, provisions of Subchapter C will apply to Subchapter S corporations to the extent that they are not inconsistent with Subchapter S. *Id.* § 1371(a). This provision was added by the Subchapter S Revision Act of 1982. Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669. Prior to 1982, however, the same provision could be found in Treas. Reg. § 1.1372-1(c), T.D. 6432, 1960-1 C.B. 323, 324.

[225] S. REP. No. 640, 97th Cong., 2d Sess. 19, *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 3253, 3271. The regulations specifically provide that §§ 311 and 331 will apply to S corporations. Treas. Reg. § 1.1372-1(c)(3), (5), T.D. 6432, 1960-1 C.B. 323, 324. Moreover, the Tax Court has held that § 336 will apply to S corporation distributions in complete liquidation. Fairman v. Commissioner, 32 T.C.M. 1084, 1087 n.6 (1973) (CCH Dec. 32,178 (M)); *see also*, J. EUSTICE & J. KUNTZ, FEDERAL INCOME TAXATION OF SUBCHAPTER S CORPORATIONS, ¶ 15.2[1][a], n.12 (Supp. 1983).

[226] S. REP. No. 640, *supra* note 225, at 3270–3271.

[227] That section provides in full:

> DISTRIBUTIONS OF APPRECIATED PROPERTY. — If —
> (1) an S corporation makes a distribution of property (other than an obligation of such corporation) with respect to stock, and
> (2) the fair market value of such property exceeds its adjusted basis in the hands of the S corporation,
> then notwithstanding any other provision of this subtitle, gain shall be recognized to the S corporation on the distribution in the same manner as if it had sold such property to the distributee at its fair market value.

I.R.C. § 1363(d) (1982).

gains; it did not provide for recognition of losses. Congress was concerned that a full repeal of nonrecognition for both gains and losses might encourage taxpayers to create artificial losses to offset other income.[228]

Similarly, in the Tax Reform Act of 1969,[229] Congress partially repealed *General Utilities* but limited the repeal to recognition of gains. Section 311(d)(1) added by that Act provides that gain (but not loss) shall be recognized upon the distribution of property in a redemption.[230] Moreover, provisions recently passed by the House and approved by the Senate would provide generally for the recognition of gain (but not loss) upon the *ongoing* distribution of appreciated property.[231] As the Tax Reform Act of 1969, the Subchapter S Revision Act of 1982, and legislation recently passed by the House and approved by the Senate indicate, it is not a foregone conclusion that repeal of the *General Utilities* principle will apply to both gain and loss transactions.

This is not to suggest that Congress *should* limit repeal of *General Utilities* to distributions of appreciated property. As noted above, such an approach would generate inconsistencies in tax policy. Moreover, such limitations enacted in connection with the present proposals for reform and simplification of Subchapter C might create further incentives for purely tax-motivated transactions. Corporations may seek creative and complex mechanisms to permit recognition of loss. The result of a limited repeal might be neither reform nor simplification. Before undertaking such a limited repeal, it is essential that such implications be considered.

3. *Impact of Repeal of* General Utilities *on the "Related Party" Provisions.*

If *General Utilities* is repealed for distributions of both appreciated and depreciated property, several questions arise regarding the deduction of losses between "related parties" under section 267. One such question is whether a loss nevertheless will be disallowed if the distribution is to a shareholder with more than fifty percent of the stock.

[228] *See* Oberst, *Reform of the Subchapter S Distribution Rules: Repudiation of Section 311(a)*, 38 TAX L. REV. 79, 101 n.134 (1982).

[229] Pub. L. No. 91-172, title IX, § 905(a), 83 Stat. 487, 713 (1969).

[230] For the text of § 311(d)(1), see *supra* note 52. *See also supra* notes 48-63 and accompanying text.

[231] *See supra* note 219.

a. *Section 267: Present Law and Legislative History.* Section 267 provides, in pertinent part, that "[n]o deduction shall be allowed — (1) in respect of losses from sales or exchanges of property (other than losses in cases of distributions in corporate liquidations), directly or indirectly, between persons specified within any one of the paragraphs of subsection (b)."[232] These parties include, among others, "an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual."[233]

Prior to 1934, taxpayers could effectively deduct losses resulting from "sales" of property between family members.[234] Absent a statute disallowing losses between "related parties," the Commissioner's only weapon in attacking the loss deduction was to challenge the bona fides of the transaction. In *Higgins v. Smith*,[235] an early landmark case, the Commissioner convinced the United States Supreme Court that a loss on a transfer between a shareholder and his wholly owned corporation should be disallowed because the transaction was not bona fide. Challenging the bona fides was, however, an uphill battle for the Commissioner, one which he frequently lost.[236]

During the 1930's, congressional concern with the increasing use of tax avoidance strategies reached high levels. In 1933, the House Ways and Means Committee appointed a subcommittee to study methods to prevent avoidance and evasion of the Internal Revenue laws.[237] Several proposals for changes in the tax laws were generated by the subcommittee's work. Among them was the predecessor to section 267, first adopted in the Revenue Act of 1934.[238] In explaining this provision, the House Committee Report stated simply that "[e]xperience shows that the practice of creating losses through transactions between members

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232 I.R.C. § 267(a)(1) (1982).

233 *Id.* § 267(b)(2). Also considered related for purposes of § 267 are two or more corporations which are more than 50% owned by the same individual if either of the corporations is a personal holding company or foreign personal holding company. *Id.* § 267(b)(3).

234 *See, e.g.*, Fawsett v. Commissioner, 31 B.T.A. 139, 142 (1934); Gummey v. Commissioner., 26 B.T.A. 894 (1932), *acq.* 1934-2 C.B. 8.

235 308 U.S. 473 (1940).

236 *See supra* note 234.

237 This study produced a preliminary report which proposed the disallowance of losses among family members. HOUSE COMM. ON WAYS AND MEANS, 73D CONG., 2D SESS., PRELIMINARY REPORT ON METHODS OF PREVENTING THE AVOIDANCE AND EVASION OF THE INTERNAL REVENUE LAWS TOGETHER WITH SUGGESTIONS FOR THE SIMPLIFICATION AND IMPROVEMENT THEREOF (Comm. Print 1933).

238 Revenue Act of 1934, ch. 277, § 24(a)(6), 48 Stat. 680, 691 (current version at I.R.C. § 267 (1982)).

of a family and close corporations has been frequently utilized for avoiding the income tax. It is believed that the proposed change will operate to close this loophole of tax avoidance."[239] Over the years, the list of related parties has been extended, and additional rules have been added regarding attribution and subsequent resale of the property.[240] Nevertheless, section 267 in its present form is essentially as it was when initially enacted.

Early in the history of the "family loss" disallowance provision, taxpayers attempted to avoid application of the rule by establishing the bona fides of the transaction. These efforts proved to be unsuccessful. After an examination of congressional intent behind the "family loss" provision, the United States Supreme Court pointed out in *McWilliams v. Commissioner* that the statute states an absolute prohibition —

> *not a presumption* — against the allowance of losses on any sales between the members of certain designated groups . . . . It is a fair inference that even legally genuine intragroup transfers were not thought to result, usually, in *economically genuine realizations of loss*, and accordingly that Congress did not deem them to be appropriate occasions for the allowance of deductions.[241]

With this history in mind, the applicability of section 267 to corporate distributions should *General Utilities* be repealed can be examined.

b. *Should Section 267 Disallow Losses After Repeal of* General Utilities? If the rationale behind section 267 is the disallowance of losses which are not likely to be "economically genuine," it appears that section 267 should apply to disallow losses upon certain distributions to controlling shareholders. And, in fact, the Senate staff and ALI proposals have provided as much.[242] In order for section 267 to apply to corporate distributions after a repeal of *General Utilities*, though, some technical revisions may be necessary.

Section 267, as presently written, disallows deductions "in respect of losses from *sale or exchanges* of property . . . be-

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[239] H.R. REP. No. 704, 73d Cong., 2d Sess. 23 (1934).

[240] *See* I.R.C. § 267(c), (d) (1982).

[241] 331 U.S. 694, 699 (1947) (emphasis added).

[242] *See* ALI PROPOSAL, *supra* note 10, at 116, where the ALI lists § 267 as an exception to the general recognition rule for cost basis transfers. *See also* STAFF REPORT, *supra* note 10, at 66. Without any mention of the liquidation exception in § 267(a), however, the Senate staff simply states that "[l]osses [upon liquidation] also would be recognizable except to the extent that section 267 limits deduction . . . ." *Id.*

tween persons specified within any one of the paragraphs of subsection (b)."[243] One technical question which arises under this language is whether a corporate liquidating or nonliquidating distribution can be viewed as a "sale or exchange" for purposes of section 267. To resolve this problem, section 267 could be amended to provide that any corporate distribution is "deemed" to be a "sale or exchange" for purposes of that provision.

However, this would raise additional questions with regard to earnings and profits.[244] For instance, since the loss would not be deductible, should earnings and profits be decreased? If so, should the distributing corporation's reduction to earnings and profits reflect adjusted basis or fair market value of property distributed?

The first of these questions is already addressed by the regulations under section 312, which state that "[a] loss . . . may be recognized though not allowed as a deduction (by reason, for example, of the operation of section[] 267 . . .) but the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss."[245]

The corporation presumably will be interested in obtaining the largest possible reduction to earnings and profits. Where property has depreciated in value, the corporation's adjusted basis will be higher than fair market value. Ordinarily, upon distributing an asset in kind, the corporation will reduce earnings and profits by the adjusted basis of the property.[246] In contrast, on a sale the corporation's reduction to earnings and profits will be equivalent to its recognized loss, that is, the excess of basis over fair market value.[247] The issue that arises is whether, if the distribution is "deemed" to be a "sale or exchange" for purposes of providing section 267 coverage, this will also limit the corporation's earnings and profits reduction.

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243 I.R.C. § 267(a) (1982) (emphasis added).

244 The Senate Finance Committee staff proposal would, however, eliminate the earnings and profits concept for purposes of dividends, treating ongoing distributions as ordinary income. STAFF REPORT, *supra* note 10, at 77–78.

245 Treas. Reg. § 1.312-7(b)(1), T.D. 6152, 1955-2 C.B. 61, 107. This analysis is in accordance with the theory behind amendments to I.R.C. § 312 provided in H.R. 2163, *supra* note 17, § 47. In seeking to provide an earnings and profits calculation which more accurately reflects economic gain and loss, § 47 (a)(4), provides for an in increase by the amount of the corporation's "realized" gains on a distribution of appreciated property, whether or not such gain is recognized. S. REP. No. 169, 98th Cong., 2d Sess. 200 (1984).

246 I.R.C. § 312(a)(3) (1982).

247 *See* Rabinovitz, *Nonliquidating Distributions in Kind: Effect of Recognition of Gain on Earnings and Profits*, 17 UCLA L. REV. 408, 418–19 (1969) (discussion of effect of losses on earnings and profits).

This issue, though, is not as troublesome as it first appears. The distributing corporation should be entitled to an earnings and profits reduction that reflects the adjusted basis of the asset distributed.[248] One can reach this result even if the transaction is viewed as a "sale or exchange." In fact, the transaction may theoretically be broken down into two steps: a "sale or exchange" followed by an immediate cash distribution to the shareholders.

An ongoing corporation and its shareholders are clearly concerned with the status of the earnings and profits account for purposes of determining the tax consequences of future dividends.[249] Thus, these problems regarding earnings and profits are of greater interest to the ongoing corporation than the liquidating corporation. Nevertheless, if, as proposed, liquidating and nonliquidating distributions are to be covered by the same recognition provision, these problems must be considered.

A better solution to the statutory language problem might be to provide in the general cost basis transfer recognition provision that losses between related parties as defined in section 267 will not be allowed, notwithstanding the fact that the corporate distribution may not technically be a "sale or exchange."

c. *The Section 267 Liquidation Exception.* The language of section 267 disallows deductions for losses "other than losses in cases of distributions in corporate liquidations."[250] Given the rigid interpretation of section 267 in *McWilliams*,[251] it seems that the disallowance of loss provision can be avoided only by fitting within this liquidation exception.

Under present law, the liquidation exception in section 267 is of little relevance to the distributing corporation; losses are already disallowed by virtue of section 336. If *General Utilities* is repealed, however, the meaning of the exception will increase in importance to the distributing corporation. Unfortunately, neither the statute nor the legislative history suggests a specific explanation or rationale for the liquidation exception. Case law also is not of much assistance; litigation on the liquidation exception to section 267(a)(1) is quite sparse.

One possible explanation for the liquidation exception in sec-

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[248] *See* I.R.C. § 312(a)(3) (1982).
[249] *Id.* § 316.
[250] *Id.* § 267(a)(1).
[251] 331 U.S. 694 (1947); *see supra* note 241 and accompanying text.

tion 267(a)(1) can be found in the "economically genuine realization of loss" concept expounded in the Supreme Court's landmark opinion in *McWilliams*.[252] Where the corporation is ceasing its business, the loss generated is more likely to be "economically genuine"; an ongoing business may be more tempted to generate mere "paper losses" for tax avoidance purposes.

The Second Circuit hypothesized in *McCarthy v. Conley* that this explanation "could account for the exception in section 267(a)."[253] In *McCarthy*, the taxpayer held twenty-five percent of the stock in a family corporation. She sold all of her shares to the corporation in a redemption transaction, claiming a loss from the sale on her tax return.[254] The Commissioner disallowed the loss under section 267(a)(1). Mrs. McCarthy argued that this transaction fit within the "liquidation exception" to section 267 because it was a "partial liquidation" of the corporation. Troubled by her argument, the court rejected her claim, stating that:

> [I]n the case of a total liquidation, there is no difficulty in determining whether or not a loss has been incurred by all of the members of the family who joined the corporation's venture. This could account for the exception in section 267(a). But where the shares of only one family member are redeemed by a family corporation, "an economically genuine realization of loss" to the family is somewhat obscured. As a group, they still hold 100% of the outstanding stock and the corporate enterprise may remain intact.[255]

Without some "discontinuance of a proportionate amount of the business" or "corporate contraction," the court was unable to find a partial liquidation resulting in an "economically genuine realization of loss" to the taxpayer.[256] The court's opinion suggested that unless the liquidation was a complete liquidation, the taxpayers would have trouble establishing an "economically genuine loss."[257]

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[252] *Id.*

[253] McCarthy v. Conley, 341 F.2d 948, 953 (2d. Cir), *cert. denied*, 382 U.S. 838 (1965). The court in *McCarthy* indicated that the case was one of first impression. *Id.* at 950 n.3.

[254] The taxpayer received "sale or exchange" treatment as opposed to dividend treatment on the "complete termination of interest" redemption pursuant to I.R.C. § 302(b)(3). 341 F.2d at 949. Because all of the remaining stock was owned by her brothers and sisters, she was not deemed to own any of their stock under the § 318 attribution rules. *Id.* at 954 n.16. The § 318(a)(1) family attribution rule does not provide for attribution of ownership among siblings. I.R.C. § 318(a) (1982).

[255] 341 F.2d at 953.

[256] *Id.*

[257] Under the court's rationale in *McCarthy*, a taxpayer might have been able to fit

McCarthy is among the few cases to interpret the liquidation exception to section 267. Even fewer cases interpret that section's exception as applied to the distributing corporation. This is not surprising since under present law recognition of loss by the distributing corporation upon liquidation is clearly prohibited by section 336.

There is, however, one pre-1954 case dealing with the deductibility of losses to the liquidating corporation in which the court interpreted the liquidation exception to the loss disallowance provision quite narrowly. In *Mathews v. Squire*,[258] a trustee was appointed to liquidate and distribute assets of the corporation. Rather than distribute depreciated assets in liquidation to the majority shareholder, the trustee sold the assets "in aid of liquidation" at a loss to the majority shareholder and subsequently distributed the cash proceeds to both the purchasing and other shareholders. In a literal interpretation of the liquidation exception, the court concluded that a sale of assets by trustee *in aid of* liquidation is not a liquidation covered by the exception.[259] Thus, the court concluded that the corporation could not deduct the loss sustained upon sale of the assets to its majority shareholder.[260]

If the *General Utilities* doctrine as applied in sections 336 and 311 is repealed, renewed attention will be focused on the section 267(a)(1) liquidation exception. The application of this exception to the distributing corporation again will become relevant. A literal interpretation such as that found in *Mathews* would create concern for liquidating corporations.

IV. Relief Proposals For Distributions in Liquidation

Even the Senate Finance Committee staff, which has proposed full repeal of *General Utilities* for both liquidating and nonliquidating distributions, is aware of the growing concern that repeal of the nonrecognition rule for liquidating corporations would be too harsh.[261] In the event that relief is determined

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within the "liquidation exception" for a partial liquidation representing a true corporate contraction. Today, however, this line of reasoning would be restricted by the repeal of the partial liquidation rules in TEFRA. *See supra* notes 66–67 and accompanying text. *But see* I.R.C. § 302(b)(4) (1982).

[258] 59 F. Supp. 827 (N.D. Wash. 1945). The loss provision at issue was the Internal Revenue Code of 1939, § 24(b)(1)(B) (predecessor to I.R.C. § 267).

[259] 59 F. Supp. at 827.

[260] *Id.* at 828.

[261] It might here be noted that, in addition to limiting its repeal of *General Utilities* in

to be necessary, the Senate Finance Committee staff has identified several relief measures which might be adopted.[262]

A. *Shareholder Credit Proposal*

Among the relief measures identified is the ALI shareholder credit proposal. Under Proposal C3, "[a]ny shareholder receiving a liquidating distribution from a corporation shall be allowed a credit against tax for his proportionate share of the corporation's liquidating capital-gain tax."[263] The credit, however, would be limited so as not to exceed the shareholder's own capital gains tax on the liquidation.[264] In other words, shareholders would pay either their own capital gain or their share of the corporate capital gain, whichever is greater.[265]

This credit proposal would answer some of the objections raised against the repeal of *General Utilities* as applied to liquidating distributions. As drafted, the credit is limited to the shareholder's proportionate share of the corporation's liquidating *capital gains tax*.[266] As to pre-incorporation appreciation and goodwill, both of which will generate capital gains,[267] the credit generally will result in a tax at the corporate, but not at the shareholder, level. In contrast, gain on ordinary income

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the Subchapter S Revision Act of 1982 to distributions of appreciated property, *see supra* notes 223–228 and accompanying text, Congress also limited its repeal to nonliquidating distributions. Thus, Congress indicated that it is prepared to treat liquidating and nonliquidating distributions differently. Although not explicit in the statute itself, the repeal of *General Utilities* for Subchapter S corporation distributions of appreciated property appears to apply only to ongoing distributions; new § 1363(d) will not apply to complete liquidations. *See* S. REP. NO. 640, *supra* note 225, at 3270–3271 (emphasis added), where the Senate says, with regard to new § 1363(d): "Gain will be recognized by a subchapter S corporation on a distribution of appreciated property, *other than distributions in complete liquidation of the corporation*, in the same manner as if the property had been sold to the shareholder at its fair market value." *See also* EUSTICE & KUNTZ, *supra* note 225. Proposed technical amendments to the Subchapter S Revision Act of 1982 would *explicitly* provide that § 1363(d) shall not apply to distributions of property in complete liquidation. *See* H.R. 4170, *supra* note 17, § 621(a), 130 CONG. REC. 2711 (1984).

[262] See STAFF REPORT, *supra* note 10, at 65, 93–94.

[263] ALI PROPOSAL, *supra* note 10, at 135 (Proposal C3).

[264] The limitation to Proposal C3 (Shareholder Credit for Corporate Tax on Liquidating Capital Gains) reads: "The credit shall not exceed the amount by which the shareholder's tax liability would be reduced if his gain on the liquidation were excluded in computing his income tax." *Id.* at 135.

[265] *Id.* at 136 (Comments to Proposal C3).

[266] *Id.* at 135 (emphasis added).

[267] Unlike other intangibles such as "covenants not to compete," goodwill is a capital asset, the sale of which will generate capital gain. *See, e.g.*, Ensley Bank & Trust Co. v. United States, 154 F.2d 968, 969 (5th Cir.), *cert. denied*, 329 U.S. 732 (1946).

items, such as inventory, will be taxed twice. This limitation would provide relief from double taxation for those items which have been most troublesome.

On the other hand, by allowing a shareholder credit for the corporation's overall capital gains tax, the proposal goes further than necessary to remedy the specific problems associated with pre-incorporation appreciation and goodwill. Moreover, the shareholder credit approach would generate many troublesome technical and practical problems. For instance, computation of the credit available to each shareholder will be difficult where there are numerous shareholders whose shares have frequently changed hands.[268] Further difficulties may be encountered in allocating the credit among holders of different classes of stock. Additional problems arise if it later is discovered that the corporation's computation of its capital gains tax was in error. In that situation, how should the credit taken by the corporation's shareholders be adjusted?[269] Should shareholders be entitled to carry forward or carry back losses which they are unable to use?[270] Even this incomplete list of issues suggests that although the repeal of *General Utilities* together with a shareholder credit relief provision might result in reform, it would not result in simplification.

B. *Historic Asset Exemption*

An alternative form of relief is an exemption from the corporate level tax on liquidation for certain "historic" capital assets held for a prescribed period of time.[271] By including tangible assets and certain types of intangible assets, such as goodwill, within the definition of "historic assets," this form of relief would answer some of the objections discussed above. Like the shareholder credit proposal, however, it provides greater relief than that necessary to respond to the problems of pre-incorpo-

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[268] This point was raised by several of those who testified in recent Senate Finance Committee hearings. *See 1983 Senate Hearings*, *supra* note 7, at 13 (statement of James M. Roche, of McDermott, Will & Emery); *id.* at 8 (statement of Edwin S. Cohen). *See also id.* at 10 (statement of Ronald A. Pearlman). While recognizing the technical problems, the Treasury Department generally supports a shareholder credit approach. *Id.*

[269] *See id.* at 13 (statement of James M. Roche).

[270] *See id.* at 10 (statement of Ronald A. Pearlman); *id.* at 13 (statement of James M. Roche).

[271] STAFF REPORT, *supra* note 10, at 93.

ration appreciation and goodwill. Both the shareholder credit and historic assets exceptions respond in a more general way to the perceived hardship of double taxation upon liquidations.

Like the shareholder credit proposal, several problems exist with respect to the historic asset approach. First, it will be necessary to define those "historic assets" which will be exempt from corporate tax. For instance, how long must an asset be held by the corporation before it will be considered "historic" for purposes of this relief provision?[272]

Another concern with the "historic asset" relief proposal raised by the Senate staff is the step-up in basis received by shareholders in liquidation. By itself, the exemption of historic assets from the *corporate* level tax will not alter these basic rules. Unless there is some simultaneous revision of the shareholder liquidation provisions under sections 331 and 334, shareholders will continue to receive a fair market value basis in assets received on liquidation which can be used for depreciation purposes. Shareholders might thus be encouraged to liquidate and reincorporate, taking advantage of a step-up in basis each time.[273] Like the shareholder credit, it appears that the historic asset relief measure will not be simple. The provisions must be drafted carefully to minimize tax avoidance strategies.

C. *Nonrecognition or Deferral Through the Shareholders*

1. *Background: Carryover or Substituted Basis as a Deferral Mechanism.*

The shareholder credit and historic asset relief proposals do not involve any revision of the present sections governing the tax treatment of the shareholders upon liquidation.[274] Relief also could be obtained through various changes to these shareholder provisions, particularly the basis rules. Many types of corporate transactions under present law do not result in immediate recognition of gain. Instead, deferral of gain or loss is achieved

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[272] The Senate staff suggests three or five years or more. *Id.*

[273] The Commissioner does have some weapons with which to attack the liquidation-reincorporation problem. Litigation of these issues, however, may be complex, time-consuming, and costly. For a good discussion of the case law and the complexity of litigation in this area, see Note, *New Answers to the Liquidation--Reincorporation Problem*, 76 COLUM. L. REV. 268 (1976).

[274] I.R.C. §§ 331, 333, 334 (1982).

through use of basis rules.[275] A carryover or substituted basis can be applied to stock or other property received in an exchange, thus deferring recognition of the gain or loss until its subsequent sale or disposition.

If it is determined that immediate recognition of gain upon liquidation at both the corporate and shareholder levels is unduly harsh, a deferral of one of these gains might be achieved through use of a special basis rule. Because shares of the corporation will be surrendered and canceled upon a complete liquidation, however, the only remaining properties to which a carryover or substituted basis might attach are the assets distributed to the shareholders in liquidation. At this point, a policy choice becomes necessary. If any gain is to be deferred through the use of a basis carryover or substitute, which gain should it be: the shareholder's "sale or exchange" gain, or the corporation's appreciation gain?[276]

2. *Deferral of Corporate Tax.*

One possible relief measure would involve a deferral of the corporate level tax on asset appreciation through use of a carryover basis to the shareholders. Under this approach, the shareholder's gain or loss upon liquidation would be immediately recognized, as it is under present law.[277] Instead of receiving the assets with a fair market value basis as presently provided in section 334(a), however, the shareholders would receive a carryover basis from the corporation in the assets distributed. In this fashion, a double tax is imposed on the liquidation. The corporate level of taxation simply has been shifted to the shareholders and deferred until subsequent disposition of the assets by the shareholders.[278]

One potential risk with this approach, however, is the possibility that the corporate tax will never be collected. This risk exists under present law because of the provision which allows

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[275] *See, e.g., id.* §§ 333, 334(c) (deferral of shareholder's gain upon elective one-month liquidation); *id.* §§ 351(a), 358(a) (deferral of shareholder's gain upon incorporation); *id.* §§ 354, 358, 361, 362 (deferral of gain upon reorganization).

[276] Discussion of the two different types of gain that occur upon complete liquidation appears at *supra* note 181 and accompanying text.

[277] I.R.C. § 331(a), 1001 (1982).

[278] This shifting may not be tremendously significant, however. If the corporation had been subject to an immediate capital gains tax, it would have distributed that much less in value to its shareholders. Differences in the tax ultimately paid will result, however, to the extent that the corporation and its shareholders are taxed at different rates.

a shareholder's basis in assets to be stepped up to fair market value upon death.[279] To resolve this problem, it may be necessary to make some revisions in the step-up at death provisions of section 1014.

3. *Variation on the Deferral of Corporation Tax Approach.*

Those opposed to a repeal of *General Utilities* in the liquidation context may not be mollified by the above proposal. Although it eliminates the immediate hardship of double taxation, the threat of the second level of taxation remains. The primary concern of these opponents has been the effect on closely held corporations whose shareholders wish to continue the business after liquidation.[280]

This corporate level deferral relief measure can be varied, however, to deal with this concern. For instance, as suggested above there could be an immediate recognition of shareholder gain and a carryover basis. Rather than continue the carryover basis indefinitely, this basis could be gradually stepped up to fair market value over a period of years if, in fact, the shareholders continued operation of the business. A sale of the assets by the shareholders shortly after liquidation would still trigger recognition of the corporate level of taxation.

4. *Shareholder Nonrecognition.*

If it is determined that further relief from double taxation upon complete liquidation is warranted, there is yet another alternative — the elimination of the shareholder level of taxation. This alternative would provide for a tax-free unwinding of the corporation as a parallel to the tax-free incorporation provisions.[281] The proponents of this relief measure argue that, just

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[279] *See* I.R.C. § 1014 (1982). Among the assumptions upon which the Senate staff proposal is explicitly premised is that shareholders will be entitled to a "step-up in basis in shares of stock held at death." STAFF REPORT, *supra* note 10, at 4.

[280] *See supra* notes 138–142 and accompanying text.

[281] This approach has been advocated by the Treasury Department in its statements before the Senate Finance Committee. *See 1983 Senate Hearings*, *supra* note 7, at 18 (statement of Ronald A. Pearlman); *see also supra* notes 183–184 and accompanying text.

The concept is not a new one. A bill before the House in 1954 provided for nonrecognition to shareholders upon liquidation with a carryover basis in assets from the corporation. H.R. 8300, § 331, 83d Cong., 2d Sess., 100 CONG. REC. 2957 (1954). For a brief discussion of this bill, see Cohen, Gelberg, Surrey, Tarleau & Warren, *Corporate* as the initial incorporation of a corporation may be a tax-free exchange under section 351, the corporation also should be permitted to unwind without tax. Where a group of investors transfers assets to a corporation and immediately after transfer continues to control the corporation, it has been the judgment of Congress that such a transfer reflects a "mere change in the form of ownership" and is not an appropriate occasion for the imposition of tax.[282] Similarly, where assets are distributed in liquidation to shareholders who intend to retain control and continue operation of the business, the transaction arguably reflects a "mere change in the form of ownership."

Under this alternative, one tax would be imposed at the corporate level and the shareholder "sale or exchange" rules in section 331 would be eliminated and replaced with a shareholder nonrecognition provision. Further relief could be provided by combining this nonrecognition provision with an election permitting the corporation and its shareholders to elect a cost or carryover basis liquidation. If this election is not made available, the corporation would pay an immediate tax on liquidation and the shareholders would receive a step-up in basis. If the election is made available, however, no tax would be collected from the corporation at the time of liquidation by analogy to the Senate staff and ALI nonrecognition proposals for carryover basis transfers.[283] Furthermore, if a general nonrecognition rule is provided for the recipient shareholder, no tax will be collected from the shareholder at the time of liquidation. Gain on the appreciation of corporate assets is preserved by a carryover basis and will be taxed upon subsequent sale by the shareholders.

In making the suggestion that a cost or carryover election be provided for liquidations, the Treasury Department recognized a "step-up at death" problem similar to the problem discussed in connection with the deferral proposal above. Here, however, the problem is even more acute. Combined with a complete shareholder nonrecognition provision, a basis step-up at death might result in a complete escape from taxation of the shareholder and corporate level gain for a carryover basis elective

Liquidations Under the Internal Revenue Code of 1954, 55 COLUM. L. REV. 37, 37–38 (1955).

282 Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir.), *cert. denied*, 310 U.S. 650 (1940).

283 *See* STAFF REPORT, *supra* note 10, at 59–60; ALI PROPOSAL, *supra* note 10, at 73–74.

transaction. The Treasury Department has, therefore, proposed that a condition to making an election available would be the disallowance of a basis step-up upon death of the shareholder.[284]

This elective approach has some appeal in that it is consistent with the corporate acquisition proposals discussed earlier.[285] On the other hand, a shareholder nonrecognition provision combined with a carryover basis election would result in no immediate taxation upon liquidation. This is inconsistent with the overall policy of the present reform proposals.

D. *Miscellaneous Relief Proposals*

Additional relief proposals are listed in the Senate staff report. These include a reduction in the corporate tax rate and a phase-in of the new tax on cost basis transfers over a transitional period.[286] A phase-in is a possibility — such transitional rules would not be new to the corporate tax world.[287] An across the board reduction in the corporate tax rate, on the other hand, would be far more relief than is necessary to deal with the limited problem of the harshness of double taxation on liquidation. Until a thorough analysis of the question of integrating the corporate and shareholder tax is made, such a reduction should not be considered.

V. Conclusion

It has been suggested that the repeal of *General Utilities* would render numerous other Code provisions obsolete, permitting their repeal as well. This, it is argued, will result in tremendous simplification of Subchapter C. The list of Code provisions which might be eliminated is truly impressive. It includes sections 311, 333, 336, 337, 338, and 341.[288]

That section 311 can be eliminated should come as no sur-

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[284] *1983 Senate Hearings*, *supra* note 7, at 18 (statement of Ronald A. Pearlman).

[285] *See supra* notes 148 through 153 and accompanying text. *But see* Blum, *supra* note 6, at 523 ("No occasion [should] ever arise for carrying over an asset basis from a corporation to an individual shareholder. That abomination in the existing law should be scrapped entirely.").

[286] Staff Report, *supra* note 10, at 93–94.

[287] *See, e.g.*, the incremental provisions regarding Domestic International Sales Corporations (DISC's) added by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 1101, 90 Stat. 1520, 1655–60 (current version at I.R.C. § 995(e) (1982)).

[288] This listing does not include the reorganization provisions in I.R.C. §§ 354–368 (1982) which also might be repealed if the "corporate acquisition" proposals are adopted.

prise. After all, it is the statutory embodiment of the *General Utilities* principle itself. It is far from clear, however, that outright repeal of the remaining provisions enumerated above will be feasible. Each of those provisions deals in some measure with liquidations.

There is no question that reform and simplification of Subchapter C are greatly needed. Repeal of the *General Utilities* nonrecognition rule is an important part of that reform. As suggested above, however, a large chorus of voices is calling for some kind of relief from complete repeal of *General Utilities* in the liquidation context. If such relief is forthcoming, as it undoubtedly will be, it will be difficult to achieve substantial simplification along with the reform. Any relief measure adopted will involve complexities.

Before Congress can be sure that the numerous provisions listed above safely can be eliminated from Subchapter C, a careful examination of any relief measure adopted must be undertaken. For example, if substantial relief is provided for the liquidating corporation, the collapsible corporation scheme may continue to be attractive. It may be necessary, then, to continue some provision to combat this loophole.[289]

It is clear that some hardship will be imposed on the small closely held business if *General Utilities* is repealed for liquidating distributions. Unfortunately, the appropriate response to this hardship is not as clear. One possible response simply is not to repeal *General Utilities* for liquidating distributions at all. That this is a possibility Congress might consider is apparent from its recent revisions of Subchapter S of the Internal Revenue Code, in which it repealed *General Utilities* for ongoing, but not for liquidating, distributions.[290] This is also the approach taken by H.R. 2163 and H.R. 4170.[291] This approach, though, does not have much to commend it. It would result in entirely inconsistent treatment of transactions which from a "realization" point of view cannot be distinguished.[292]

Even a partial relief measure which is adopted only for liquidating distributions would create inconsistencies. Such inconsistency nevertheless may be necessary as a policy matter to alleviate hardships on small closely held businesses wishing to

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[289] A brief discussion of the collapsible corporation "loophole" and the congressional response to it can be found *supra* at notes 69–73 and accompanying text.

[290] *See supra* note 261 and accompanying text.

[291] *See supra* note 17 and accompanying text.

[292] *See supra* notes 12–137 and accompanying text.

liquidate. If Congress chooses to move forward with a repeal of *General Utilities*, it is likely that some relief measure will be simultaneously enacted for liquidating distributions. It is this author's contention that the most viable relief measure is the corporate deferral mechanism, perhaps combined with a gradual step-up in basis to shareholders who in fact continue to operate the business after liquidation. If the hardship of double taxation upon liquidation does fall most heavily on shareholders wishing to continue the business, this solution provides some relief without giving away too much of the federal fisc.

The philosophy of the Senate staff and ALI proposals is generally sound. More detail is needed, however, concerning the application of the principles expressed in those proposals to specific situations. For any relief measure considered, great care must be taken in designing that relief to assure that further incentives for tax avoidance are not created.

There is no doubt that the time is ripe for a careful examination of many tax issues. It should be noted, however, that the trend in recent years has been to expand the availability of "pass-through" business entities.[293] If Congress extends the double taxation concept as envisioned by a "true" repeal of *General Utilities* at a time when "pass-through" options are increasing and talk of integration is growing, it would appear to be working at cross-purposes. A strengthening of the double tax may well encourage eligible taxpayers to elect Subchapter S corporation status or to operate as partnerships. This, in turn, may lead to a greater proliferation of tax shelters. Important issues are clearly at stake. Before any major legislative action is taken, Congress should undertake a deep and thorough examination of corporate tax policy.**

[293] In the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669, for example, Congress increased the permitted number of shareholders from 25 to 35. *Id.* § 2. It expanded the permissible types of stock which may be held. *Id.* For a complete analysis of changes made by the Subchapter S Revision Act of 1982, see generally Kanter, *To Elect or Not to Elect Subchapter S--That Is the Question*, 60 TAXES 882 (1982); *Lang, Subchapter S Revision Act of 1982: Dealing With Transition Rules*, 60 TAXES 928 (1982); Oberst, *supra* note 228.

If the Subchapter S corporation election is unavailable for any reason, businesses can also organize as partnerships subject to the "pass-through" provisions of Subchapter K of the I.R.C. I.R.C. §§ 701–761 (1982). In fact, from 1976 through 1981 there has been a gradual increase (from 7.5 to 8.5) in the percentage of partnership returns filed as compared to those filed by corporations and sole proprietorships. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 528, table 875 (1982–83) (statistics for 1976–1979); U.S. SMALL BUSINESS ADMINISTRATION, THE STATE OF SMALL BUSINESSES: A REPORT OF THE PRESIDENT 30, table 2.1 (1983) (statistics for 1980); *id.* at 8, table 1.2 (1984) (statistics for 1981).

**As this was going to press, the House and Senate were scheduled for conference on H.R. 2163 and H.R. 4170.

ARTICLE

THE EQUAL CREDIT OPPORTUNITY ACT: A FUNCTIONAL FAILURE

JOHN H. MATHESON*

The Equal Credit Opportunity Act was enacted in 1974 as (1) a consumer protection statute designed to provide accurate information to and about consumers involved in credit transactions, and (2) an antidiscrimination statute designed to shield protected classes of consumers from discrimination in the granting of credit. The Federal Reserve Board promulgated regulations to further these statutory goals. Congress intended that the Act would be enforced through both private litigation and public compliance programs. Few private lawsuits have been brought under the Act, however, and public enforcement efforts have neither checked credit discrimination nor halted perpetuation of prior discrimination.

Professor Matheson believes that courts, government enforcement agencies, and consumers should focus on substantive (rather than procedural) violations of the Act and its implementing regulations. The Act should be amended to allow for a minimum damage recovery for successful plaintiffs. The definition of "adverse action" in the regulations should be amended to acknowledge that credit granted on different terms than those requested by an applicant may indicate illegal discrimination. Detailed statistical information must be kept by credit-granting institutions and made available to private litigants and government enforcement agencies to assist them in identifying and eliminating credit discrimination. Professor Matheson believes that these changes will help create a statutory and regulatory framework that will promote better compliance by creditors with the Act's provisions and enhance enforcement efforts by both private parties and public agencies.

In 1974, Congress passed the Equal Credit Opportunity Act[1] (hereinafter ECOA or the Act) to ensure that "financial institutions and other firms engaged in the extension of credit make that credit equally available to all creditworthy customers without regard to sex or marital status."[2] Two years later, Congress expanded the ECOA to prohibit credit discrimination based on race, color, national origin, age, receipt of public assistance income, or the exercise in good faith of the rights guaranteed under the Consumer Credit Protection Act.[3] The ECOA was

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1 Equal Credit Opportunity Act, Pub. L. No. 93-495, §§ 501–503, 88 Stat. 1521 (1974) (current version at 15 U.S.C. §§ 1691–1691f (1982)).

2 Act of Oct. 28, 1974, Pub. L. No. 93-495, § 502, 88 Stat. 1521 (1974).

3 Equal Credit Opportunity Act Amendments of 1976, Pub. L. No. 94-239, §§ 1–8, 90 Stat. 251 (1976) (current version at 15 U.S.C. §§ 1691–1691f (1982)).

instantly hailed as a watershed in the battle to provide knowledge about and accessibility to credit.[4]

The Equal Credit Opportunity Act serves two purposes.[5] First, like other credit legislation such as the Truth in Lending Act[6] and the Fair Credit Reporting Act,[7] the ECOA is a consumer protection statute designed to provide accurate information to or about consumers involved in credit transactions. Second, the ECOA is an antidiscrimination statute like the Equal Employment Opportunity Act.[8] The ECOA assumes that consumer credit is a positive and necessary aspect of our economy to which all qualified applicants should have equal access;[9] compliance with the procedural directives of ECOA does not always guarantee freedom from liability, unlike compliance with the provisions of the Truth in Lending Act.[10]

This Article demonstrates how the Equal Credit Opportunity Act, through a combination of its explicit provisions and unperceived flaws, has been a functional failure in combating credit discrimination. Part I presents a brief overview of the statute and its implementing regulation. Part II examines the Act's dual enforcement mechanism of public compliance programs and pri-

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[4] *See, e.g.*, Note, *The Equal Credit Opportunity Act Amendments of 1976: A Meaningful Step Toward the Elimination of Credit Discrimination*, 26 CATH. U.L. REV. 149 (1976); Comment, *Equal Credit for All--An Analysis of the 1976 Amendments to the Equal Credit Opportunity Act*, 22 ST. LOUIS U.L.J. 326 (1978).

[5] *See* Equal Credit Opportunity, 63 Fed. Res. Bull. 101 (1977).

[6] 15 U.S.C. §§ 1601–1667 (1982).

[7] 15 U.S.C. §§ 1681–1690 (1982).

[8] Title VII of the Civil Rights Act of 1964, 42 U.S.C. §§ 2000e to 2000e-17 (1976).

[9]

> Credit has ceased to be a luxury item, either for consumers or for business entrepreneurs. Consumer credit outstanding continues to grow at a phenomenal pace and now stands slightly below $200 billion, not even counting 1–4 family mortgage credit which would add more than $400 billion to that total. Virtually all home purchases are made on credit. About two-thirds of consumer automobile purchases are on an installment basis. Large department stores report that 50% or more of their sales are on revolving or closed-end credit plans. Upwards of 15% of all consumer disposable income is devoted to credit obligations other than home mortgages.
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> In this circumstance the Committee believes it must be established as clear national policy that no credit applicant shall be denied the credit he or she needs and wants on the basis of characteristics that have nothing to do with his or her creditworthiness. The Committee readily acknowledges that irrational discrimination is not in the creditor's own best interests because it means he is losing a potentially valuable and creditworthy customer. But, despite this logical truth, the hearing record is replete with examples of refusals to extend or to continue credit arrangements for applicants falling within one or more of the categories addressed by this bill.

S. REP. No. 589, 94th Cong., 2d Sess. 3, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 403, 405.

[10] *See* 15 U.S.C. § 1640 (1982).

vate litigation. The dearth of private lawsuits brought under the Act and reasons for their absence is examined in Part III. Part IV describes how public enforcement efforts under the Act have neither acted as an independent check on discrimination nor provided the impetus to halt perpetuation of prior discrimination. Part V considers several fundamental policy issues affected by the ECOA that to date have escaped judicial consideration. Finally, Part VI suggests several amendments needed to institute effective enforcement of the Act.

I. Overview of the Act and Regulation B

Credit has become a functional substitute for cash in our economy, and consequently credit decisions can greatly influence an individual's economic choices. The Equal Credit Opportunity Act was adopted after a study revealed that creditors, including banks, credit card issuers, credit unions, and small businesses, were unjustly denying credit to members of certain groups, such as racial minorities and women.[11] The ECOA attempts to lessen some of the private sector's control over individual purchasing power by seeking to correct the inaccurate use of stereotypes and to promote wider availability of credit by prohibiting use of those stereotypes in credit decisions.[12]

The statute and its implementing Regulation B cover all phases of a credit transaction.[13] Regulation B identifies and

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[11] NAT'L COMM'N ON CONSUMER FINANCE, CONSUMER CREDIT IN THE UNITED STATES 151–53 (1972).

[12] The general rule and fundamental proscription of the ECOA's implementing regulation is that "[a] creditor shall not discriminate against an applicant on a prohibited basis regarding any aspect of a credit transaction." 12 C.F.R. § 202.4 (1983). The critical terms are defined in the Act or in the regulations, including "discriminate," which is defined as "to treat an applicant less favorably than other applicants." *Id.* § 202.2(n).

[13] 12 C.F.R. § 202.2(m) (1983). The transaction, however, must involve "credit," which is defined as "the right granted by a creditor . . . to defer payment of a debt, incur debt and defer its payment, or purchase property or services and defer payment therefor." 12 C.F.R. § 202.2(j) (1983). "Creditor" is defined in Regulation B as

> A person who, in the ordinary course of business, regularly participates in the decision of whether or not to extend credit. The term includes a creditor's assignee, transferee, or subrogee who so participates. For purposes of §§ 202.4 and 202.5(a), the term also includes a person who, in the ordinary course of business, regularly refers applicants or prospective applicants to creditors, or selects or offers to select creditors to whom requests for credit may be made. A person is not a creditor regarding any violation of the Act or this part committed by another creditor unless the person knew or had reasonable notice of the act, policy, or practice that constituted the violation before its involvement with the credit transaction. The term does not include a person whose only participation in a credit transaction involves honoring a credit card.

12 C.F.R. § 202.2(*l*) (1983).

addresses in detail various phases of the credit-granting procedure, with particular focus on the application process, the evaluation process, and the reporting of reasons for adverse action.[14] Regulation B prohibits a creditor from requesting any information with respect to certain applicant characteristics.[15] By lim-

[14] Several classes of transactions are exempted from many of Regulation B's procedural and technical restrictions on the credit process. Section 202.3 lists these exemptions, which include credit relating to public utilities, securities transactions, incidental consumer credit, extensions of credit primarily for business or commercial purposes, and governmental credit. 12 C.F.R. § 202.3(a)-(f) (1983). Though these areas remain susceptible to the general ban on discrimination in § 202.4, § 202.3 effectively provides that unsuccessful credit applicants can bring suit for technical violations of the Act only in cases involving individual consumer credit.

[15] 12 C.F.R. § 202.5(d) (1983). Problems arise when the regulations allow the same information to be used for one purpose, yet attempt to restrict its use for another purpose. It is relatively easy to preclude use of race in a credit determination when the creditor has no information about an applicant's race. It is much more difficult to control the use of that information once it has been obtained. Regulation B somewhat wishfully provides that a creditor may consider in evaluating an application any information that the creditor obtains as long as that information is not used to discriminate against an applicant on a prohibited basis. For example, a creditor is prohibited from asking an applicant's race for purposes of credit evaluation, *id.* § 202.5(d)(5), but is required to obtain information concerning race in certain transactions for purposes of monitoring the Act's effectiveness. *Id.* §§ 202.5(b)(2), 202.13(a). Although a credit-evaluation inquiry into race is prohibited, *id.* § 202.5(d)(5), that same provision allows inquiry into the applicant's immigration status. Most strikingly, although the Act declares that age discrimination is unlawful, it permits a creditor to consider the age of an *elderly* applicant, if the applicant's age is used by the creditor in the applicant's favor. *Id.* § 202.6(b)(2)(iv).

A creditor may not inquire into an applicant's sex, *id.* § 202.5(d)(3); it may, however, indirectly obtain information regarding an applicant's sex from the applicant's first name or the applicant's use of an optional title such as Ms. or Mrs. Information about birth control practices or intent to bear children may not be elicited, but a creditor may request the number of an applicant's dependents. *Id.* § 202.5(d)(4). A creditor may request an applicant's marital status only if the application is for other than individual unsecured credit. *Id.* § 202.5(d)(1). A creditor may not inquire into whether an applicant's income is derived from alimony, child support or separate maintenance, unless the applicant is informed that such income need not be revealed and the applicant wants it to be considered in determining creditworthiness. *Id.* § 202.5(d)(2). As a practical matter, a woman who receives sporadic alimony or child support payments may be caught between conflicting implications of the Act. If she asks the creditor to consider this income, she may be denied credit because of another's history of irregular payment or poor credit rating rather than because of her own character and capacity to repay. Yet, if she chooses to withhold information regarding these payments from the creditor, she risks being denied credit because of insufficient income.

Sometimes the specific rules in the regulations concerning use of information establish subtle distinctions between permissible and impermissible uses of the same information. For example, a creditor cannot take into account the existence of a telephone listing in the applicant's name, but can consider whether there is a telephone in the applicant's home. *Id.* § 202.6(b)(4). Part-time income and support payments cannot be disregarded, but the creditor may subjectively determine the likelihood that such income will continue. *Id.* § 202.6(b)(5). These distinctions isolate and ban creditor practices that, in the instances cited above, tend to discriminate against women whose phone is listed in their husband's name, who can only work part-time because of family obligations, or who have little control over the regularity with which they receive support payments. Such subtlety, however, may work against Regulation B's objective of clarifying what is acceptable creditor behavior in application evaluation.

iting the collection of this information, Regulation B aims to prevent creditors from basing credit decisions on improper assumptions.

Regulation B is also designed to assist applicants in identifying and enforcing their rights. A creditor has an affirmative duty to inform an unsuccessful applicant of her right to request a statement of the reasons she was denied credit, and to furnish those reasons to the applicant upon her request.[16] The creditor must also provide the applicant with a statement of the ECOA's purpose and the name of the governmental agency that enforces the Act in that particular transaction.[17]

II. The Dual Enforcement Model

The ECOA employs a dual enforcement model in seeking to achieve its goal of ensuring the widest possible access to credit. Compliance with the ECOA is enforced both by government agencies and through private litigation. The Act authorizes the Federal Reserve Board to prescribe regulations to clarify and amplify specific statutory provisions in light of its legislative purpose,[18] although overall administrative enforcement of the Act rests with the Federal Trade Commission, with limited authority delegated to eleven other federal agencies.[19]

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[16] 12 C.F.R. § 202.9 (1983). *See generally* Taylor, *Meeting the Equal Credit Opportunity Act's Specificity Requirement: Judgmental and Statistical Scoring Systems*, 29 Buffalo L. Rev. 73, 81–90 (1980). Regulation B provides a creditor with the option of formulating its own statement of reasons for adverse action on an application. Section 202.9(b)(2) of Regulation B also contains a form prepared by the Federal Reserve Board as a sample statement of reasons for adverse action as a model for creditors to follow. Where a credit scoring system is used, no particular method is required in selecting the reasons provided for rejection, and no particular number of reasons must be disclosed. The Federal Reserve Board has stated, however, that disclosure of more than four reasons is not likely to be helpful to the applicant. 12 C.F.R. § 202.901(d) (1983).

[17] 12 C.F.R. § 202.9(b) (1983).

[18] 15 U.S.C. § 1691b (1982). The Federal Reserve Board has similar authority under the Truth in Lending Act. Truth in Lending Act § 105, 15 U.S.C. § 1604 (1982).

[19] The enforcement agencies and the creditors for which they are responsible are the following: Comptroller of the Currency (national banks); Federal Reserve Board (state-chartered member banks); Federal Deposit Insurance Corporation (non-member insured banks); Federal Home Loan Bank Board (institutions subject to § 5(d) of the Home Owners' Loan Act of 1933, 12 U.S.C. § 1464(d) (1982), § 407 of the National Housing Act, 12 U.S.C. 1730 (1982), and §§ 6(i) and 17 of the Federal Home Loan Bank Act, 12 U.S.C. §§ 1426(i), 1437 (1982)); Securities and Exchange Commission (brokers and dealers); National Credit Union Administration (federal credit unions); Interstate Commerce Commission (common carriers); Civil Aeronautics Board (air carriers); Secretary of Agriculture (activities subject to the Packers and Stockyards Act, 7 U.S.C. §§ 181–229 (1982)); Farm Credit Administration (federal land banks, land bank associations, federal intermediate credit banks and production credit associations); Small Business

Critics claimed that the enforcement provisions of the 1974 Act were inadequate.[20] Enforcement by the Federal Trade Commission was limited to the issuance of cease and desist orders against noncomplying creditors,[21] while damage actions were left to private litigation. Furthermore, punitive damages of up to $10,000 in an individual action and the lesser of $100,000 or one percent of the creditor's net worth in a class action[22] were believed to be insufficient.

In response to these criticisms, the 1976 amendments, while retaining the dual enforcement framework, significantly strengthened the compliance provisions of the Act. A new section was added authorizing the United States Attorney General to institute civil proceedings in two circumstances. First, any of the twelve administrative agencies responsible for enforcement of the Act could refer matters to the Attorney General for litigation. Second, the Attorney General could independently commence civil proceedings when deemed necessary to prohibit or remedy a pattern of pervasive discrimination.[23] Private enforcement was bolstered by raising the ceiling of potential recovery of punitive damages in class actions to the lesser of $500,000 or one percent of the creditor's net worth.[24] Addition-

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Administration (small business investment companies); and Federal Trade Commission (all other creditors). 15 U.S.C. § 1691c(a)(1)-(9) (1982).

[20] *See, e.g.*, *Equal Credit Opportunity Act Amendments and Consumer Leasing Act: Hearings on S. 483, S. 1927 & H.R. 6516 Before the Subcomm. on Consumer Affairs of the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 1st Sess. 14 (1975) (statement of Rep. Sullivan (D-Mo.)). [hereinafter cited as *1975 Hearings*].

[21] Any violation of the Equal Credit Opportunity Act is subject to the same disciplinary action as a violation of the Federal Trade Commission Act. 15 U.S.C. §§ 41, 45, 1691c(c) (1982). In the case of noncompliance with an order of the Commission, violators are subject to a civil penalty. 15 U.S.C. § 45(*l*) (1975).

[22] Act of Oct. 28, 1974, Pub. L. No. 93-495, § 503, 88 Stat. 1524 (1974).

[23] Act of March 23, 1976, Pub. L. No. 94-239, § 6, 90 Stat. 253 (1976) (current version at 15 U.S.C. § 1691e(g), (h) (1982)). This provision relied on the Justice Department's substantial civil rights legislation enforcement experience to achieve maximum compliance under the Act. S. REP. No. 589, 94th Cong., 2d Sess. 13, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 403, 415; *1975 Hearings*, *supra* note 20, at 26.

[24] Act of March 23, 1976, Pub. L. No. 94-239, § 6, 90 Stat. 253 (1976) (current version at 15 U.S.C. § 1691e(b) (1982)). This amendment caused much debate, with some claiming that a low limit would discourage class action suits, that a high ceiling was necessary to secure compliance, and that active private enforcement would reduce public enforcement costs. *See* S. REP. No. 589, 94th Cong, 2d Sess. 13, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 403, 415; *1975 Hearings*, *supra* note 20, at 210 (statement of Jeffrey M. Bucher, Gov'r, Federal Reserve Board); *id.* at 301 (statement of Benny Kass, Att'y at Law, Washington, D.C.). Others (including creditors) argued that the present ceiling was adequate, that vexatious litigation would be encouraged if the ceiling were raised, and that a high ceiling could bankrupt small companies while allowing excessive recoveries against large business. *1975 Hearings*, *supra* note 20, at 303, 307, 334.

ally, a Consumer Advisory Council was established to render advice to the Federal Reserve Board concerning the Act and other related matters.[25]

As amended, the Equal Credit Opportunity Act appeared to be an imposing piece of antidiscrimination legislation. Commentators anticipated a substantial increase in administrative activity and litigation, as toughened public and private enforcement mechanisms combined to promote compliance with the Act.[26] The intervening years, however, have produced only a few public enforcement actions and a trickle of litigation.

III. UNDERSTANDING THE PAUCITY OF PRIVATE LITIGATION

Congress intended that private actions would provide the bulwark of enforcement for violations of the ECOA.[27] The ECOA has spawned surprisingly little litigation, however, for a statute promising to revolutionize the credit industry. Fewer than fifty cases have been reported under the statute in the decade since its enactment,[28] less than the number brought under the Truth in Lending Act in an average *month*,[29] and far less than the number of employment cases filed in an average *week* under Title VII.[30] In spite of this dearth of private actions, the Federal

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[25] Act of March 23, 1976, Pub. L. No. 94-239, § 3(a), 90 Stat. 253 (1976) (current version at 15 U.S.C. § 1691b(b) (1982)). The Council has responsibility to render advice on all aspects of the Consumer Credit Protection Act under the auspices of the Federal Reserve Board. S. REP. No. 589, 94th Cong., 2d Sess. 11–12, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 403, 413.

[26] *See, e.g.*, Schiller, *The Equal Credit Opportunity Act: A Wellspring of Litigation?*, 32 Mo. B.J. 407 (1976); *1975 Hearings*, *supra* note 20, at 575–76 (letter from Dawson, Riddell, Taylor, Davis & Holroyd submitted on behalf of Beneficial Corporation).

[27] S. REP. No. 589, 94th Cong., 2d Sess. 13, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 403, 415.

[28] A LEXIS search for ECOA cases (GEN FED and STATES libraries) identified 77 decisions citing the ECOA. Of these, only 48 involve actual cases based in whole or part on the Act. *See also* 1981 ATT'Y GEN. REP. TO CONGRESS PURSUANT TO THE EQUAL CREDIT OPPORTUNITY ACT AMENDMENTS OF 1976, at 4 ("Although the Equal Credit Opportunity Act [Amendments] ha[ve] now been in effect for more than five years, we know of only 29 private cases being brought under it."); M. GREENFIELD, CONSUMER TRANSACTIONS 214 (1983) ("From 1975 through 1980 consumers filed fewer than thirty cases to enforce their rights under the ECOA.").

[29] *Cf.* F. MILLER & B. CLARK, CASES AND MATERIALS ON CONSUMER PROTECTION 199 (1980) ("There have been to date some 14,000 lawsuits" under TILA, enacted in 1968).

[30] Over 8,000 discrimination suits were filed in federal courts in 1983, a weekly average of over 150. 115 LAB. REL. REP. (BNA) 116 (1984) Over 47,000 charges were filed with the EEOC in 1973, and the Commission in 1972 took informal action in 2,800 cases and closed 970 cases after a formal decision. MARSHALL, KNAPP, LEGGETT & GLOVER, EMPLOYMENT DISCRIMINATION: THE IMPACT OF LEGAL AND ADMINISTRATIVE REM-

Reserve Board discovered over 17,000 violations of the Act during routine bank examinations over one eighteen-month period.[31]

The paucity of private litigation under the ECOA may discourage potential plaintiffs from bringing credit discrimination suits because they believe they only have a slim chance of prevailing. Furthermore, the small number of cases brought may cause legislators or administrators to overestimate the statute's effectiveness as a regulatory device. Although startling, the lack of litigation under the Act is readily explainable as a result of certain provisions of the Act and Regulation B, combined with the nature of the credit market.

A. *The Strictures of the Statute and Regulation B*

It is easy to see why the Act and its implementing regulations have chilled private enforcement. First, there is no minimum statutory recovery under the Equal Credit Opportunity Act.[32] Existence of a statutory minimum is especially important in discrimination cases, because actual damages are often speculative.[33] Congress recognized this in the Truth in Lending Act, under which a creditor is liable for a minimum of $100 in addition to court costs, legal fees and actual damages.[34]

Second, the Act's provisions regarding notice of adverse action[35] do little to encourage private enforcement. In amending the Act, Congress had to decide whether written notification of

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EDIES 3–4 (1978). By 1983, the number of job bias charges filed with the EEOC had increased to 112,000 annually. 115 LAB. REL. REP. (BNA) 115 (1984). In 1977 the EEOC initiated 181 lawsuits, but in 1982 it filed only 82 suits. 114 LAB. REL. REP. (BNA) 185 (1983).

[31] Statements to Congress, 64 Fed. Res. Bull. 742–743 (1978) (statement of Philip C. Jackson, Gov'r, Federal Reserve Board, before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the Comm. on Government Operations, U.S. House of Representatives, September 15, 1978).

[32] *See* 15 U.S.C. § 1691c (1982).

[33] Several courts have held that mental distress, humiliation, and embarrassment are cognizable "actual damages" under the Act even though no out-of-pocket loss resulted. *See* Anderson v. United Finance Co., 666 F.2d 1274, 1277 (9th Cir. 1982); Sayers v. General Motors Acceptance Corp., 522 F.Supp. 835, 841 (W.D. Mo. 1981); Owens v. Magee Finance Service, Inc., 476 F. Supp. 758, 770 (E.D. La. 1979); Shuman v. Standard Oil Co. of California, 453 F.Supp. 1150, 1153 (N.D. Cal. 1978). An award of punitive damages under the Act, while not dependent on a showing of actual injury, has been construed as requiring a minimum finding of reckless disregard of the requirements of the law. *See* Anderson v. United Finance Co., 666 F.2d at 1278 and cases cited therein.

[34] 15 U.S.C. § 1640 (1982). This statutory penalty is imposed with respect to violation of a number of specific TILA requirements. 15 U.S.C. § 1640(a)(3) (1982).

[35] 15 U.S.C. § 1691(d)(2) (1982).

the reasons for adverse action should be automatically furnished to an applicant, furnished only upon an applicant's request, or not furnished at all.[36] The original Senate Bill embodying the 1976 amendments required automatic notification.[37] While some argued that this requirement would discourage credit discrimination, educate consumers, and assist administrative enforcement,[38] creditors complained of its expense and burden.[39] In the end, Congress compromised and required creditors to furnish a written explanation of reasons for adverse action only upon the applicant's request.[40] The amendments also provided, however, that creditors must notify applicants of their right to request disclosure of these reasons. Theoretically, the difficulty of bringing credit discrimination suits without knowing the reasons for denial has been eliminated,[41] but as a practical matter few consumers take the time to request a written explanation of the creditor's denial.[42]

Additionally, the promulgation of Regulation B itself may have deterred private actions. At hearings on the initial adoption of the ECOA in 1974, the Federal Reserve Board argued that the Act would be better enforced without specific rules,[43] allowing the courts to mold the Act's broad proscription against discrimination in light of individual cases. Nonetheless, Congress

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[36] The original Act did not require any form of notice to applicants. The Federal Reserve Board, despite lack of explicit authorization, promulgated regulations requiring notice. 12 C.F.R. § 202.5(m)(1)–(2) (1976).

[37] S. 1927, 94th Cong., 1st Sess. § 701(d), *reprinted in 1975 Hearings, supra* note 20, at 148–149.

[38] S. Rep. No. 589, 94th Cong., 2d Sess. 4, 7–8, *reprinted in* 1976 U.S. Code Cong. & Ad. News 403, 406, 409–410; *see generally* Thain, *Credit Advertising and the Law: Truth in Lending and Related Matters*, 1976 Wash. U.L.Q. 257, 258.

[39] *See, e.g., 1975 Hearings, supra* note 20, at 264–65 (testimony of Forrest D. Jones on behalf of the American Bankers Association). *See also id.* at 285 (response to questions directed to Forrest D. Jones). Sears, Roebuck & Co. prepared data indicating that each letter of rejection could cost over five dollars to prepare, and that the cost of sending such letters to rejected applicants in 1974 would be over $8 million. *Id.* at 402.

[40] 15 U.S.C. § 1691(d)(2)(B) (1982). *See also* 15 U.S.C. § 1691(d)(5) (1982), providing an exemption for small businesses.

[41] *See 1975 Hearings, supra* note 20, at 219 (statement of Sheldon Feldman, Ass't Dir. for Special Statutes, Federal Trade Comm'n); S. Rep. No. 589, 94th Cong., 2d Sess. 8, *reprinted in* 1976 U.S. Cong. Code & Ad. News 403, 410.

[42] *See 1975 Hearings, supra* note 20, at 375–82 (statement of John A. Dillon on behalf of Natonal Bankamericard, Inc.). The content of the letter stating the reasons for the adverse action is a complex matter in itself, particularly when statistical methods of credit determination are employed. *See generally*, Taylor, *Meeting the Equal Credit Opportunity Act's Specificity Requirement: Judgmental and Statistical Scoring Systems*, 29 Buffalo L. Rev. 73 (1980).

[43] *Credit Discrimination: Hearings on H.R. 14856 and H.R. 14908 Before the Subcomm. on Consumer Affairs of the House Comm. on Banking & Currency*, 93d Cong., 2d Sess. 231 (1974) (statement of Jeffrey M. Bucher, Gov'r, Federal Reserve Board).

ordered the Board to promulgate regulations to enforce the Act.[44] In response, the Board spelled out in great detail the kinds of information that could, and could not, be asked of applicants or used to evaluate applicants,[45] and also published model application forms.[46]

Contrary to expectations,[47] the complexity of Regulation B, combined with creditors' generally greater familiarity with the Act's requirements, actually may have discouraged successful private litigation. A creditor's good faith reliance on or conformity with promulgated rules and forms immunizes it from liability; therefore ambiguities in the Act or Regulation B are effectively resolved against an applicant.[48] Furthermore, an applicant must prove *actual* damages for any violations of the Act that are not so protected.[49]

The realities of the credit market enhance the problems posed by the Act and Regulation B for private enforcement. Individuals who are denied credit by large creditors may not assert their rights because of institutional formidability and obvious bargaining inequalities. Conversely, unsuccessful applicants for credit from small, local credit-granting businesses may not assert their rights because they fear reprisal or do not wish to alienate the creditor. Additionally, the availability of credit alternatives further discourages prosecution of possible ECOA violations. Most credit applicants realize that alternative sources of credit exist.[50] Except for the most uncreditworthy, effort is

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[44] Act of Oct. 28, 1974, Pub. L. No. 93-495, § 503, 88 Stat. 1522 (1974) (current version at 15 U.S.C. § 1691b(a) (1982)).

[45] 12 C.F.R. §§ 202.5–202.6 (1983).

[46] 12 C.F.R. Part 202, App. B (1983).

[47] *See, e.g., 1975 Hearings, supra* note 20, at 575–76 (letter From Dawson, Riddell, Taylor, Davis & Holyroyd submitted on behalf of Beneficial Corporation). *See generally* Comment, *An Empirical Analysis of the Equal Credit Opportunity Act*, 13 U. MICH. J.L. REF. 102, 112–17 (1979).

[48] 15 U.S.C. § 1691e(e) (1982). This same immunity results from official staff interpretations. *Id. See also* 12 C.F.R. § 202.1(d) (1983).

[49] *See supra* note 33. *See also* Markham v. Colonial Mortgage Service Co., 605 F.2d 566, 571 (D.C. Cir. 1979) (no interim attorneys' fee award).

[50] *See, e.g.,* Fischl v. General Motors Acceptance Corp., 708 F.2d 143, 145 (5th Cir. 1983); McKenzie v. United States Home Corp., 704 F.2d 778 (5th Cir. 1983). A competitive model of the credit market would conclude that discrimination by one creditor unrelated to creditworthiness would allow its competitors to underprice it and thereby force it out of business. Certainly some portions of the credit market face these pressures. *See, e.g.,* Marshall, *Discrimination in Consumer Credit*, in REGULATION OF CONSUMER FINANCIAL SERVICES, 240, 244 (A. Heggestad ed. 1981). On the other hand, transaction costs of acquiring information may allow leeway for discrimination by firms. *See* Furubatyn & Petrovich, *Property Rights and Economic Theory: A Survey of Recent Literature*, 10 J. OF ECONOMIC LITERATURE 1137–83 (1972).

usually better spent seeking credit alternatives than challenging a questionable credit denial.

Moreover, much discrimination occurs not when credit is completely denied, but when credit is granted on different terms from those sought by the applicant. For example, a person seeking an unsecured loan may be required to provide collateral, or a loan application for ninety-five percent financing might be countered by an offer to finance only eighty percent. Neither of these situations necessarily involves ECOA-prohibited discrimination, but they both raise the question whether they are sufficient "adverse action" to require notification to the consumer of her ECOA rights and a statement of reasons for the denial of credit on the requested terms. In order to be effective, the notice of adverse action should be required within the broadest sphere of situations which may constitute credit discrimination.

The Act defines adverse action as "a denial or revocation of credit, a change in the terms of an existing credit arrangement, or a refusal to grant credit in substantially the amount or on substantially the terms requested,"[51] a definition which is broad enough to include all significant discrimination in credit terms. In Regulation B, however, the Federal Reserve Board limited the Act's definition of adverse action so that no notice of adverse action is required when a counteroffer is accepted by the consumer, even when the terms of the credit are substantially different from those sought by the consumer.[52] Given the fact that the consumer's primary goal is simply to obtain credit on some terms,[53] the Board's definition provides a large loophole for creditors who are able to adjust their terms (often institutions making installment or home mortgage loans).[54] A consumer who accepts credit on terms different from those requested has no right to receive notice of adverse action.[55] Because the notice is designed to increase consumer awareness of possible discrim-

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[51] 15 U.S.C. § 1691(d)(6) (1982).

[52] 12 C.F.R. § 202.2(c)(1) (1983). In contrast, the Fair Credit Reporting Act requires that an adverse action notice be given whenever credit "is denied or the charge for such credit or insurance is increased . . . ." 15 U.S.C. § 1681m(a) (1982).

[53] *See, e.g.*, NAT'L COMM'N ON CONSUMER FINANCE, CONSUMER CREDIT IN THE UNITED STATES 11 (1972) ("[c]onsumers seldom shop for credit outside their own city.")

[54] Variation in charges on a case-by-case basis is much less likely with respect to credit or charge cards, and in those situations consumer shopping can easily occur between companies competing for card business.

[55] *See* Dorsey v. Citizens & Southern Financial Corp., 678 F.2d 137, 139 (11th Cir. 1982).

ination,[56] dispensing with the notice in these circumstances decreases the likelihood that a discrimination claim will be brought.

B. *Proof Problems in Private ECOA Suits*

1. *Approaches to Proving Discrimination.* Congress clearly envisioned that large-scale private litigation alleging substantive discrimination would be brought under the Act. The statute provides for generous class action recoveries and attorneys' fee awards.[57] A class action can result in substantial financial sanctions that would deter a creditor from repeatedly violating the law.[58]

Despite these expectations, most suits have been based on purely technical violations of the Act's information bars or notification provisions. A handful of substantive discrimination claims have been prosecuted, all based on isolated instances of discrimination.[59] No class actions have been successfully prosecuted.[60]

To understand this lack of far-reaching substantive litigation under the Act, it is important to focus on the methods of proof of substantive discrimination that were initially developed in employment discrimination cases. Absent clear proof of discrim-

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[56] *See* S. REP. No. 589, 94th Cong., 2d Sess. 8, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 403, 410; Equal Credit Opportunity, 63 Fed. Res. Bull. 101, 102 (1977). *See generally* Note, *The Not-So-Equal Credit Opportunity Act*, 5 ORANGE COUNTY B.J. 363, 366 (1978).

[57] 15 U.S.C. § 1691e (1982).

[58] Discussion of the class action as a consumer enforcement mechanism is found in Fetterly, *The Application of the Class Action to Consumer Litigation*, 24 FED'N INS. COUNSEL Q. 4 (1973); Landers, *Of Legalized Blackmail and Legalized Theft: Consumer Class Actions and the Substance-Procedure Dilemma*, 47 S. CAL. L. REV. 842 (1974).

[59] *See, e.g.*, Brothers v. First Leasing, 724 F.2d 789 (9th Cir. 1984) (ECOA prohibitions against discrimination on the basis of sex and marital status apply to consumer leases); Miller v. American Express Co., 688 F.2d 1235 (9th Cir. 1982) (cancellation of wife's supplementary account upon spouse's death); Markham v. Colonial Mortgage Service Co., 605 F.2d 566 (D.C. Cir. 1979) (refusal of lender to aggregate incomes of unmarried couple applying for mortgage loan). *See also* United States v. American Future Systems, Inc., 571 F.Supp. 551 (E.D. Pa. 1983) (special purpose credit program which discriminated in favor of white, single women).

[60] A denial of class certification was affirmed in Denard v. Michigan Nat'l Bank, 636 F.2d 1217 (6th Cir. 1980). Dismissal of the named plaintiff's claim meant the death of the class in Nguyen v. Montgomery Ward & Co., 513 F.Supp. 1039 (N.D. Tex. 1981). *See also* Humphrey v. J.B. Land Co., 478 F. Supp. 770 (S.D. Tex. 1979); Gary v. Spires, 473 F.Supp. 878 (D. S.C. 1980).

inatory intent,[61] a consumer has two ways to prove discrimination: disparate treatment or disparate impact.[62]

Disparate treatment occurs when some people are treated less favorably than others because of an identifiable characteristic such as race, sex or national origin. Discriminatory intent is proved by evidence that the creditor's stated reason for refusing credit to the plaintiff was not applied by the creditor to others situated similarly to the plaintiff.[63] In essence, proof of disparate treatment is an attempt to show discriminatory intent by means of circumstantial evidence.

Beginning with *McDonnell Douglas Corp. v. Green*,[64] Title VII employment discrimination cases have set forth the process of proving disparate treatment by allocating the burden of production between the plaintiff employee and the defendant employer. A plaintiff can establish a prima facie case of discrimination in an employment discrimination suit by showing that she: (1) is a member of a protected class; (2) applied and was qualified for the job for which applicants were sought; (3) was rejected despite her qualifications; and (4) after her rejection the position remained open and persons of her qualifications continued to be sought.[65] Similarly, in an ECOA suit, a rejected credit applicant might prove disparate treatment by showing that: (1) she belonged to a protected class; (2) she applied for credit and was financially able and willing to repay; (3) she was nevertheless refused credit; and (4) the creditor continues to seek to extend credit to other applicants with similar willingness and ability to repay.[66]

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[61] Such evidence is understandably rare. One of the closest approximations of an intentionally discriminatory statement appears in Morgan v. First National Bank of Springdale, Civ. No. 77-5055 (W.D. Ark. Jan. 16, 1979). In *Morgan*, a black applicant was told that the "bank had lent out all its available money" and was asked whether he was a customer of the bank but he was not told that the bank's policy was to lend only to customers.

[62] The disparate treatment/disparate impact dichotomy is deceptive for two reasons. First there may be no clear line between the two types of claims in any given case. Second, this two-category grouping hides a greater variety of distinctions among types of discrimination. *See generally* Miller v. American Express Co., 688 F.2d 1235 (9th Cir. 1982); Lamber, Reskin & Dworkin, *The Relevance of Statistics to Prove Discrimination: A Typology*, 34 HASTINGS L.J. 553 (1983).

[63] *See* Sayers v. General Motors Acceptance Corp., 522 F. Supp. 835 (W.D. Mo. 1981); Cragin v. First Federal Savings and Loan Ass'n, 488 F. Supp. 379 (D. Nev. 1980).

[64] 411 U.S. 792 (1973).

[65] McDonnell Douglas Corp. v. Green, 411 U.S. 792, 802 (1973).

[66] *See generally* Sayers v. General Motors Acceptance Corp., 522 F.Supp. 835 (W.D. Mo. 1981); Cragin v. First Federal Savings and Loan Ass'n, 488 F. Supp. 379 (D. Nev. 1980). *See also* Crawford v. Northeastern Oklahoma State Univ., 713 F.2d 586 (10th

Once the plaintiff has proved a prima facie case of discrimination, the creditor must "articulate some legitimate non-discriminatory reason"[67] for the applicant's rejection. As the Court explained the shifting burden of proof in *Furnco Construction Co. v. Waters*,[68] a "prima facie case under *McDonnell Douglas* raises an inference of discrimination only because [the court] presume[s] these acts, if otherwise unexplained, are more likely than not based on the consideration of impermissible factors."[69] The creditor's burden to rebut this inference can be met by articulation of a reason for the action that is not based on a prohibited classification. The burden of production then shifts back to the plaintiff to prove that the creditor's stated reason is merely a pretext for discrimination.[70]

Alternatively, a plaintiff may show that the apparently neutral application of the defendant's credit criteria results in a systematic exclusion of one of the classes protected by the Act, resulting in a disparate impact on that group. Disparate impact differs from disparate treatment in that in the former case the plaintiff need not prove that the creditor *intentionally* discriminated against the applicant.[71]

Cir. 1983) (in discriminatory discharge employment discrimination suit, plaintiff need not show qualifications of person hired in place of plaintiff, but merely that another was employed in plaintiff's stead).

[67] McDonnell Douglas Corp. v. Green, 411 U.S. 792, 802 (1973).

[68] 438 U.S. 567 (1978).

[69] *Id.* at 577.

[70] McDonnell Douglas Corp. v. Green, 411 U.S. 792, 804–05 (1973). In practical terms, the burden on the plaintiff is weighty compared with that of the defendant. Proof of pretext, in addition to developing a prima facie case, often involves complex use of statistics which are neither easy to interpret nor readily available to the plaintiff. In addition, a recent Supreme Court decision, Texas Dept. of Affairs v. Burdine, 450 U.S. 248 (1981), has interpreted the employer/creditor's burden to be "only the burden of explaining clearly the non-discriminatory reasons for its actions," not the burden of actually proving the legitimacy of that reason. After *Burdine*, it appears that in the employment context, and probably in the credit area as well, the burden of production in proving discriminatory intent has been shifted more heavily onto the shoulders of the party charging discrimination.

[71] As stated by the Supreme Court in the seminal employment discrimination case of Griggs v. Duke Power Co., 401 U.S. 424, 431–32 (1971):

> The Act proscribes not only overt discrimination but also practices that are fair in form, but discriminatory in operation. The touchstone is business necessity. If an employment practice which operates to exclude Negroes cannot be shown to be related to job performance, the practice is prohibited.
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> . . . .
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> We do not suggest that either the District Court or the Court of Appeals erred in examining the employer's intent; but good intent or absence of discriminatory intent does not redeem employment procedures or testing mechanisms that operate as "built-in headwinds" for minority groups and are unrelated to measuring job capability.

A three-step disparate impact test, also known as the "effects test,"[72] was first enunciated by the Supreme Court in two employment discrimination cases, *Griggs v. Duke Power Company*[73] and *Albemarle Paper Co. v. Moody*.[74] This test operates as a disparate treatment test in shifting the burden of proof between the parties. In essence, a disparate impact test requires a plaintiff to show that the creditor's facially neutral standard *in fact* selects applicants in a significantly discriminatory pattern. If the creditor's practices are shown to have a disparate impact on a certain group, the creditor must show that the challenged policy is predictive of performance or that business necessity mandates the use of the allegedly discriminatory practice. Under Title VII, the practice must be job-related; under the ECOA the practice must relate to creditworthiness. In order to prevail, the plaintiff must present a less discriminatory alternative that equally serves the legitimate business purposes of the creditor.[75]

2. *Credit Discrimination Proof Problems*. As a practical matter, an unsuccessful credit applicant faces difficult obstacles in proving allegations of discrimination. In order to prove either disparate treatment or disparate impact, the applicant must develop data on other applicants.[76] To prove disparate treatment, the applicant must show that the only difference between herself and others granted credit was her sex, race or other protected classification. The need for statistical data is even greater to prove disparate impact. The applicant must show that the creditor rejected statistically significant disproportionate numbers of persons in protected classes. This assumes that applicants can be separated by statutory classification.

Under the ECOA and Regulation B, the development of such applicant pool data is virtually impossible. The Act does not prohibit a creditor from requesting information regarding protected characteristics, but merely prohibits discrimination based

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[72] *See* S. REP. No. 589, 94th Cong., 2d Sess. 4–5, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 403, 406; 12 C.F.R. § 202.6, n.7 (1983) (explictly approving use of effects test in ECOA cases).

[73] 401 U.S. 424 (1971).

[74] 422 U.S. 405 (1975).

[75] *See* Dothard v. Rawlinson, 433 U.S. 321, 329 (1979); Albemarle Paper Co. v. Moody, 422 U.S. 405, 425 (1975).

[76] Cherry v. Amoco Oil Co., 490 F. Supp. 1026 (N.D. Ga. 1980). For a discussion of the possible use of population statistics in lieu of applicant pool data, *see infra* note 91.

on those characteristics.[77] Regulation B goes beyond the statute, however, by absolutely prohibiting creditors from requesting information relating to certain protected characteristics.[78]

The prohibition in Regulation B on information requests relating to certain characteristics may have been based on the theory that prevention of the recording of information would prevent discrimination. For the great bulk of credit requests, however, these information bars only impede effective private enforcement. If creditors cannot collect the data, applicants cannot learn it from creditors through discovery, and cannot prove that other unsuccessful applicants share the protected characteristic. An applicant therefore cannot establish a prima facie case of discrimination.[79]

The effect of this information void is magnified because discrimination is inherent in the credit-granting process among applicants deemed good business risks, or "creditworthy," and those deemed to present unacceptably high risks. Creditors use two general types of application evaluation systems: judgmental and statistical. Traditionally, creditors have judged creditworthiness subjectively. A credit officer examines an applicant's personal characteristics and other related information (such as home ownership, income, length of employment and credit references) in evaluating an applicant's ability and willingness to pay.[80] The credit officer bases her decision on both her prior

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[77] 15 U.S.C. § 1691 (1982). Some negative inference might be drawn from other sections of the Act. *See, e.g.*, 15 U.S.C. § 1691(b)(1), (2), and (4) (1982). The legislative history of the Act, however, seems to dispel that inference. *See* H.R. REP. No. 210, 94th Cong., 1st Sess. 5 (1975). *See generally* Maltz & Miller, *The Equal Credit Opportunity Act and Regulation B*, 31 OKLA. L. REV. 1, 20 (1978).

[78] 12 C.F.R. § 202.5(d) (1983). One exception to this prohibition relates to the purchase of residential property, where creditors are specifically required to record information on protected classifications. 12 C.F.R. § 202.13(a) (1983). Other sporadic exceptions exist with respect to specific characteristics and requests. *See supra* notes 15–16 and accompanying text. *See generally* Maltz & Miller, *The Equal Credit Opportunity Act and Regulation B*, 31 OKLA. L. REV. 1, 20–25 (1978).

[79] *See, e.g.*, Cherry v. Amoco Oil Co., 490 F.Supp. 1026 (N.D. Ga. 1980). *Cf.* Consumers Union of United States, Inc. v. Heimann, 589 F.2d 531 (D.C. Cir. 1978) (Truth in Lending Act documents not obtainable under FOIA).

[80] Information generally falls into one of three categories: capacity, character, and collateral. "Capacity" refers to an applicant's ability to repay the loan. "Character" concerns whether she will repay, and "collateral" concerns whether the creditor will be protected if she does not repay. The primary purpose of the ECOA is to assure that every stage of the credit decisionmaking process is fair and does not rely upon factors unrelated to any applicant's ability or desire to be a safe credit risk. *See* Churchill, Nevin & Watson, *The Role of Credit Scoring in the Loan Decision*, THE CREDIT WORLD, March 1977, at 6.

experience as a credit risk evaluator and institutional guidelines.[81]

The other method of evaluating creditworthiness, statistical analysis or "credit scoring," uses a numerical formula to predict creditworthiness. The Federal Reserve Board sanctions the use of a credit scoring system if it is "empirically derived" and "demonstrably and statistically sound."[82] Each factor in the applicant's credit profile is given a numerical score based on a preset schedule, and the applicant's total score is determined by adding the individual attribute scores. The creditor's action is objectively determined by the score's position on an established scale. Credit is granted, denied, or the application is held pending acquisition of further information, such as a credit report. No subjective factors need enter into the credit decision.[83]

The information bars of Regulation B do not prevent illegal discrimination by most judgmental creditors. Many judgmental creditors, such as banks and other financial institutions, employ loan officers who meet with prospective loan customers face to face. The applicant's race, sex, and age are clearly visible to the person making the initial credit decision. The very fact that the system is judgmental and allows the credit officer wide discretion means that factors such as an applicant's race, sex, marital status and age may receive consideration in the determination of whether to grant credit. Under these circumstances, the Regulation's prohibitions merely eliminate the possibility of

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[81] The judgmental system of credit analysis suffers from several flaws. First, the system is based on the imperfect recollection of the credit officer, that is both limited and distorted by prior experiences. Second, either because of the strength of the credit officer's recollection or because of informal institutional guidelines, the judgmental system reacts slowly to changes in creditworthiness of the applicant pool. For example, reliance on the maxim of the three "P's" (never lend to preachers, plumbers or prostitutes) or the three "B's" (never lend to beauticians, bartenders or barbers) may have some intuitive appeal but little or no empirical verification. *See* Main, *A New Way to Score with Lenders*, MONEY, Feb. 1977, at 73.

[82] 12 C.F.R. § 202.2(p)(2) (1983). A scoring system is considered to be empirically derived if it evaluates creditworthiness primarily by allocating points to key attributes, with the points derived from empirical comparison of the creditor's past creditworthy and noncreditworthy applicants. 12 C.F.R. § 202.2 (p)(1) (1983). A scoring system is demonstratively and statistically sound if it is "developed for the purpose of predicting the creditworthiness of applicants with respect to legitimate business interests of the creditor utilizing the system, including, but not limited to, minimizing bad debt losses and operating expenses in accordance with the creditor's business judgment." 12 C.F.R. § 202.2(p)(2)(ii) (1983).

[83] Some creditors do combine credit scoring with a judgmental element for a class of applicants neither clearly creditworthy nor uncreditworthy. *See* Hsia, *Credit Scoring and the Equal Credit Opportunity Act*, 30 HASTINGS L.J. 371, 395–96 (1978).

demonstrating the factors in the credit decision for purposes of proving disparate treatment.[84]

The converse situation applies to creditors using credit scoring systems, such as large department store chains (*e.g.*, Sears or Penneys), credit card companies (*e.g.*, Visa and Mastercard), and very large finance companies.[85] Barring questions relating to protected characteristics certainly prevents their consideration in a scoring system, but if no bar existed, creditor reliance on such characteristics in a purely mechanical scoring system would be relatively easy to detect.[86]

A more subtle problem is also presented by the information bars in the credit scoring context. Although discrimination cannot take place by direct consideration of protected-class characteristics, a creditor may substitute significantly correlated proxies for those prohibited pieces of information. For example, zip codes might be substituted for race,[87] or home ownership might be used in place of race or sex.[88] Use of these proxies could be challenged on grounds of disparate impact as having the effect of rejecting members of a protected class in disproportionate numbers.[89]

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[84] As part of the hearings on the 1976 amendments to the ECOA, a regulatory provision was suggested which would have limited the recording of protected-class characteristics to those visible to the creditor. *See* HEARINGS ON THE 1976 AMENDMENTS TO THE EQUAL CREDIT OPPORTUNITY ACT BEFORE THE FEDERAL RESERVE BOARD, 16–17 (August 12, 1976) (on file at the Federal Reserve Board) (statement of J. Stanley Pottenger, Assistant Att'y Gen., Civil Rights Division, Dept. of Justice); Fed. Res. Bd. Press Release (July 15, 1976) at 38–40.

[85] *See* Shay, Brandt & Sexton, *Public Regulation of Financial Services: The Equal Credit Opportunity Act*, in REGULATION OF CONSUMER FINANCIAL SERVICES, 208 (A. Heggestad ed. 1981).

[86] If applications are computer scored, the computer program would show that suspect class factors were considered as part of the program's total score determination. If applications are scored by humans, the "program" is the scale presented to the person figuring the score. Any phantom points given for prohibited characteristics would be detected because the given total score would be greater than the predicted score based on the scale's points for consideration of proper factors.

[87] This was the basis of the claim in Cherry v. Amoco Oil Co., 490 F.Supp. 1026 (N.D. Ga. 1980). The substitution of zip codes for race is so widely accepted that at least one full-scale attempt was made to prohibit place-of-residence discrimination. *See Credit Card Redlining: Hearings on S. 15 Before the Subcomm. on Consumer Affairs of the Comm. on Banking, Housing, and Urban Affairs*, 96th Cong., 1st Sess. 5 (1979) [hereinafter cited as *1979 Hearings*].

[88] *See, e.g.*, Nevin and Churchill, *The Equal Credit Opportunity Act: An Evaluation*, 43 J. MARKETING, Spring 1979, at 95, 100–02. The question is not whether the information has no relation to risk, for nearly any factor a creditor could choose may have some correlation to wealth and therefore to traditional standards of creditworthiness. Rather the question is one of sufficient relation to risk. The regulations purport to act as a mechanical check on the types of information acquired. By prohibiting the acquisition of information that is highly prejudicial or of little predictive value, it is assumed the misuse of that information can also be controlled.

[89] *See, e.g.* Griggs v. Duke Power Co., 401 U.S. 424 (1971) (Title VII employment

To prove an effects test case, an applicant must be able to statistically compare the proportion of members of the relevant protected class who are within the applicant pool with the proportion in the group granted credit. The cost of collecting and presenting this information when statistical data is available is extremely high,[90] but if the creditor is barred from collecting information altogether on protected characteristics, comparative proportions cannot even be determined.[91] Thus, the Regulation B information bars originally designed to protect disadvantaged consumers prevent those same consumers from proving systemic discrimination under the effects test.[92]

Even assuming that a consumer could clear the initial data

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discrimination case); Cherry v. Amoco Oil Co., 490 F.Supp. 1026 (N.D. Ga. 1980) (ECOA). In the employment area, it is often relatively easy to identify a discriminatory employer practice and its effect on employees singly or in a group. In contrast, a creditor's use of complex statistical systems may consider numerous factors, some of which may relate to creditworthiness only in conjunction with other factors. The plaintiff may choose either to attack the system as a whole or to attempt to isolate elements which appear to adversely affect a protected class. The use and interpretation of statistics itself requires an expertise which may be outside the experience of most plaintiffs and counsel. There is always the danger that the plaintiff may through inexperience with the use of statistics produce exhaustive quantitative data that ends up proving the wrong point. Finally, as a matter of cold reality, few rejected credit applicants are likely to have the financial resources to finance both the discovery and use of experts necessary to build a strong statistical case.

[90] *See generally* Hsia, *Credit Scoring and the Equal Credit Opportunity Act*, 30 HASTINGS L.J. 371, 421–422 (1978); *1979 Hearings*, *supra* note 87, at 63 (statement of Robert L. Schwind).

[91] Whether the disproportionate impact may be shown by use of population statistics, or whether resort to actual applicant data will be required, depends to some extent on whether the selective criterion is related to biology or performance. *See* Lamber, Raskin & Dworkin, *The Relevance of Statistics to Prove Discrimination: A Typology*, 34 HASTINGS L.J. 553, 585–88 (1983). This dichotomy, however, seems to beg the question. In any event, courts applying ECOA have not been receptive to use of population statistics. *See* Morgan v. First Nat'l Bank of Springdale, Civ. No. 77-5055 (W.D. Ark. Jan 16, 1979). The plaintiff in Cherry v. Amoco Oil Co., 490 F.Supp. 1026 (N.D. Ga. 1980), attempted to devise substitute statistics that the court found wanting. For a description of the methods used *see 1979 Hearings*, *supra* note 87, at 20–63. *See generally* Griggs v. Duke Power Co., 401 U.S. 424, 430 (1971); Personnel Adm'r of Mass. v. Feeney, 442 U.S. 256, 269–70 (1979).

[92] Much has been written about the application of the effects test to ECOA cases on the mistaken presumption that it would be a significant part of private ECOA enforcement. *See, e.g.*, Baer, *The Equal Credit Opportunity Act and the "Effects Test"*, 95 BANKING L.J. 241 (1978); Note, *Credit Scoring and the ECOA: Applying the Effects Test*, 88 YALE L.J. 1450 (1979). Regulation B itself negates some of the potential impact of the effects test in one other way. The regulations allow a creditor to use factors such as minimum income and past credit history to evaluate creditworthiness. Use of any factor that correlates with wealth or past economic advantage, however, will inevitably disproportionately disfavor minorities and women. One possible way for consumers to use the disparate impact test to their advantage would be to attack the creditor's scoring system as a whole, claiming that it rejects protected class members in a disproportionate manner, and shifting to the creditor the burden of showing that such disproportionate impact is justified. *See* Miller v. American Express Co., 688 F.2d 1235, 1242 n. 3 (9th Cir. 1982) (Poole, J., dissenting).

availability and cost hurdles a credit scoring system poses to establishing a prima facie case, an applicant pursuing a disparate impact claim faces other obstacles. Under the three-part disparate impact test, the creditor would then have to prove that the criterion attacked has a manifest relationship to creditworthiness.[93] The Federal Reserve Board has lifted this burden from creditors' shoulders by proclaiming that, in an "empirically derived" and "statistically sound" credit scoring system, all factors employed by the creditor inherently have a manifest relationship to creditworthiness.[94] The consumer must then show that the legitimate needs of the creditor can be as readily served by substitution of some other factor.[95] By hypothesis, however, the scoring system uses the most predictive pieces of information available.[96] It just may be that the category used is as discriminatory as it is predictive.[97]

It appears that the only situation where the information bars might help an applicant is in a judgmental system where the person evaluating the loan application does not ever see the applicant. Such systems are used by some large financial institutions in major metropolitan areas. There ground level personnel take credit applications, but credit decisions are made upstairs.[98] Usually in such larger institutions loans are made and applications are assessed according to a written policy. In this situation the regulation's information bars would prevent the creditor from taking into account protected characeristics in assessing creditworthiness. As in the credit-scoring situation, however, factors which the institution's formal credit policy identifies as significant may in effect be proxies for protected categories.[99] Once again, however, proof of the disproportionate impact of these proxies is all but impossible because Regulation

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[93] *See supra* notes 73–75 and accompanying text. Griggs v. Duke Power Co., 401 U.S. 424, 432 (1971) (factor used by employer in Title VII case must have "manifest relationship to employment in question").

[94] Equal Credit Opportunity, 63 Fed. Res. Bull. 101, 107 (1977). *See also* Nevin and Churchill, *The Equal Credit Opportunity Act: An Evaluation*, 43 J. MARKETING, Spring, 1979, at 95, 100–02.

[95] *See* Albemarle Paper Co. v. Moody, 422 U.S. 405, 425 (1975).

[96] *See* Hsia, *Credit Scoring and the Equal Credit Opportunity Act*, 30 HASTINGS L.J. 371, 417–30 (1978).

[97] Nevin & Churchill, *The Equal Credit Opportunity Act: An Evaluation*, 43 J. MARKETING, Spring, 1979, at 95, 100–02.

[98] This appears to be the system of credit decisionmaking that provided the basis for the regulations. For an example of this system in operation, *see* Fischl v. General Motors Acceptance Corp., 708 F.2d 143, 145 (5th Cir. 1983).

[99] *See* Statements to Congress, 65 Fed. Res. Bull. 475, 476 (1979); *see also supra* notes 87–97 and accompanying text.

B prohibits the creditor from requesting the information necessary to identify members of the protected class.

IV. Anemic Public Enforcement

Although public enforcement of the Equal Credit Opportunity Act is divided among several government agencies, three are of primary importance.[100] The Federal Reserve Board's authority to prescribe and amend Regulation B, together with its authority to enforce compliance by state-chartered member banks, makes it the primary proponent of public enforcement. The Federal Trade Commission is responsible for credit card issuers and all creditors not specifically responsible to other agencies. Finally, the ability of the Attorney General to bring civil proceedings for ECOA violations, added as part of the 1976 amendments, creates a significant opportunity for effective and visible public enforcement.

A. *Federal Reserve Board*

The task of the Federal Reserve Board (Board) in securing compliance with the Equal Credit Opportunity Act has not been easy. The Board's difficulties in promulgating regulations to carry out the Act[101] derive from the inherently discriminatory nature of the credit-granting process.[102] A creditor must fully consider an applicant's characteristics in order to make a rational and profitable judgment as to creditworthiness. Congress, however, has condemned the denial of credit to certain individuals or groups on the basis of certain characteristics that it considers unrelated to creditworthiness.[103] If Congress could not adequately resolve these competing tensions in enacting the statute, it may be unrealistic to believe that the Board would fare better.[104]

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[100] *See supra* notes 18–19, 23 and accompanying text.

[101] *See generally* 15 U.S.C. § 1691b(a) (1982).

[102] *See generally* Hsia, *Credit Scoring and the Equal Credit Opportunity Act*, 30 Hastings L.J. 371 (1978).

[103] S. Rep. No. 589, 94th Cong., 2nd Sess. 3, *reprinted in* 1976 U.S. Code Cong. & Ad. News 403, 405; H.R. Rep. No. 210, 94th Cong. 2nd Sess. 3 (1976).

[104] *See generally* Hume, *A Suggested Analysis for Regulation of the Equal Credit Opportunity Act*, 52 Wash. L. Rev. 335, 342 (1977). For a sampling of the views of commentators on the efficacy of the Board's regulations, compare Comment, *Equal Credit: Promise as Reality*, 11 Harv. C.R.-C.L. L. Rev. 186, 214 (1976) with Note,

Most of the commentary on the Act criticizes the lines drawn by the Board in promulgating Regulation B.[105] The Board performs a dual administrative role, overseeing the regulation of ECOA (and a dozen other consumer credit protection laws for which Congress has assigned the Board special responsibility),[106] while also supervising and regulating commercial banks.[107] Early on, the Board candidly recognized the conflict inherent in its dual role: "There is always the risk that Federal regulations might—without intending to do so, and without even accomplishing positive benefits—so hobble the credit-granting process as to significantly increase credit losses."[108] These concerns underlay the Board's initial views that no regulations should be adopted[109] and that the 1976 amendments broadening the Act were premature.[110]

The Board has followed its Congressional mandate in adopting regulations and has taken substantial steps to enforce compliance with the Act. The Board has attempted to educate consumers and creditors regarding the requirements of the Act and Regulation B.[111] The Board receives, reviews and investigates or refers to other agencies approximately 700 consumer equal credit opportunity complaints each year.[112] In 1981 the Board adopted an Interagency Policy Statement defining the parameters of regulatory enforcement strategy in an effort to coordinate the ECOA enforcement policies of the Federal Deposit Insur-

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The Not-So-Equal Credit Opportunity Act, 5 ORANGE COUNTY B.J. 363, 364 (1978) and Comment, *Equal Credit for All--An Analysis of the 1976 Amendments to the Equal Credit Opportunity Act*, 22 ST. LOUIS U.L.J. 326, 345 (1978).

[105] *See, e.g.*, Blakely, *Credit Opportunity for Women: The ECOA and Its Effects*, 1981 WIS. L. REV. 655; Maltz & Miller, *The Equal Credit Opportunity Act and Regulation B*, 31 OKLA. L. REV. 1 (1978); Reizenstein, *A Fresh Look at the Equal Credit Opportunity Act*, 14 AKRON L. REV. 215 (1980); Taylor, *Meeting the Equal Credit Opportunity Act's Specificity Requirement: Judgmental and Statistical Scoring Systems*, 29 BUFFALO L. REV. 73 (1980); Comment, *The 1976 Amendments to the Equal Credit Opportunity Act*, 28 BAYLOR L. REV. 633 (1976); Comment, *Equal Credit for all--An Analysis of the 1976 Amendments to the Equal Credit Opportunity Act*, 22 ST. LOUIS U.L.J. 326 (1978).

[106] 1980 FED. RES. BD. ANN. REP. 167.

[107] 1981 FED. RES. BD. ANN. REP. 180–93; Complying with Consumer Credit Regulations: A Challenge, 63 Fed. Res. Bull. 769, 770 (1977).

[108] Statements to Congress, 61 Fed. Res. Bull. 280 (1975).

[109] *See supra* note 43 and accompanying text.

[110] Statements to Congress, 61 Fed. Res. Bull. 474–76, 479–80. For a less generous view of the Board's purposes in taking these and other positions, *see* Comment, *Equal Credit: Promise or Reality*, 11 HARV. C.R.-C.L. L. REV. 186 (1976).

[111] 1980 FED. RES. BD. ANN. REP. 178; *see, e.g.*, Equal Credit Opportunity, 63 Fed. Res. Bull. 101–07 (1977).

[112] 1981 FED. RES. BD. ANN. REP. 157; 1980 FED. RES. BD. ANN. REP. 185.

ance Corporation, the Office of the Comptroller of the Currency, and the National Credit Union Administration.[113]

Since the enactment of the ECOA, the Board has adopted an affirmative program of special compliance examinations of state member banks.[114] These examinations show a steady improvement in bank compliance.[115] The Board also has undertaken studies of the cost of compliance by creditors and the use by consumers of the protective provisions of the Act and regulations.[116]

The Board has focused its enforcement programs on compliance with the procedural requirements of the Act and Regulation B, such as application forms, notifications of reasons for credit denials, data notation requirements, and record keeping.[117] This has been instrumental in eliminating technical violations of the ECOA and Regulation B, educating creditors about the Act's requirements, and providing consumers with the knowledge and data needed to understand the Act and enforce their rights.

Despite this active program, however, there appears to be a lack of broad scale attacks by the Board on possible deep-seated discrimination problems.[118] The Board has chosen to approach enforcement in a low-key manner, opting for the present not to "publicly name institutions that repeatedly fail to correct discriminatory practices."[119] The Board has released strong policy statements on such basic substantive matters as discouraging applicants on a prohibited basis and using credit criteria in a discriminatory manner in evaluating applications.[120] The ques-

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[113] 46 Fed. Reg. 56,500 (1981).

[114] Complying with Consumer Credit Regulations: A Challenge, 63 Fed. Res. Bull. 769–73 (1977); Statements to Congress, 66 Fed. Res. Bull. 20–23 (1980).

[115] In 1982 the Board found that more than two-thirds of the examined banks were in full compliance with Regulation B, up from 51 percent in 1981, 40 percent in 1980 and 23 percent in 1979. Only 20 percent of the noncomplying institutions in 1981 had violated five or more of Regulation B's more than 170 provisions. Other agencies have reported a similar improvement in compliance. 1982 FED. RES. BD. ANN. REP. 155, 1981 FED. RES. BD. ANN. REP. 154–55; 1980 FED. RES. BD. ANN. REP. 177–78.

[116] *See* Exercise of Consumer Rights Under the Equal Credit Opportunity and Fair Credit Billing Acts, 64 Fed. Res. Bull. 363 (1978); Announcements, 67 Fed. Res. Bull. 625 (1981). *See generally* Nevin & Churchill, *The Equal Credit Opportunity Act: An Evaluation*, 43 J. MARKETING, Spring, 1979, at 95; Murphy, *Economies of Scale in the Cost of Compliance With Consumer Credit Protection Laws: The Case of Implementation of the Equal Credit Opportunity Act of 1974*, 10 J. BANK RESEARCH 248 (1980).

[117] 1982 FED. RES. BD. ANN REP. 155–56; Statements to Congress, 64 Fed. Res. Bull. 742, 743 (1978).

[118] The Board in the past three years has taken formal action against only a handful of institutions. 1982 FED. RES. BD. ANN. REP. 156; 1981 FED. RES. BD. ANN. REP. 154; 1980 FED. RES. BD. ANN. REP. 177.

[119] Statements to Congress, 64 Fed. Res. Bull. 742, 743 (1978).

[120] *See* Announcements, 67 Fed. Res. Bull. 855–56 (1981). Interagency Policy State-

tion is whether the Board can and will effectively enforce its asserted policies.

To some extent the Board (like other public enforcement agencies) faces the same problems of proof which beset private litigants. Proof of widespread illegal discrimination requires access to applicant pool data.[121] For monitoring purposes, Regulation B requires a creditor to request an applicant's sex, race (or national origin), marital status, and age only in connection with a written mortgage loan application for the purchase of residential real estate and only if the applicant consents to give such information.[122] The limited scope and quality of this monitoring data prevents the Board from effectively using it to identify patterns of discrimination as part of its compliance procedures.[123]

Despite the lack of available information, the Board has identified and prohibited a narrow group of practices likely to have a disparate impact on protected groups, such as the use of statistics relating to the likelihood of bearing or rearing children,[124] the consideration of the existence of a telephone listing in the name of an applicant,[125] and the discounting or exclusion from consideration of an applicant's income because such income is derived from part-time employment, an annuity, a pension, or other retirement benefits.[126] Beyond these isolated prohibitions lie a host of questionable criteria used by creditors[127] that the Board, as primary public proponent of the Act, should challenge on the basis of disparate impact. Because of the gen-

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ment, 46 Fed. Reg. 56,500 (1981); Supervisory Enforcement Policy for the Equal Credit Opportunity Act and the Fair Housing Act, released by the Federal Financial Institutions Examination Council (1981) (on file with HARV. J. ON LEGIS.).

[121] *See supra* notes 76–99 and accompanying text. Such access however, will not provide ammunition against some practices, such as subtle prescreening through advertisements. *See also* Hsia, *Credit Scoring and the Equal Credit Opportunity Act*, 30 HASTINGS L.J. 371, 438–42 (1978) (prescreening in credit scoring context may be discriminatory).

[122] 12 C.F.R. § 202.13 (1983).

[123] The Board has indicated that at present it does not plan to expand the detail or scope of the Regulation B monitoring information. Statements to Congress, 64 Fed. Res. Bull. 742, 743 (1978); Statements to Congress, 66 Fed. Res. Bull. 20, 26–27 (1980).

[124] 12 C.F.R. § 202.6(b)(3) (1983). *See also* Anderson v. United Finance Corp., 666 F.2d 1274, 1277 (9th Cir. 1982) (spousal signature).

[125] 12 C.F.R. § 202.6(b)(4) (1983).

[126] 12 C.F.R. § 202.6(b)(5) (1983). This provision allows a creditor to consider the probable continuance of such income. *See also* Geary, *Annual Survey of Consumer Financial Services Law Developments, Equal Credit Opportunity*, 38 BUS. LAW. 1287 (1983).

[127] *See supra* notes 87–89 and accompanying text.

eral unavailability of data and the significant costs of obtaining it, the Board has decided that "in the credit arena . . . the effects test will remain largely a matter for the courts to apply."[128]

B. *Federal Trade Commission*

The Equal Credit Opportunity Act delegates overall enforcement authority to the Federal Trade Commission (FTC), except where other agencies are specifically required by the Act to oversee certain groups of creditors.[129] This residual authority includes the major credit card companies, department stores, some credit unions and sales finance companies. The FTC has the opportunity to be a major factor in ECOA enforcement.

That promise remains unfulfilled. Since the Act's enactment, the FTC has proclaimed that its limited resources have prevented it from effectively policing creditor actions.[130] Unlike the Federal Reserve Board, the FTC has no program for the periodic examination of individual creditors, and cannot have such a program without extensive restructuring.[131] Investigation of consumer complaints and sporadic special industry investigations form the bulwark of the limited FTC program.[132]

FTC enforcement activities have been minimal. In 1977 the FTC announced "an industrywide investigation of compliance with the Equal Credit Opportunity Act by mortgage lending and credit card companies."[133] Over the next three years a total of only seven consent orders or judgments were entered.[134] In 1981 and 1982, FTC enforcement of ECOA was virtually nonexistent, resulting in criticism from one of its own members and a promise by its chairman of increased enforcement activity.[135] No significant increase, however, has occurred to date.[136]

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[128] Statements to Congress, 66 Fed. Res. Bull. 20, 24 (1980).

[129] 15 U.S.C. § 1691c(c) (1982).

[130] *1975 Hearings*, *supra* note 20, at 218 (statement of Sheldon Feldman, Asst. Director for Special Statutes, Fed. Trade Comm'n).

[131] Complying with Consumer Credit Regulations: A Challenge, 63 Fed. Res. Bull. 769, 772 (1977).

[132] 1981 FED. RES. BD. ANN. REP. 154–55.

[133] 1977 FTC ANN. REP. 19.

[134] 1978 FED. RES. BD. ANN. REP. 298; 1979 FTC ANN. REP. 7, 37–38; 1980 FTC ANN. REP. 3, 30, 47–49.

[135] *See* Capitol Reports, Inc., *Issues Summary 1982*, WASHINGTON CREDIT LETTER, Dec. 20, 1982, at 6–7 (available from Capitol Reports, Inc., Suite 1107, 1750 Pennsylvania Ave., N.W., Washington, D.C. 20006).

[136] *See* 1982 FED. RES. BD. ANN. REP. 156.

C. *United States Attorney General*

The Attorney General's role in ECOA enforcement is twofold. First, civil actions can be commenced based on referrals made by the other agencies responsible for compliance.[137] Second, the Attorney General can initiate proceedings based on a belief that a creditor is engaged in a pattern or practice of discrimination.[138] Not surprisingly, given the lethargic enforcement activities of other agencies and their emphasis on voluntary compliance, there has been only one referral to date to the Attorney General by another federal agency.[139] Self-initiated actions, therefore, have been the sole focus of Justice Department enforcement.

The Attorney General receives slightly over a hundred consumer complaints annually, each of which is investigated.[140] Each year several actions have been instituted alleging widespread discrimination by creditors, but it was not until the spring of 1982 that one of these actions was tried on the merits.[141]

Any expectation that the Department of Justice might assume a broader role in ECOA enforcement has been quashed by two developments, one self imposed and one judicially imposed. In his 1980 Annual Report, the Attorney General recognized the sharp contrast between the small number of private suits and the findings of numerous ECOA violations during routine examinations by the various federal administrative enforcement agencies.[142] The following year the Attorney General attempted to develop new procedures, relying on statistical studies, to trigger investigations and identify creditor practices that had a broad impact on consumers.[143] The experiment was unsuccessful, however, and the 1982 Report stated that the "Civil Rights Division does not plan to devote significant resources to this

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[137] 15 U.S.C. § 1691e(g) (1982).

[138] 15 U.S.C. § 1691e(h) (1982).

[139] *See* United States v. Montgomery Ward & Co., Civ. Action. No. 79-1412 (D. D.C., consent decree filed May 29, 1979); 1982 ATT'Y GEN. REP. TO CONGRESS PURSUANT TO THE EQUAL CREDIT OPPORTUNITY ACT AMENDMENTS OF 1976, at 1 (January 28, 1983). [hereinafter cited as ATT'Y GEN. REP. 1982] The Annual Reports for prior years also reflect an absence of referrals.

[140] ATT'Y GEN. REP. 1982, *supra* note 139, at 1. (115 Complaints received).

[141] *Id.* at 2. *See also* United States v. American Future Systems, Inc., 571 F.Supp. 551 (E.D. Pa. 1983).

[142] 1980 ATT'Y GEN. REP. TO CONGRESS PURSUANT TO THE EQUAL CREDIT OPPORTUNITY ACT AMENDMENTS OF 1976 at 3.

[143] 1981 ATT'Y GEN. REP. TO CONGRESS PURSUANT TO THE EQUAL CREDIT OPPORTUNITY ACT'S AMENDMENTS OF 1976 at 3.

approach in the future."[144] The hope that public resources could be used to develop creditor applicant pool data and to overcome Regulation B's built-in inhibitions of private disparate impact suits thus died.

Equally important was the Third Circuit's summary affirmance of the district court decision in *United States v. Beneficial Corp.*[145] At issue was the Act's mandate to the Attorney General to pursue civil litigation "for such relief as may be appropriate, including injunctive relief."[146] The Attorney General argued that this phrase should be construed to allow for money damages for private individuals injured by the creditor's actions. Despite the District Court's recognition that it may be "unlikely because of the size of the claims involved and the difficulty in proving same that there will be such actions by individual claimants or class actions representing such plaintiffs,"[147] summary judgment for defendants was granted on this issue. In the absence of specific congressional authorization, the Attorney General could not use government resources to enforce ECOA to recover monetary relief for injured individuals. The summary action of the Third Circuit seems to have put the final hope for effective public enforcement and relief to rest.

V. Facing the Fundamental Issues in the Second Decade

Credit discrimination against individuals on the basis of age, race, sex, religion and other factors did not gain widespread attention until the early 1970's. In 1972 the National Commission on Consumer Finance issued a report that concluded that "widespread instances of unwarranted discrimination in the granting of credit to women" existed.[148] Despite substantial evidence of pervasive discrimination,[149] the Commission did not recommend

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144 Att'y Gen. Rep. 1982, *supra* note 139, at 3.

145 673 F.2d 1302 (3d Cir. 1981), *aff'g* 492 F. Supp. 682 (D. N.J. 1980).

146 15 U.S.C. § 1691e(h) (1982).

147 United States v. Beneficial Corp., 492 F.Supp. 682, 688 (D. N.J. 1980). *See also* United States v. Long, 537 F.2d 1151 (4th Cir. 1975), *cert. denied*, 429 U.S. 871 (1976) (Att'y Gen'l has no authority to seek money damages other than restitution under Fair Housing Act).

148 National Commission on Consumer Finance, Consumer Credit in the United States 160 (1972).

149 For example, the Commission heard testimony that revealed problems in the following areas: (1) Single women have more trouble than single men in obtaining credit; (2) Creditors generally require a woman upon marriage to reapply for credit, usually in

legislation to prohibit credit discrimination because it preferred private competition to public regulation.[150]

Nonetheless, two congressional committees investigated the area; one report identified thirteen specific discriminatory practices used against women alone.[151] These investigations prompted enactment of the Equal Credit Opportunity Act. Suits brought under the ECOA, however, have focused on procedural rather than substantive violations of the Act. This focus has hidden several fundamental questions that the courts have yet to address under the ECOA.

Putting aside the issue of intentional credit discrimination,[152] the nature of the creditor's past experiences determines an ap-

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her husband's name; (3) Creditors are unwilling to extend credit to a married woman in her own name; (4) Creditors are often unwilling to consider the wife's income when a married couple applies for credit; (5) Women who are divorced or widowed have trouble reestablishing credit. Women who are separated have a particularly difficult time, because the accounts may still be in their husband's name. *Id.* at 152–53.

[150] *Id.* at xxiii, 160.

[151]

(1) Single women have more trouble than single men in obtaining credit.
(2) Creditors generally require a woman upon marriage to reapply for credit, usually in her husband's name.
(3) Creditors are unwilling to extend credit to a married woman in her own name.
(4) Creditors are often unwilling to consider the wife's income when a married couple applies for credit.
(5) Women who are separated have a particularly difficult time, since the accounts may still be in the husband's name.
(6) Creditors arbitrarily refuse to consider alimony and child support as a valid source of income when such source is subject to validation.
(7) Creditors apply stricter standards to married applicants where the wife rather than husband is the primary supporter for the family.
(8) Creditors request or use information concerning birth control practices in evaluating a credit application.
(9) Creditors request or use information concerning the creditworthiness of a spouse where an otherwise creditworthy married person applies for credit as an individual.
(10) Creditors refuse to issue separate accounts to married persons where each would be creditworthy if unmarried.
(11) Creditors consider as "dependents" spouses who are employed and not actually dependent on the applicant.
(12) Creditors use credit scoring systems that apply different values depending on sex or marital status.
(13) Creditors alter an individual's credit rating on the basis of the credit rating of the spouse.

Credit Discrimination, 1974: Hearings on H.R. 14856 and H.R. 14908 Before the Subcomm. on Consumer Affairs of the House Comm. on Banking and Currency, 93d Cong., 2d Sess. 17 (1974); *Economic Problems of Women: Hearings Before the Joint Economic Committee*, 93d Cong., 1st Sess. (1973).

[152] *See generally* Shay, Brandt, & Sexton, *Public Regulation of Financial Services: The Equal Credit Opportunity Act* in REGULATION OF CONSUMER FINANCIAL SERVICES 208 (A. Heggestad ed., 1981).

plicant's likelihood of getting credit.[153] The first problem with this system is inertia. Reaction by creditors to changes in the composition and creditworthiness of the pool of credit applicants occurs slowly.[154] A presumption exists against certain classifications that is not easily overcome.[155] While factors such as occupation, home ownership, or length of time on the job may be related to creditworthiness, reliance by creditors on such data may have a disproportionate impact on consumers who perform certain jobs, who have not owned homes, or who have been unable to secure long-term employment. The question remains whether it is discriminatory for creditors to use these secondary characteristics to deny credit to otherwise qualified applicants.

For example, Regulation B prohibits consideration of the existence of a telephone listing in the applicant's name,[156] but does not prohibit consideration of home ownership. Both factors are probative of creditworthiness and both are significantly correlated to sex,[157] but one is much easier for applicants to change than the other. The easily modified characteristic, however, is the one prohibited from consideration. The reverse correlation between the predictive ability of factual information used in credit analysis and the ability or inability of an applicant to alter that information magnifies the effect of historical data on an applicant's ability to obtain credit.

Neither the ECOA nor the courts have provided clear standards for halting perpetuation of past discrimination.[158] Any attempt to totally eradicate the effects of past discriminatory

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[153] *See generally* Hsia, *Credit Scoring and the Equal Credit Opportunity Act*, 30 HASTINGS L.J. 371, 372–77 (1978).

[154] *See, e.g.*, D. KAMERSCHEN & E. KLISE, MONEY AND BANKING 513–620 (6th Ed. 1976).

[155] This problem is minimized with respect to credit scoring systems because Regulation B requires periodic revalidation of credit scoring systems. 12 C.F.R. § 202.2(p)(2)(iv) (1983). *See generally* Long, *Credit Screening System Selection*, 11 J. FINANCIAL & QUANTITATIVE ANALYSIS 363 (1976).

[156] 12 C.F.R. § 202.6(b)(4) (1983).

[157] *See supra* note 15; *see also* Nevin & Churchill, *The Equal Credit Opportunity Act, An Evaluation*, 43 J. MARKETING, Spring, 1979, at 95, 100 (finding significant correlation between home ownership and age and marital status).

[158] *See generally* Brest, *The Supreme Court, 1975 Term--Foreword: In Defense of the Antidiscrimination Principle*, 80 HARV. L. REV. 1, 31–36 (1976); Eisenberg, *Disproportionate Impact and the Illicit Motive: Theories of Constitution and Adjudication*, 52 N.Y.U. L. REV. 36 (1977); Fiss, *Groups and the Equal Protection Clause*, 5 PHIL. & PUB. AFF. 107, 144–45 (1976); Schnapper, *Perpetuation of Past Discrimination*, 96 HARV. L. REV. 829 (1983).

practices would clearly place a substantial financial burden on the credit industry.[159] The lack of any requirement, however, to affirmatively modify traditional credit decisionmaking processes merely perpetuates discrimination. As in other areas, the permissible extent of affirmative action programs and their precise relationship to past discrimination remains unclear.[160]

Furthermore, the data on which current evaluation systems and practices are built may be inherently discriminatory. For example, women and minorities have been underrepresented in the credit process, and creditors' evaluation systems are therefore heavily based on a sample of white, male credit recipients. Minority and female applicants may be penalized for not possessing characteristics traditionally identified with white males.[161]

Such a built-in bias not only penalizes applicants who do not possess such characteristics, but also fails to consider special characteristics of the members of protected classes that may make them superior credit risks. Patterns of geographic distribution, economic life styles, and financial practices among some protected groups may differ from traditional models.[162] These findings could fundamentally affect our view of equality in credit determinations.

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[159] Preventing creditors from considering variables which have a high correlation to actual creditworthiness, but which have a disproportionate impact on groups of applicants, will increase creditor costs and to some extent decrease fund availability. *See, e.g.* Benston, *Risk on Consumer Finance Company Personal Loans*, 32 J. OF FINANCE 593 (1977); Murphy, *Economies of Scale in the Cost of Compliance with the Consumer Protection Laws: The Case of Implementation of the Equal Credit Opportunity Act of 1974*, 10 J. OF BANK RESEARCH 248 (1980); Smith, *The Equal Credit Opportunity Act of 1974: A Cost/Benefit Analysis*, 32 J. OF FINANCE 609 (1977).

[160] *See generally* Mississippi Univ. for Women v. Hogan, 458 U.S. 718 (1982) (state statute that excludes males from enrolling in state-supported nursing schools violates the Equal Protection Clause); United Steelworkers of America v. Weber, 443 U.S. 193 (1979) (Title VII does not prohibit *all* race conscious affirmative action plans); Univ. of California v. Bakke, 438 U.S. 265 (1978) (race can be taken into account in admissions decisions but strict numerical quotas are not allowed). *See also* Grove City College v. Bell, 104 S. Ct. 1211 (1984) (Title IX prohibition on educational discrimination applies only to individual programs receiving federal aid).

[161] *See generally* Hsia, *Credit Scoring and the Equal Credit Opportunity Act*, 30 HASTINGS L.J. 371, 389–91, 393–98 (1978); Smith, *Measuring Risk in Consumer Installment Credit*, 11 MANAGEMENT SCI. 327, 333, 337–38 (1964).

[162] NATIONAL COMMISSION ON CONSUMER FINANCE, CONSUMER CREDIT IN THE UNITED STATES 151–60 (1972); *Hearings on S. 483, S. 1900, S. 1927, S. 1961 and H.R. 5616 Before the Subcomm. on Consumer Affairs of the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 1st Sess. 481–526 (1975) (Comptroller of the Currency, Fair Housing Lending Practices Project); Goulet, *Credit Potential of Women*, 9 J. CONSUMER CREDIT MANAGEMENT 102, 102–06 (1978). *See also* Johnson, *Does Credit Scoring Treat Servicemen Fairly?*, THE CREDIT WORLD, Oct. 1974, at 25 (identifying unique credit characteristics of service personnel).

A study of the accounts of a large metropolitan bank which issues credit cards based on a credit scoring system is illustrative.[163] Twenty applicant characteristics, ranging from occupation and income to length of time at current address, were used in several different credit scoring models.[164] The study showed that the ability of traditional historical information to predict creditworthiness varied markedly between males and females.[165] The study found that ECOA's prohibition on distinguishing data on the basis of sex can in fact hurt women because it creates a presumption that the relationship between risk indicators and credit performance is identical for men and women. For example, with regard to credit references:

> If men typically handle financial matters, only one or two bank references may be an indicator of risk, while for women, the establishment of even one such relationship may be indicative of good credit performance . . . . If women have on average only two while men have four, but credit references carry the same weight in determining creditworthiness, the model will understate the creditworthiness of women in a pooled regression.[166]

Controlling for such variations, the study found that from 18 to 63 percent more females would be accepted at various identified levels of acceptable risk.[167] Put simply, the "arguments in favor of separate credit models [for men and women in order to eliminate discrimination in credit granting based on sex] are compelling."[168]

Because the ECOA requires that all equally qualified applicants be treated equally, it is essential to define what "equally qualified" means. Most credit evaluation systems consider factors based on a historical data pool that is dominated by white

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[163] G. CHANDLER AND D. EWERT, DISCRIMINATION ON THE BASIS OF SEX UNDER THE EQUAL CREDIT OPPORTUNITY ACT, (Working Paper No. 8, Credit Research Center, Purdue Univ. 1976) (on file with HARV. J. ON LEGIS.).

[164] *Id.* at 3, 6.

[165] *Id.* at 9–11.

[166] *Id.* at 8–9. Other results show that "[h]aving a 'retail sales job' is quite common among female labor force participants and carries relatively little weight, but is apparently highly correlated with unsatisfactory performance for males. Banking relationships and home ownership also carry relatively higher weights for women than for men. The presence of these characteristics in the female pool is less frequent than among males, but they are apparently indicative of good credit performance." *Id.* at 10.

[167] *Id.* at 15.

[168] *Id.* at 17. The Chandler-Ewert study focused solely on the disparate predictive effect of traditional variables. Different economic and financial practices may dictate consideration of totally separate structural models for credit prediction among various groups. *See supra* note 162 and accompanying text.

males. Given this bias, "equality" in the credit context may not mean refusing to consider protected characteristics, but may mean affirmatively recognizing that applicants with certain characteristics may form a select sub-group. Even if not used as a basis for finding creditor treatment discriminatory, the identification of such credit sub-groups can lead to a statutorily sanctioned special purpose credit program of affirmative action.[169]

The courts have yet to resolve these difficult issues under the Equal Credit Opportunity Act. The questions are not necessarily insoluble; they simply have not been raised in the credit context. Absent access by private parties and public agencies to a data pool presently unavailable under Regulation B, however, such issues will only be addressed in law reviews.

VI. REFINEMENT OF THE ENFORCEMENT FRAMEWORK

It is clear from the evidence that the substantive effects of the Equal Credit Opportunity Act over the past ten years have differed from original expectations. Consideration of the extent of society's desire to identify and eliminate credit discrimination should spur amendment of the Act, Regulation B, or both, and tougher administrative enforcement.

Initially, Congress should amend the Act to provide for a statutory minimum damage recovery. Experience with the Truth in Lending Act's minimum $100 recovery[170] illustrates the desirability of a parallel provision under ECOA, where actual damages are equally difficult to prove.[171] Moreover, since a minimum statutory recovery would promote technical accuracy by creditors in complying with the Act, enforcement of technical violations could be substantially shifted from administrative agencies to private parties.[172]

Revisions of Regulation B could also improve the effectiveness of the ECOA. The definition of "adverse action" should be changed to reflect the fact that variation in the terms on which

[169] 15 U.S.C. § 1691(c)(3) (1982). Development of special purpose credit programs presumes the ability to analyze the data necessary for special program design. Under the present regulation, however, such data is unavailable. *See supra* notes 76–99 and accompanying text. *See also* United States v. American Future Systems, Inc., 571 F. Supp. 551 (E.D. Pa. 1983) (special purpose credit program which made distinctions based upon race, marital status, and other prohibited bases violated ECOA).

[170] 15 U.S.C. § 1640(a)(2)(A)(i) (1982).

[171] *See, e.g.*, Mars v. Spartanburg Chrysler Plymouth, Inc., 713 F.2d 65 (4th Cir. 1983) (plaintiff entitled to damages under Truth in Lending Act even though no actual injuries were sustained).

[172] *See supra* notes 114–117 and accompanying text.

credit is granted may be an indication of illegal discrimination.[173] This would make applicants and creditors more conscious of the possibility of this form of illegal discrimination.

Regulation B must also be revised to require creditors to collect data relating to applicant characteristics which identify applicants as members of protected classes. The tension here is clear. Prohibition of the collection of data relating to these characteristics furthers the appearance of neutrality and avoids false issues of discrimination.[174] As discussed earlier, however, this prohibited information often is available to creditors either directly or through highly-correlated proxy variables.[175] The availability of data concerning protected applicants is essential to challenge credit discrimination in many of these situations.[176] Collection of this data is needed both for adequate effects test enforcement and for special purpose affirmative action programs to benefit groups who have been historically discriminated against or who may be better credit risks than the white male credit majority.

Implementing these changes alone will not lead to the elimination of credit discrimination. These amendments, however, would create a statutory and regulatory framework that would promote better compliance by creditors and enhance enforcement efforts by both public agencies and private parties. An accompanying shift in focus from procedural compliance to substantive violation would emphasize the ECOA's unique role among consumer protection legislation as an antidiscrimination statute and raise issues of substantive discrimination previously unaddressed by the courts.

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[173] *See supra* notes 35–42 and accompanying text.

[174] An applicant who is requested to supply information relating to protected characteristics may feel discriminated against by the very request for such information. Some lessening of this reaction may be accomplished by prefacing such requests with the statement that "recording of the following information is required pursuant to the Equal Credit Opportunity Act and Regulation B."

[175] *See supra* notes 84–89 and accompanying text.

[176] The Board recognized the practical difficulties in proving discrimination but maintained the information bars despite consumer requests that they be eliminated:

> When the earlier version of Regulation B was being drafted, feminist groups fought hard for a provision banning questions about an applicant's sex or marital status on application forms. They believed that keeping this information from creditors would reduce discrimination against women. Such a ban also was viewed as a way of re-educating those who still though that these factors were crucial to the credit decision. But a year later these same groups were supporting civil rights groups in calling for a provision in Regulation B requiring creditors to ask the sex and race of applicants for credit. This change was based on the realization that these data constituted an important enforcement tool.

Equal Credit Opportunity, 63 Fed. Res. Bull. 101, 103 (Feb. 1977).

ARTICLE

JOINT RESEARCH AND DEVELOPMENT VENTURES AND THE ANTITRUST LAWS

DANIEL M. CRANE*

In recent years it has become clear that the American economy is not immune to foreign competition. The business community argues that relaxation of American antitrust law is necessary if the United States is to effectively meet competitive pressure from Western Europe and Japan. In this article, Mr. Crane focuses on the application of the antitrust laws to joint ventures for research and development as an area ripe for legislative reform. Under the antitrust laws, certain business practices are per se illegal, but most are considered under a more flexible rule-of-reason approach. Joint ventures are examined under the latter standard because they offer potentially beneficial results. In an effort to allay the uncertainty of the business community about how the laws will be enforced, the Justice Department has established criteria for implementing the antitrust laws as they apply to joint ventures. These efforts, however, have met with little success. In contrast, Western Europe and Japan businesses operate under antitrust regimes different from that of the United States. In Western Europe, joint ventures for research and development that meet certain criteria are exempted from antitrust restrictions. In Japan, statutory provisions have been relaxed to permit cartels.

Legislative proposals aimed at changing the antitrust treatment of research joint ventures differ in myriad ways. Mr. Crane discusses these bills in terms of such important variables as access rights, operational provisions, and certification procedures. In conclusion, he argues that reform to encourage joint ventures for research and development is necessary and poses no threat to the general policy of free competition. He further argues that foreign access to the domestic joint ventures should be conditioned on reciprocal opportunities. Finally, the ventures should be of limited size, under supervised self-certification, and absolutely immune from antitrust prosecution if they meet statutory qualifications.

I. STATEMENT OF THE PROBLEM

American firms are no longer merely competing among themselves. They must compete in an international marketplace. Many high tech companies must especially compete against Japanese enterprises that have the support of the Japanese government, Japanese banks, and Japanese labor all acting in concert. The odds are thus stacked against American business. This changing reality ought to prompt a revision of policies that hamper our ability to compete.[1]

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* Of Counsel, Larkin, McCarthy, Noel, Falk & Minshall, Washington, D.C. A.B., Holy Cross College, 1968; M.A., University of Virginia, 1970; Ph.D., University of Virginia, 1974; J.D., Boston College, 1974; M.P.A., Harvard University, 1981.

[1] *Hearings on Joint Research and Development Ventures Before the Senate Judiciary Comm.*, 98th Cong., 1st Sess. (1983) (in press) (testimony of Sen. Tsongas (D-Mass.)).

Consensus in politics is difficult to achieve, but the realization that something must be done to restore the international competitiveness of the American economy is widely shared. There is, however, little consensus about how to deal with this problem. The current debate centers on whether the country should adopt an industrial policy that requires the government to assume an affirmative role in promoting competitive vitality.

Although this debate is not likely to be resolved for some time, bipartisan support has emerged for the reform of U.S. antitrust policy. There is a growing belief that the antitrust laws have had a negative effect on the ability of American firms to compete with their international rivals, especially in technology-intensive sectors. Several pieces of legislation have been introduced in Congress which seek to reduce or eliminate the antitrust risks encountered by American firms wishing to participate in collaborative research and development endeavors.[2] Although these bills have a number of prominent backers, including President Ronald Reagan and Senators Edward Kennedy (D-Mass.), John Glenn (D-Ohio), Gary Hart (D-Colo.), and Robert Dole (R-Kan.), there are skeptics who question not only whether the antitrust laws have placed American firms at a competitive disadvantage but also the advisability of modifying a system which itself is designed specifically to maintain free competition within the economy.

Conservative scholars such as Robert Bork have argued that antitrust laws should be employed exclusively to enhance economic efficiency, thereby maximizing consumer welfare.[3] Thus, the only legitimate subject of antitrust concern should be economically inefficient and undesirable practices, such as arrangements among competitors to restrict output. While this viewpoint has recently gained in popularity, the historical goals of antitrust have been broader: these include such values as dispersion of economic power, freedom and opportunity to compete on the merits, consumer satisfaction, protection of a competitive market economy, and preservation of small business for its own sake.[4]

For its part, the Supreme Court has described the purpose of

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[2] See *infra* note 207.

[3] *See* R. BORK, THE ANTITRUST PARADOX (1978).

[4] *See* FOX, *The Modernization of Antitrust: A New Equilibrium*, 66 CORNELL L. REV. 1140, 1182 (1981).

the Sherman Act,[5] which forbids contracts, combinations, or conspiracies in restraint of trade, as follows:

> The Sherman Act was designed to be a comprehensive charter of economic liberty aimed at preserving free and unfettered competition as the rule of trade. It rests on the premise that the unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress, while at the same time providing an environment conducive to the preservation of our democratic political and social institutions.[6]

The Clayton Act,[7] which forbids mergers or acquisitions tending substantially to lessen competition, also expresses a policy preference for market competition. In that Act, out of a "fear of what was considered to be a rising tide of economic concentration in the American economy," Congress mandated that economic concentration be nipped "in its incipiency" by establishing a policy disfavoring corporate growth through acquisitions.[8] As the Supreme Court stated in *United States v. Philadelphia National Bank*:

> [A] merger which produces a firm controlling an undue percentage share of the relevant market, and results in a significant increase in the concentration of firms in that market, is so inherently likely to lessen competition substantially that it must be enjoined in the absence of evidence clearly showing that the merger is not likely to have such anticompetitive effects.[9]

Underlying this policy is the belief that "corporate growth by internal expansion is socially preferable to growth by acquisition."[10]

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[5] 15 U.S.C. §§ 1–7 (1982).

[6] Northern Pacific Ry. Co. v. United States, 356 U.S. 1, 4 (1958); *see also* United States v. Topco Assocs., 405 U.S. 596, 610 (1972) ("Antitrust Laws in general, and the Sherman Act in particular, are the Magna Carta of free enterprise. They are as important to the preservation of economic freedom and our free-enterprise system as the Bill of Rights is to the protection of our fundamental personal freedoms.") (Marshall, J.); United States v. Aluminum Co. of Am., 148 F.2d 416, 427 (2d Cir. 1945) ("possession of unchallenged economic power deadens initiative, discourages thrift and depresses energy—that immunity from competition is a narcotic, and rivalry is a stimulant, to industrial progress . . .") (L. Hand, J.).

[7] 15 U.S.C. §§ 12–27 (1982).

[8] Brown Shoe Co. v. United States, 370 U.S. 294, 315, 317 (1962).

[9] 374 U.S. 321, 363 (1963).

[10] *Id.* at 370. With respect to the Sherman Act, see also United States v. Citizens & S. Nat'l Bank, 422 U.S. 86, 116 (1975) (A business must expand through internal expansion "rather than by arranging treaties with its competitors.").

These policy goals made the courts reluctant to assess the relative economic efficiencies of an arrangement challenged under the antitrust laws. Congress "did not condone 'good trusts' and condemn 'bad' ones; it forbad all."[11] And, "[i]f a decision is to be made to sacrifice competition in one portion of the economy for greater competition in another portion, this too is a decision that must be made by Congress and not by private forces or by the courts."[12] This reluctance of the courts to engage in a balancing of competing economic interests and objectives is appropriate. It is up to the Congress to articulate clearly the purposes behind the antitrust laws and to make the difficult choices as to what types of economic arrangements will be permitted or discouraged.

The American economy has undergone a remarkable transformation since the passage of the Sherman Act in 1890. The United States is no longer isolated from the rest of the world but is open to intense international competition. The ability to maintain international technological competitiveness is obviously of paramount importance to the well-being of the economy.[13] For several years, American businessmen have argued that the antitrust laws have not contributed to the accomplishment of this goal. One aspect of this general indictment relates to joint ventures formed to conduct research and development: it is claimed that joint ventures represent a useful and necessary device to achieve technological progress[14] and that the antitrust laws unduly restrict the ability of American companies to undertake such arrangements.[15]

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[11] United States v. Aluminum Co. of Am., 148 F.2d 416, 427 (2d Cir. 1945).

[12] United States v. Topco Assocs., 405 U.S. 596, 611 (1972).

[13] *See* E. MANSFIELD, THE ECONOMICS OF TECHNOLOGICAL CHANGE 7 (1968) ("Technological change is a key element in the competitive struggle among firms. The extent and quality of a firm's research and development program can make it an industry leader or head it for bankruptcy.") [hereinafter cited as E. MANSFIELD, ECONOMICS].

[14] From an economic perspective, a technological innovation may be defined as "the first commercial application of a new or improved process or product." E. MANSFIELD, J. RAPOPORT, A. ROMEO, E. VILLANI, S. WAGNER & F. HUSIC, THE PRODUCTION AND APPLICATION OF NEW INDUSTRIAL TECHNOLOGY 12 (1977). Because technological innovation as so defined is not susceptible to easy measurement, it has become commonplace to use research and development efforts as a proxy for determining the rate of technological innovation. *See* Ginsburg, *Antitrust, Uncertainty and Technological Innovation*, 24 ANTITRUST BULL. 635, 647–48 (1979).

[15] The recent decline in research and development activities in the United States, however, cannot be attributed exclusively to the antitrust laws. Indeed, evidence of a decline in the rate of technological innovation itself is sketchy and indirect, derived from such factors as a decline in productivity, the number of patents filed, a negative balance of trade, and a declining market share in technologically advanced products.

The Reagan Administration has endorsed joint research ventures because they "reduce duplication, promote the efficient use of scarce technical personnel, and help to achieve desirable economies of scale."[16] Unlike the United States, Western Europe and Japan have endorsed collaboration as absolutely necessary to attain technological preeminence. For example, Japanese law permits cooperative research and development in areas, such as the computer industry, targeted by the Ministry of International Trade and Industry ("MITI").[17] As one authority has pointed out, "corporate resources that might otherwise be spent competing among Japanese computer companies can be directed toward a long-term goal that may significantly aid Japanese industry as a whole."[18] Japan's recent success in the semiconductor industry also stems in large measure from a combination of government-backed loans and research subsidies and the pooling of technical and scientific talent to promote efficient research and development.[19]

The Japanese are not, however, blind to the virtues of competition. One observer has stated that "[p]aradoxically Japanese firms seem to be simultaneously more cooperative and more competitive than their American counterparts."[20] In effect, the Japanese government promotes cooperation in the early stages of innovation while fostering competition in the process and product development stages. Joint research and development efforts are promoted in Japan in order to foster the development of new technologies, but competition among Japanese producers is vigorous, even though it is controlled to some degree.[21]

In the United States, the increasing complexity and expense of research and development make it difficult for companies to match independently the commitments of the Japanese and

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See Ginsburg, *supra* note 14, at 635, 641, 643; *see also Vanishing Innovation*, BUS. WEEK, July 3, 1978, at 46.

[16] *Japanese Technological Advances and Possible United States Responses Using Research Joint Ventures: Hearings Before the Subcomm. on Investigations and Oversight and the Subcomm. on Science, Research and Technology of the House Comm. on Science and Technology*, 98th Cong., 1st Sess. 191 (1983) (statement of D. Bruce Merrifield, Ass't Sec'y of Commerce) [hereinafter cited as *Science and Technology Hearings*].

[17] *Id.* at 198; *see also infra* text accompanying notes 186–206.

[18] *Science and Technology Hearings*, *supra* note 16, at 134 (statement of Robert Cooper, Director, Defense Advanced Research Projects Agency).

[19] *Id.* at 45 (statement of Erich Bloch, Chairman, Semiconductor Research Cooperative).

[20] *Id.* at 19 (statement of Prof. Harvey Brooks, Harvard Univ.).

[21] *Id.* at 86–87 (statement of Prof. John Zysman, Univ. of Cal. at Berkeley, and Director, Berkeley Roundtable on the International Economy).

other foreign countries in order to achieve technological superiority.[22] Cooperative action is required, however, not just because large enterprises may be more conducive to technological innovation, but because of the serious manpower and capital shortages plaguing the U.S. economy.[23]

The bulk of the cost, risk, and time in the innovation process does not arise from basic research but from development and introduction of commercially useful products.[24] Yet, only one in twenty such projects ever becomes profitable.[25] Risks are often severe enough to deter funding in the earliest stages of some research and development.[26] As a result of the high costs of bringing research up to the level of commercial application, basic research is frequently licensed at low cost to our foreign competitors.[27] At issue, therefore, is how to reduce these risk factors in order to induce the private sector to exploit all available technological opportunities.

One particular risk factor relates to the legal environment. In recent years courts and enforcement officials have been less willing to sacrifice economic efficiency in favor of competition.[28]

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[22] Although cooperation may be necessary to conduct large research projects efficiently, in some circumstances, it may be equally desirable to pursue several parallel approaches to the problem to maximize the likelihood of success. *See* E. MANSFIELD, ECONOMICS, *supra* note 13, at 96–97 (the "optimal number of approaches [is] inversely related to the cost of each approach and directly related to the prospective amount of learning").

[23] *Science and Technology Hearings*, *supra* note 16, at 30 (statement of John Lacey, Exec. Vice Pres., Control Data Corp.); *see* E. MANSFIELD, ECONOMICS, *supra* note 13.

[24] *Science and Technology Hearings*, *supra* note 16, at 202 (statement of D. Bruce Merrifield). *But cf.* "Basic knowledge is an asset that can be applied by many individual companies in unique ways to create new products, enhance existing ones and ultimately determine the international competitiveness of a company's product line." *Research and Development Joint Ventures: Hearing Before the Subcomm. on Science, Research and Technology of the House Comm. on Science and Technology*, 98th Cong., 1st Sess. 58, 66–67 (1983) (statement of Ronald Myrick, Semiconductor Industry Ass'n.) [hereinafter cited as *Research and Development Hearings*].

[25] *Science and Technology Hearings*, *supra* note 16, at 199 (statement of D. Bruce Merrifield).

[26] *Id.* at 202. Because of escalating research costs in high technology industries, "[t]he United States can no longer afford the duplication of effort and waste of resources that result when many companies attempt individually to advance the frontiers of research . . . ." *Research and Development Hearings*, *supra* note 24, at 65 (statement of Ronald Myrick).

[27] Apparently, much of the basic research which underlies the Japanese computer projects was not developed in Japan, but in the United States. *See Science and Technology Hearings*, *supra* note 16, at 133 (statement of Robert Cooper). Indeed, Japan has long emphasized technology transfer to develop new products. As of 1981, Japan had purchased $1.6 billion in technology, compared to sales of $500 million. Also, whereas 80% of U.S. technology is exported to advanced industrialized countries, most Japanese technology is exported to developing countries. *See id.* at 103 (statement of Joji Arai, Director, Japan Productivity Center).

[28] *Id.* at 265 (testimony of Steven Olson, Assoc. Gen. Counsel of Control Data Corp.).

Nevertheless, a common assertion of American business for many years has been that "[u]ncertainty as to what is and what is not legal often forces business decision-makers to turn down profitable ventures in order to avoid costly and time-consuming court determinations."[29]

Unfortunately, it is difficult, if not impossible, to gauge the actual effects of this perceived uncertainty on business planning. As the Justice Department under the Carter administration argued, "[t]he allegation that businesses feel discouraged [to form joint ventures] goes to their state of mind and is obviously impossible to verify or refute. On the other hand, the known facts tend to refute any concrete assertion about the inhibitory effect of the antitrust laws."[30] Moreover, much of the concern over the legality of joint ventures stems from several cases more than three decades old, involving foreign joint ventures between American firms and their leading foreign competitors; the ventures contained numerous collateral restraints intended as part of a broader scheme to divide world markets.[31] As such, the cases lend only marginal support to those who claim that the antitrust laws are impeding legitimate business transactions.

Opponents of change in antitrust law claim that the government's policy is clear: a joint venture will be legal so long as

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[29] *The Present State, Current Theory and Trends of International Antitrust Laws: Hearings Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. of the Judiciary*, 93d Cong., 1st & 2d Sess. 1418 (1973 & 1974) (reprint of National Association of Manufacturers, *The International Implications of U.S. Antitrust Laws*) [hereinafter cited as *International Antitrust Hearings*]. "In dealing with legal questions, business executives can live with almost any arbitrary rule—they won't like it, but they can adjust to it. But they abhor uncertainty." *Science and Technology Hearings, supra* note 16, at 264 (statement of Steven Olson); *see also Research and Development Hearings, supra* note 24, at 66 (statement of Ronald Myrick).

[30] Letter from Thomas E. Kauper, Ass't Att'y Gen., Antitrust Div., Dep't of Justice, to Arch Booth, Chief Exec. Officer, U.S. Chamber of Commerce, *reprinted in International Antitrust Hearings, supra* note 29, at 173. Despite Kauper's claim, at least one report has found "several examples . . . in which proposals for technically meritorious joint research projects were discouraged by legal counsel because of the uncertain possibility of future antitrust attack. In each such case joint research did not occur, and the research was not undertaken at the individual firm level." Ginsburg, *supra* note 14, at 677 n.91, *quoting* Advisory Subcomm. on Regulation of Industry Structure and Competition of Advisory Comm. on Industrial Innovation, U.S. Dept. of Commerce, Draft Report 36 (Dec. 20, 1978).

[31] *See, e.g.*, Timken Roller Bearing Co. v. United States, 341 U.S. 593 (1951); United States v. Imperial Chemical Industries, 100 F. Supp. 504 (S.D.N.Y. 1951); United States v. Minnesota Mining & Mfg. Co., 92 F. Supp. 947 (D. Mass. 1950); United States v. U.S. Alkali Export Ass'n, 86 F. Supp. 59 (S.D.N.Y. 1949) (illegal for a U.S. export association to fix prices with its competitors abroad); United States v. National Lead Co., 63 F. Supp. 513 (S.D.N.Y. 1945) (side agreement that none of the American partners to the joint venture would compete individually in the European market held illegal), *aff'd* 332 U.S. 319 (1947).

"the size and risks of the projects are so great that one company alone cannot undertake the project," and, conversely, will be held illegal when used as "a device for suppressing individual competition which otherwise could or would have occurred or for excluding competitors . . . ."[32] Some observers have concluded that absent specific evidence of business plans abandoned because of the antitrust laws, the laws should not be amended.[33] Further, relaxation of the antitrust laws to enable one or more American firms to compete more effectively in the domestic market against foreign competition has been opposed because "in concentrated industries imports are an important and significant competitive force, and their elimination . . . would not be justified."[34]

This article seeks to put the controversy into perspective. It analyzes the legal background, comparative experience, and proposed solutions. Section II discusses the current state of antitrust law as it applies to joint ventures. Section III discusses the Justice Department implementation of antitrust law in this area. Section IV presents the Western European and Japanese legal regimes for comparison. Section V reviews some legislative proposals.

II. The Antitrust Laws and Joint Ventures: A Review

Two distinct approaches in interpreting the antitrust laws have evolved over the years; one emphasizes certainty, the other flexibility. The difficulty of assessing the alleged efficiencies of an agreement or practice that would violate the antitrust laws has led the courts to apply a rule of per se illegality to certain practices. In *Northern Pacific Railway v. United States*, the Supreme Court summarized the rationale behind the per se approach as follows:

> [T]here are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use. This principle of *per se* unreasonableness not only

[32] Letter from Thomas E. Kauper to Arch Booth, *supra* note 30, at 173.

[33] *See id.*; *Science and Technology Hearings*, *supra* note 16, at 282 (statement of Prof. Joseph F. Brodley, Boston Univ. Law School).

[34] *International Antitrust Hearings*, *supra* note 29, at 185 (memorandum of the Dep't of Justice Concerning Antitrust and Foreign Commerce).

> makes the type of restraints which are proscribed by the Sherman Act more certain to the benefit of everyone concerned but it also avoids the necessity for an incredibly complicated and prolonged investigation into the entire history of the industry involved . . . in an effort to determine at large whether a particular restraint has been unreasonable—an inquiry so often fruitless when undertaken.[35]

Among the types of economic arrangements which have been deemed illegal per se are price fixing, division of markets, and group boycotts. Although these practices are not common in the joint venture context, they are condemned whenever and however they appear. Thus, a joint venture which fixes prices between the partners is illegal per se, as is a division of territories if it is part of an "aggregation of trade restraints."[36]

While the per se doctrine provokes some objections on economic grounds and more opposition by business to the harsh results which have sometimes ensued from its inflexible approach, it is hard to fault its utility from an administrative viewpoint.[37] The per se rule provides business decisionmakers with a degree of certainty as to what is illegal. Moreover, the courts are not well-equipped to engage in the sophisticated economic analysis necessary to assess such arrangements. As the Supreme Court noted in *United States v. Topco Associates,* "[o]ur inability to weigh, in any meaningful sense, destruction of competition in one sector of the economy against promotion of competition in another sector is one important reason we have formulated *per se* rules."[38] With respect to joint ventures, however, the prevalent mode of analysis generally eschews the per se approach in favor of the more flexible, but less certain, rule of reason.

So long as the restraint on trade falls outside of the relatively

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[35] 356 U.S. 1, 5 (1958) (Black, J.).

[36] *Id.; see also* United States v. Topco Assocs., 405 U.S. 608, 609 n.9 (1972) (division of markets among horizontal competitors is a per se violation); United States v. Sealy, Inc., 388 U.S. 350, 354, 357 (1967).

[37] In United States v. Container Corp. of Am., 393 U.S. 333, 341 (1969) (Marshall, J., dissenting), the per se rule was described as follows:

> *Per se* rules always contain a certain degree of arbitrariness. They are justified on the assumption that the gains from imposition of the rule will far outweigh the losses and that significant administrative advantages will result. In other words, the potential competitive harm plus the administrative costs of determining in what particular situations the practice may be harmful must far outweigh the benefits that may result. If the potential benefits in the aggregate are outweighed to this degree, then they are simply not worth identifying in individual cases.

[38] 405 U.S. 608, 609–10 (1972).

few per se categories and is ancillary to a legitimate transaction, the rule of reason is applied to assess its legality. In particular, the courts analyze the legality of a joint venture by examining its structure and conduct and the intent of the participants. While a joint venture arrangement cannot legitimize an otherwise unlawful cartel arrangement, limited ancillary restraints reasonably necessary to the achievement of the legitimate business purposes of the venture are permitted.[39] The court, however, will closely scrutinize the market power of the partners, especially if they are competitors, and will examine potentially less restrictive alternatives and access provisions. As was observed in *National Society of Professional Engineers v. United States*, the test is whether the challenged restraints "were unreasonably restrictive of competitive conditions."[40]

Although the rule of reason is flexible, it is still bound by the policies of the Sherman Act, which assume that competition is the best method of resource allocation.[41] This rule ignores arguments regarding "the expediency or non-expediency of having made the contracts or the wisdom or want of wisdom of the statute which prohibited their being made."[42] Nor do the unique characteristics of a particular industry justify monopolistic arrangements on the grounds that such arrangements are more economically efficient than competition.[43] Decisions of this sort are believed to be made more appropriately by Congress, for the courts are "confined to a consideration of impact on competitive conditions."[44]

While restraints of trade have been analyzed under both the per se and rule of reason approaches, since the decision in *Continental T.V. v. GTE Sylvania*,[45] the fact-intensive rule of reason has been in ascendancy. This analysis is used to scrutinize the effects of joint ventures on competition.

A "joint venture" is a separate business entity which is controlled by two or more nonrelated parent firms that join together for the limited purpose of forming the venture.[46] Unlike a

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[39] *See* National Soc'y of Professional Eng'rs v. United States, 435 U.S. 679, 689 (1978).

[40] *Id.* at 690.

[41] *Id.* at 695.

[42] Standard Oil Co. v. United States, 221 U.S. 1, 65 (1911).

[43] National Soc'y of Professional Eng'rs v. United States, 435 U.S. 679, 689 (1978).

[44] *Id.* at 690; *see also* Rosebrough Monument Co. v. Memorial Park Cemetery Ass'n, 666 F.2d 1130, 1138 (8th Cir. 1981).

[45] 433 U.S. 36 (1977).

[46] Brodley, *Joint Ventures and Antitrust Policy*, 95 HARV. L. REV. 1521, 1526 (1982) [hereinafter cited as Brodley, *Joint Ventures*].

merger, the integration of the firms is only partial and competition between the parties continues outside the venture. The potential efficiencies of this organizational format may offset its potential anticompetitive impact. Joint ventures are particularly appropriate vehicles to undertake projects involving high risks, technological uncertainty, and high information costs.[47] Indeed, in basic research and development a strong incentive exists to engage in joint research activity that widely distributes associated costs.[48] Research joint ventures can reduce the waste of duplicated efforts both by sharing costs and by disseminating research results—an especially efficient outcome if the participants possess complementary capabilities.[49] Because of such advantages, joint research ventures have never been condemned as per se illegal. As the Supreme Court remarked in *United States v. Line Material Co.*:

> The development of patents by separate corporations or by cooperating units of an industry is a well-known phenomenon. However far advanced over the lone inventor's experimentation this method of seeking improvement in the practices of the arts and sciences may be, there can be no objection, on the score of illegality, either to the mere size of such a group or the thoroughness of its research.[50]

Joint research ventures, however, are not always efficient. Unlike a single company project, the joint venture must serve two or more masters which may lead to deadlocks and conflicting management goals and strategies. Once a joint venture attains the necessary economies of scale, adding participants can detract from the likelihood of successful innovation. Often several smaller joint research ventures are preferable, to preserve independent sources of innovation while at the same time achieving economies of scale.[51]

Joint ventures of any sort can also present anticompetitive risks such as collusion, loss of potential competition, and market exclusion.[52] The possibility of collusion is especially great when

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[47] *Id.* at 1529; *see also* Berg & Friedman, *Corporate Courtship and Successful Joint Ventures*, CAL. MGMT. REV., Spring 1980; Hlavacek & Thompson, *The Joint Venture Approach to Technology Utilization*, 23 IEEE TRANSACTIONS ON ENG'G MGMT. 35–39 (1976).

[48] Investments in basic research do not yield a quick return, but applied research which is directed toward the commercial application of existing technology is more likely to yield an immediate profit. *See* E. MANSFIELD, ECONOMICS, *supra* note 13, at 45–48.

[49] Brodley, *Joint Ventures*, *supra* note 46, at 1570–71.

[50] 333 U.S. 287, 310 (1948).

[51] *See* Zimmerman, *Adventures in Jointness*, 37 ANTITRUST L.J. 125, 129–30 (1968).

[52] Brodley, *Joint Ventures*, *supra* note 46, at 1530.

the venturers are competitors and the venture may be used to restrict output. In effect, joint ventures may serve to minimize the transaction costs of oligopolistic market control and foster collusion by giving firms more similar goals and strategies.[53] The joint venture may undermine the incentive for the parents to compete against each other, thereby lessening actual or potential competition.[54] Finally, if the joint venture excludes other firms from membership or denies them access to the results produced by the venture, competitive equality may be seriously damaged and the efficiency of the market impaired.[55]

Disagreement as to the competitive effects of joint ventures has been matched by controversy over the relationship between market structure and the rate of technological innovation. The assumption of the antitrust laws is that competitive markets best promote innovation. This assumption has been vigorously disputed by well-respected authorities, most notably Joseph Schumpeter.[56] Schumpeter argues that in a purely competitive economy, no firm possesses a large enough market share to generate sufficient profits to fund large-scale investments in research and development. Indeed, in a purely competitive market, a firm could not reap sufficient profits from its innovation to compensate it for the risks and expenditures inherent in such undertakings. To promote technological innovation, the possibility of above-normal profits must exist as an incentive.[57]

Schumpeter's thesis, while not universally accepted, has shaped the academic debate on this issue, but has yielded no definitive empirical results.[58] For example, in absolute terms,

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[53] *Id.* at 1531. Although joint ventures may facilitate collusion, one commentator has observed that "there are so many opportunities for . . . collaboration already available to business managers so inclined that it seems unwarranted to give much weight to the additional opportunity supplied by regular meetings among representatives of the parent companies in connection with the joint venture's business affairs." Pitofsky, *Joint Ventures Under the Antitrust Laws: Some Reflections on the Significance of* Penn-Olin, 82 HARV. L. REV. 1007, 1033 (1969).

[54] Brodley, *Joint Ventures*, *supra* note 46, at 1531–32.

[55] *Id.* at 1532–33; *see also* C. KAYSEN & D. TURNER, ANTITRUST POLICY, 136–41 (1959).

[56] J. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY (2d ed. 1947).

[57] *See id.* at 105; *see also* E. MANSFIELD, ECONOMICS, *supra* note 13, at 17.

[58] One of Schumpeter's most famous adherents, John Kenneth Galbraith, writes:

> There is no more pleasant fiction than that technical change is the product of matchless ingenuity of the small forced by competition to employ his wits to better his neighbor. Unhappily, it is a fiction. Technical development has long since become the preserve of the scientist and engineer. Most of the cheap and simple inventions have, to put it bluntly, been made. Not only is development now sophisticated and costly but it must be on a sufficient scale so that successes and failures will in some measure average out . . . . Because devel-

the largest firms perform the bulk of private research and development.[59] Research conducted by large organizations, however, may not be as efficient as that conducted by smaller firms.[60] Even though larger firms devote more resources in absolute terms to research and development, more easily achieve economies of scale, and assume the financial risks involved in such undertakings,[61] the result is not necessarily increased innovation.[62] Some studies indicate that large firms may even suppress innovations which might render existing investments obsolete.[63] Furthermore, smaller firms utilize a larger percentage of their patents than do larger firms.[64]

Although there is no definitive evidence concerning the relationship of firm size to technological innovation, technological change seems to be fostered best in an environment where there is diversity in firm size.[65] If entry barriers are either too high or too low, innovation may be slowed; therefore moderate barriers may be the most conducive to innovation.[66] Professor Scherer summarizes this confusing state of affairs as follows:

> A bit of monopoly power of structural concentration is conducive to invention and innovation, particularly when advances in the relevant knowledge base occur slowly. But very high concentration has a favorable effect only in rare cases, and more often it is apt to retard progress by restrict-

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> opment is costly, it follows that it can be carried on only by a firm that has the resources associated with considerable size.

J. GALBRAITH, AMERICAN CAPITALISM 86–87 (rev. ed. 1956).

59 Ginsburg, *supra* note 14, at 649. In 1979 firms with over 10,000 employees spent 85% of total research and development funds, whereas firms with from 1,000–10,000 employees spent 11% and firms under 1,000 employees 4%. *See* NATIONAL SCIENCE FOUNDATION, RESEARCH AND DEVELOPMENT IN INDUSTRY 16 (1979).

60 Cooper, *R&D is More Efficient in Small Companies*, 42 HARV. BUS. REV. 75 (1964); *see also* Schmookler, *The Size of Firm and the Growth of Knowledge*, in PATENTS, INVENTIONS AND ECONOMIC CHANGE (Z. Gulliches & L. Hurwicz eds. 1942).

61 F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 413–14 (2d ed. 1980) [hereinafter cited as F. SCHERER, INDUSTRIAL MARKET STRUCTURE].

62 Scherer, *Antitrust and Patent Policies*, in INNOVATION, ECONOMIC CHANGE AND TECHNOLOGY POLICIES (K. Strockman ed. 1977).

63 *See* J. BLAIR, ECONOMIC CONCENTRATION: STRUCTURE, BEHAVIOR AND PUBLIC POLICY 229–32 (1972).

64 Schmookler, *supra* note 60, at 39.

65 F. SCHERER, INDUSTRIAL MARKET STRUCTURE, *supra* note 61, at 418; *see also* E. MANSFIELD, ECONOMICS, *supra* note 13, at 217. In addition to firm size and industry market structure, the attitudes of management, labor, and the public, the management of research activities, and the scientific and technological efforts of government and universitites also influence an industry's rate of technological change. *Id.* at 219.

66 Ginsburg, *supra* note 14, at 660. *See also* F. SCHERER, INDUSTRIAL MARKET STRUCTURE, *supra* note 61, at 438 ("New entrants contribute a disproportionately high share of all really revolutionary new industrial products and processes.").

> ing the number of independent sources of initiative and by dampening firms' incentive to gain market position through accelerated research and development. Likewise, it seems important that barriers to new entry be kept at modest levels, and that established industry members be exposed continually to the threat of entry by technically audacious newcomers. . . . What is needed for rapid technological progress is a subtle blend of competition and monopoly, with more emphasis in general on the former than the latter, and with the role of monopolistic elements diminishing when rich technological opportunities exist.[67]

Because there is so much uncertainty about the relationship between firm size and technological innovation—and what evidence that does exist is highly technical and industry-specific—this issue has been largely ignored in the legislative debate. Rather, the debate has focused on whether the antitrust laws as presently construed are hostile to research joint ventures, and whether they are so ambiguous that they inhibit planning of cooperative endeavors.

Because joint ventures have both competitive and anticompetitive aspects, criteria are required to measure the antitrust risk posed by these arrangements.[68] Under the current state of the law, there are three criteria: the competitive relationship between the parties to the venture, access provisions to the venture or to its product, and those ancillary restraints imposed by the parties as allegedly necessary prerequisites to the formation of the venture itself.

Often a joint venture is created to enter into a new line of business or to embark on certain activities which, for various reasons, the venturers are reluctant to undertake independently. Therefore, the potential competition doctrine, which is identified most closely with merger analysis, has become a critical tool in analyzing the competitive impact of joint ventures.

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[67] F. SCHERER, INDUSTRIAL MARKET STRUCTURE, *supra* note 61, at 438.

[68] Ginsburg, *supra* note 14, at 672. Factors relevant in applying the rule of reason include:

> [1] whether the R&D proposed to be done jointly would in any event be done by one or both of the firms independently if the joint venture is not undertaken; [2] the number and market power of those firms that would not be participating in the joint venture but would instead by pursuing independent research with the same or similar goals; [3] the degree or vigor of competition within the affected industries; and [4] the structure of the proposed joint venture, i.e., whether it has been designed to minimize the risk of anticompetitive interchanges between the parents . . . .

Id.

In *United States v. Penn-Olin Chemical Co.*,[69] the Supreme Court established a fact-intensive approach for evaluating the legality of joint ventures. Initially, the Court determined that joint ventures were subject to section 7 of the Clayton Act,[70] although they were not viewed strictly as mergers that would actually eliminate one corporation entirely from the marketplace.[71] Section 7 is designed to arrest the anticompetitive effects of a proposed acquisition in its "incipiency," which requires a prediction as to the present and future impact upon competition.[72] Indeed, "there is certainly no requirement that the anticompetitive power manifest itself in anticompetitive action before section 7 can be called into play."[73] Once a court concludes that a merger or joint venture may tend to lessen competition substantially, its section 7 inquiry is essentially at an end, because "[p]ossible economies cannot be used as a defense to illegality. Congress was aware that some mergers which lessen competition may also result in economies, but it struck the balance in favor of protecting competition."[74]

American firms under competitive attack from abroad cannot use foreign competition as an argument against applying the Clayton Act. As the Supreme Court in *Brown Shoe Co. v. United States* remarked, Congress, in enacting section 7, was concerned "with the protection *of competition*, not *competitors* . . . ."[75] Similarly, in *United States v. Philadelphia National Bank*, the Court decisively rejected the argument that the merger of two Philadelphia banks was justified to enable the defendants to compete more effectively with larger New York banks.[76] Legitimate business purpose and resulting economic benefits are no defense to a violation of section 7 of the Clayton Act.[77] The relevant test is whether a merger will lessen competition, even if it is not entirely eliminated.[78]

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[69] 378 U.S. 158 (1964).
[70] 15 U.S.C. § 18 (1982).
[71] United States v. Penn-Olin Chemical Co., 378 U.S. 158, 170 (1964).
[72] *See* FTC v. Procter & Gamble Co., 386 U.S. 568, 575–77 (1967).
[73] *Id.* at 577.
[74] *Id.* at 580.
[75] 370 U.S. 294, 320 (1962).
[76] 374 U.S. 321, 370 (1963).
[77] United States v. Columbia Steel Co., 334 U.S. 495, 527 (1948); *see also* United States v. M.P.M., Inc., 397 F. Supp. 78, 92 (D. Colo. 1975) ("A valid business purpose obviously cannot, without more, defeat the application of the Clayton Act, but it is also a proper contextual element to consider.").
[78] United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 362, 367 (1963).

As the Court observed in *Penn-Olin*, the joint venture must be examined for actual or potential limits on competition between the parents:

> The joint venture, like the "merger" and the "conglomeration," often creates anticompetitive dangers. It is the chosen competitive instrument of two or more corporations previously acting independently and usually competitively with one another. The result is "a triumvirate of associated corporations." If the parent companies are in competition, or might compete absent the joint venture, it may be assumed that neither will compete with the progeny in its line of commerce.[79]

The Court employed the potential competition doctrine because the proposed venturers in the *Penn-Olin* case were not actual competitors.[80] Under this doctrine, the court determines whether it is reasonably probable that, absent the venture, one of the parents would have entered the market independently, while the other remained as a potential competitor.[81] As the Court remarked, "[t]he existence of an aggressive, well equipped and well financed corporation engaged in the same or related lines of commerce waiting anxiously to enter an oligopolistic market would be a substantial incentive to competition which cannot be underestimated."[82]

By applying the potential competition doctrine to the joint venture context, the Supreme Court endorsed a wide-open and fact-specific mode of analysis. In determining whether a joint venture will run afoul of the potential competition doctrine the following factors are relevant: (1) the number and power of the competitors in the relevant market; (2) the background of their growth; (3) the market power of the joint venturers; (4) the relationship of their lines of commerce; (5) the competition between them and the power of each in dealing with the competitors of the others; (6) the setting in which the joint venture is created; (7) the reasons and necessities for the joint venture's existence; (8) the joint venture's line of commerce and its rela-

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[79] United States v. Penn-Olin Chemical Co., 378 U.S. 158, 169 (1964). In the joint research context, because the venture can conduct research on a scale beyond that of most of its participants, the parties may rationally conclude that independent research is not feasible. Such a decision not to compete must either be arrived at independently or be reasonably necessary to the success of the venture itself. *See* United States v. Minnesota Mining & Mfg. Co., 92 F. Supp. 947 (D. Miss. 1950).

[80] United States v. Penn-Olin Chemical Co., 378 U.S. 173–74.

[81] *Id.* at 175–76.

[82] *Id.* at 174.

tionship to its parents; (9) the adaptability of its line of commerce to noncompetitive practices; (10) the potential power of the joint venture in the relevant market; and (11) an appraisal of what competition would be in the relevant market if the parents entered it independently instead of through the joint venture.[83] Unfortunately, the potential competition doctrine is manifestly a cumbersome procedure and does not lend itself to predictable outcomes.[84]

The second criterion relevant to joint venture analysis centers on exclusion from or access to the joint venture or its results. Unlike the potential competition doctrine, which requires detailed, time-consuming inquiries involving numerous subjective factors, this second criterion is relatively manageable. Simply put, a joint venture cannot exclude competitors from participation in the venture itself, nor deny access to the output of the venture if such participation or access is critical to the survival of those competitors.

In effect, an exclusive joint venture may be tantamount to a "group boycott" which has long been held to be per se illegal under the antitrust laws.[85] For example, in *Associated Press v. United States*, the Supreme Court struck down bylaws which inhibited access to membership in the Associated Press and to the news produced by it, because these exclusionary policies seriously limited the ability of nonmembers to compete successfully.[86] Similarly, in *United States v. St. Louis Terminal*, the Court found that although two terminal companies could, in the interests of efficiency, combine to form a single facility, they could not deny access to their terminal to other companies who otherwise would be unable to stay in operation.[87] Under such circumstances, these other companies were entitled to either joint ownership or access to the facility upon reasonable terms.[88]

Because joint research and development ventures may benefit

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[83] *Id.* at 178–80.

[84] *See Science and Technology Hearings*, *supra* note 16, at 262 (statement of Steven J. Olson) ("[T]he issue ultimately turns on whether the venture 'may' lessen competition or even potential competition—hypothetical notions that seem difficult to weigh against economic realities that require fast-paced innovation and sharp reduction in product costs if competition from Europe and Japan is to be effectively met.").

[85] *See* Fashion Originators' Guild of Am. v. FTC., 312 U.S. 457 (1941).

[86] 326 U.S. 1, 12–13 (1945).

[87] 224 U.S. 383, 409 (1912); *see also* United States v. American Tel. & Tel. Co., 524 F. Supp. 1336, 1352–53 (D.D.C. 1981) (a company which controls an essential facility or "strategic bottleneck" must make access to that facility available to competitors "on fair and reasonable terms" that do not place them at a competitive disadvantage).

[88] United States v. St. Louis Terminal, 224 U.S. 383, 411 (1912).

society, they are not necessarily antitrust violations. Nevertheless, the ventures are scrutinized carefully. In general "the factfinder [must] weigh all of the circumstances of a case in deciding whether a restrictive practice should be prohibited as imposing an unreasonable restraint on competition."[89] For example, such a venture may not prohibit its participants from disclosing the innovations produced by the venture to third parties unless such a restraint is "reasonably necessary" to ensure the success of the venture itself.[90] Although membership restrictions may be reasonably necessary to accomplish the purpose of the joint venture, "[t]he presence of purposefully exclusionary or coercive conduct is a strong indication that the boycott is a naked restraint of trade; indeed, if no other purposes are present, this purpose will warrant outright condemnation of the practice."[91] Moreover, if the joint venture has sufficient market power "to shape and influence the economic environment of the particular field involved," and membership in the venture is essential to compete, membership restrictions will be permitted only to the extent that they can be justified by the legitimate competitive needs of the venture.[92] Even then the pro-competitive effects must outweigh the anticompetitive ones.[93] Membership fees, for example, must bear some reasonable relationship to the costs involved in setting up and running the venture.[94] Other criteria relating to the professional competence of the membership must be narrowly tailored to meet the legitimate business goals of the project.[95] The availability of alternative opportunities to the excluded firm will not justify exclusion, absent some legitimate business justification.[96]

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[89] Continental T.V. v. GTE Sylvania, 433 U.S. 36, 49 (1977). See also Berkey Photo, Inc. v. Eastman Kodak Co., 603 F.2d 263, 302 (2d Cir. 1979) (Kaufman, J.):

> The relevant variables might include: the size of the joint venturers; their share of their respective markets; the contributions of each party to the venture and the benefits derived; the likelihood that, in the absence of the joint effort, one or both parties would undertake a similar project, either alone or with a smaller firm in the other market; the nature of the ancillary restraints imposed and the reasonableness of their relationship to the purposes of the venture.

[90] Berkey Photo, Inc. v. Eastman Kodak Co., 603 F.2d 263, 303–04 (2d Cir. 1979); *see also* United States v. Arnold Schwinn & Co., 388 U.S. 365, 380–81 (1967).

[91] United States v. Realty Multi-List, 629 F.2d 1351, 1367–68 (5th Cir. 1980).

[92] *Id.* at 1370.

[93] *Id.* at 1374–75; *see also* Worthen Bank & Trust Co. v. National BankAmericard, 485 F.2d 119 (8th Cir. 1973).

[94] United States v. Realty Multi-List, 629 F.2d 1386 (5th Cir. 1980).

[95] *Id.* at 1369, 1375, 1386–87.

[96] Gamco, Inc. v. Providence Fruit & Produce Bldg., 194 F.2d 484, 488–89 (1st Cir. 1952).

Exclusionary membership policies are not amenable to easy condemnation or approval. If the principal purpose of such policies is to exclude competitors from the market, they will certainly be found per se illegal. As the Court stated in *United States v. General Motors Corp.*, "[e]xclusion of traders from the market by means of combination or conspiracy is so inconsistent with the free-market principles embodied in the Sherman Act that it is not to be saved by reference to the need for preserving the collaborators' profit margins . . . ."[97] When the exclusionary policy is not central to the purpose of the agreement, it may be permitted if it is shown to be reasonable and necessary to the accomplishment of a legitimate business purpose.

The third criterion for evaluating the antitrust implications of a joint venture is the nature of the ancillary restraints imposed by the participants to the joint venture to govern its operation. In *United States v. Addyston Pipe and Steel Co.*, Chief Judge Taft distinguished a permissible ancillary restraint from those restraints prohibited by the Sherman Act:

> When two men became partners in a business, although their union might restrain competition, this effect was only an incident to the main purpose of a union of their capital, enterprise, and energy to carry on a successful business, and one useful to the community. Restrictions in the articles of partnership upon the business activity of the members, with a view of securing their entire effort in the common enterprise, were, of course, only ancillary to the main end of the union, and were to be encouraged.[98]

Taft stressed that the agreement must have a legitimate main purpose to justify the ancillary restraint.[99] Unlike ancillary restraints that are permissible, so-called "naked" restraints, such as contracts to fix prices, could not stand, "however reasonable the prices they fixed, however great the competition they had to encumber, and however great the necessity for curbing themselves by joint agreements from committing financial suicide by ill-advised competition . . . ."[100]

Even if an ancillary restraint is legitimate when imposed, subsequent events may make it unreasonable. In *United States*

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[97] 384 U.S. 127, 146 (1966); *see also* Eastern States Retail Lumber Dealers Ass'n v. United States, 234 U.S. 600 (1914).

[98] 85 F. 271, 280 (6th Cir. 1898), *modified on other grounds*, 175 U.S. 211 (1899).

[99] *Id.* at 282.

[100] *Id.* at 291.

v. Pan American World Airways,[101] an airline company serving the east coast of Latin America and a steamship line serving the west coast of South America, jointly formed a new airline to service the latter area. Initially, the two partners were not competitors and, for this reason, the joint venture was permissible, as was their agreement that the venture not compete with the airline.[102] Although such territorial restrictions were necessary to open a new market and therefore were legal, the court refused to sanction an indefinite agreement not to compete. Once the joint venture had established itself and was fully capable of competing with the airline, the ancillary restraint was no longer needed and was struck down.[103]

Typically, "naked" restraints are similar in nature to those which are condemned as per se illegal under the antitrust laws. For example, in *Timken Roller Bearing Co. v. United States*, restraints accompanying a joint venture which called for the allocation of territories or price fixing were not saved by a claim that they were "ancillary" to a lawful main agreement.[104] The aggregation of restraints suggested that their dominant purpose was to avoid competition entirely rather than to promote a legitimate business purpose.[105] As the district court stated in *Timken*:

> If a joint venture or partnership is formed for the purpose of a lawful business enterprise and restraints result from the right to protect established business interests no violation of law occurs. But if the association is formed for the purpose of continuing a combination to allocate exclusive sales territories in the world, to fix prices and to eliminate competition both within and without the combination, it cannot hide from the effects of the law under the cloak of a joint venture or partnership.[106]

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[101] 193 F. Supp. 18 (S.D.N.Y. 1961), *rev'd on other grounds*, 371 U.S. 296 (1963).

[102] *Id.* at 32–33; *see also* United States v. E.I. DuPont, 118 F. Supp. 41, 218–22 (D. Del. 1953), *aff'd*, 351 U.S. 377 (1956) (territorial restraints confining the geographic markets of the joint venture to preclude competition between the parent foreign producer and the joint venture in the new U.S. market permitted).

[103] United States v. Pan Am. World Airways, 193 F. Supp. 18, 34, 37–38 & n.17 (S.D.N.Y. 1961).

[104] 341 U.S. 593, 597–98 (1951). One authority claims to have found no reported decisions of joint venture illegality absent a per se violation. *See* Brodley, *The Legal Status of Joint Ventures Under the Antitrust Laws: A Summary Assessment*, 21 ANTITRUST BULL. 453, 464 (1976) [hereinafter cited as Brodley, *Legal Status*].

[105] 341 U.S. 593, 597–98.

[106] 83 F. Supp. 284, 312 (N.D. Ohio 1949), *aff'd*, 341 U.S. 593 (1951); *see also* United States v. Topco Assocs., 405 U.S. 596 (1972).

Similarly, in *Yamaha Motor Co. v. FTC*,[107] the court struck down a joint venture between Yamaha and Brunswick Motors which restricted Yamaha from engaging in any competition in the United States involving joint venture or nonjoint venture products. The court found that this restriction only served to isolate Brunswick from competition by Yamaha and was not "reasonably necessary" to the purpose of the joint venture.[108] At most, such agreements to limit competition must be limited to the subject of the joint venture and no further.[109] Thus, while joint ventures are usually judged by the rule of reason, if they engage in behavior "inherently pernicious" to competition, such as price fixing and territorial allocations, they may be judged under the per se rule.[110]

Mere financial difficulties cannot always justify anticompetitive joint ventures.[111] In *Citizen Publishing Co. v. United States*,[112] two newspapers, one of which was in financial distress, agreed to combine their advertising and circulation departments and to share their fixed assets such as a printing plant so as to realize certain economies. Although the papers maintained separate editorial and news reporting staffs, they also agreed to price fixing and profit sharing arrangements, which effectively terminated their commercial rivalry.[113] Even though these arrangements were necessary to the economic success of the joint venture, the Court deemed them illegal per se.[114]

Similarly, in *United States v. Topco Associates*,[115] several small supermarket chains formed a joint purchasing association to enable them to compete more effectively against larger firms. By pooling their purchases, the member firms were able to achieve a sufficiently high volume to support a private label program. Each member was given an exclusive territory in which it could market these private label goods.[116] Even though this restraint was "ancillary" to the principal purpose of the

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[107] 657 F.2d 971 (8th Cir. 1982).
[108] *Id.* at 981.
[109] *Id.*
[110] Engine Specialties, Inc. v. Bombardier, Ltd., 605 F.2d 1, 11 (1st Cir. 1979).
[111] One exception to this general rule is the failing company defense, which is of limited applicability. *See, e.g.*, United States v. Greater Buffalo Press, 402 U.S. 549 (1971); International Shoe Co. v. FTC, 280 U.S. 291 (1930).
[112] 394 U.S. 131 (1969).
[113] *Id.* at 134–35.
[114] *Id.*
[115] 405 U.S. 596 (1972).
[116] *Id.* at 601–02.

agreement of enabling the smaller firms to compete more effectively with larger chains, the Supreme Court found it per se unlawful.[117] However, the Court did allow the joint purchasing operation to stand, perhaps suggesting a tolerant attitude towards joint ventures designed to foster more effective competition with market leaders.[118]

In 1977, the Supreme Court in *Continental T.V. v. GTE Sylvania*[119] overruled its holding in *United States v. Arnold Schwinn & Co.*[120] that vertically imposed territorial and customer restraints were illegal per se. Henceforth, the rule of reason would govern all nonprice vertical restraints.[121] Although *Sylvania* expressly distinguished *Topco* as a case involving horizontal restraints, the opinion nevertheless implies a more tolerant view of horizontal restraints that fall within the ancillary restraint doctrine.

Finally, in *Broadcast Music, Inc. v. Columbia Broadcasting System*,[122] the Supreme Court considered certain restraints employed by two joint licensing agencies to relieve musical copyright owners of the tasks of individually licensing and policing those using their works. As a practical matter, the blanket license formula adopted by these agencies effectively ended price competition among the copyright owners. The Court of Appeals found this practice unlawful per se,[123] but the Supreme Court reversed, finding that the practice was not "price fixing" as typically defined and that the benefits involved justified the restraints.[124] One commentator has suggested that the result of this decision was to reinvigorate the ancillary restraints doctrine, by making rule of reason analysis applicable to practices which typically would constitute per se violations of the antitrust laws.[125] Whether this proves to be the case, however, remains to be seen.

Considerable uncertainty surrounds the legal status of re-

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[117] *Id.* at 608.
[118] If the venturers were themselves "market leaders," this rationale would not apply. See Brodley, *Legal Status*, *supra* note 104, at 465–66.
[119] 433 U.S. 36 (1977).
[120] 388 U.S. 365 (1967).
[121] Continental T.V. v. GTE Sylvania, 433 U.S. 36, 58 (1977).
[122] 441 U.S. 1 (1979).
[123] 562 F.2d 130, *rev'd* 441 U.S. 1.
[124] 441 U.S. 1, 24 (1979).
[125] Louis, *Restraints Ancillary To Joint Venture and Licensing Agreements: Do* Sealy *and* Topco *Logically Survive Sylvania and Broadcast Music?*, 66 VA. L. REV. 879 (1980).

search joint ventures. It is not clear to what extent doctrines applied to joint ventures in general also apply to research joint ventures specifically. Moreover, the generally applicable legal analysis relies on fact-intensive inquiry, which by its very nature does not produce easily predicted outcomes. Even though experienced antitrust counsel may be able to overcome these difficulties in advising corporate clients on joint venture activities, American businessmen remain nervous about antitrust exposure. That nervousness is probably justified if businessmen contemplate joint ventures as a response to foreign competition, because the antitrust laws are fairly explicit in ruling out this factor as a legitimate justification for concerted activities.

III. RESEARCH JOINT VENTURES AND THE JUSTICE DEPARTMENT

The Justice Department has repeatedly rejected the view that uncertainty among businessmen as to the impact of the antitrust laws on joint research ventures has made industry reluctant to commit large sums of money to projects which may later be subject to legal challenge. Nevertheless, in an effort to reduce this uncertainty, the Justice Department's Antitrust Division published the *Antitrust Guide Concerning Research Joint Ventures* ("*Research Guide*").[126] While the *Research Guide* does not offer the legal certainty that businessmen might like, it does provide a reasonably comprehensive statement of the Justice Department's enforcement policy in this area.[127] Although it was drafted prior to the election of President Reagan, the *Research Guide* still represents official government policy and, as such,

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[126] U.S. DEP'T OF JUSTICE, ANTITRUST GUIDE CONCERNING RESEARCH JOINT VENTURES (1980) [hereinafter cited as RESEARCH GUIDE]. In addition to this guide, the Justice Department has addressed the subject of joint ventures in U.S. DEP'T OF JUSTICE, ANTITRUST GUIDE FOR INTERNATIONAL OPERATIONS (1977) [hereinafter cited as INTERNATIONAL GUIDE].

[127] In addition to the *Research Guide*, the Justice Department has established a business review procedure under which the Department will state its enforcement intentions concerning a proposed joint venture. Antitrust Division Business Review Procedure, 28 C.F.R. § 50.6 (1983). However, since this procedure does not legally bind the government or private litigants, and because the parties are required to submit to the Department detailed information which may become public, the business community has not extensively utilized this procedure. *See* Ginsburg, *Antitrust, Uncertainty and Technological Innovation*, *supra* note 14, at 675–76. Still, those parties which have utilized the procedure have fared quite well, for during the period of 1968–1980 the Justice Department gave only one proposed joint venture a completely unfavorable review. RESEARCH GUIDE, *supra* note 126, at app. B.

is a valuable planning aid to those contemplating the formation of research ventures. On the other hand, given the nonbinding, general nature of the *Research Guide* and the availability of treble damages actions to private parties, there remains no guarantee that compliance with its guidelines will immunize a research joint venture from antitrust liability.[128]

The *Research Guide* identifies three factors relevant to an inquiry into the antitrust implications of a research joint venture:

1. Will the essential elements of the joint venture lessen actual or potential competition between the participating firms?
2. Does the joint venture agreement contain restrictions on competition which are not reasonably ancillary to the essential elements of the project or are of undue scope or duration?
3. Is membership in the joint venture or access to the fruits of the research limited with the result that these limitations create undue market power in the hands of the joint venturers?[129]

If any of these questions are answered in the affirmative, then the joint research venture may well violate the antitrust laws.

The first factor in analyzing the legality of a joint research venture and its effect upon competition is the competitive relationship of the participating firms. If the joint venture is purely contractual, it is subject to analysis under section 1 of the Sherman Act.[130] A joint venture that involves the acquisition by one participant of the assets of the other is covered under section 7 of the Clayton Act.[131] Even when the market shares of the participants in a joint venture are large enough that a merger between them would be challenged under the Justice Department's Merger Guidelines,[132] a research joint venture may nonetheless be permitted, because it, unlike a merger, is not tantamount to the total elimination of a competitor.[133] Rather, it must

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[128] *See* United States v. Hammermill Paper Co., 429 F. Supp. 1271, 1280 (W.D. Pa. 1977) (Justice Department guidelines "do not have the force of law and are not binding on the courts, but courts have paid them some deference . . . .").

[129] RESEARCH GUIDE, *supra* note 126, at 4.

[130] *Id.* at 5. *See* Sherman Act, § 1, 15 U.S.C. § 1 (1982).

[131] RESEARCH GUIDE, *supra* note 126, at 5. *See* Clayton Act § 7, 15 U.S.C. § 18 (1982). Even though section 7 applies to joint ventures, joint ventures ought not be equated with mergers and acquisitions where market structure is the key determinant of legality and where the transaction permanently eliminates one of the parties from the market. RESEARCH GUIDE, *supra* note 126, at 6–7.

[132] Justice Department, *Merger Guidelines*, 2 TRADE REG. REP. (CCH) ¶¶ 4500–05 (1982).

[133] RESEARCH GUIDE, *supra* note 126, at 8.

first be determined whether the joint venture has a procompetitive effect by enabling the participants to provide a product that would not come into being absent their cooperation. In conducting such an analysis, the "guiding principle" is that "elimination of research competition should not exceed that reasonably necessary to meet the needs of effective research."[134] The impact of the research joint venture will be a function of the costs and risks of individual firm research, and market concentration. A further consideration is whether the industry in question contains high entry barriers.[135] Joint research in such industries could well slow the rate of technological progress because of the lack of actual or potential competitors.[136] In short, industry-wide joint research projects that are clearly efficient are lawful if they do not contain undue restrictions and if access to such projects is open to all.[137]

The second relevant factor in the antitrust inquiry concerns the presence of restrictions on competition which are not essential to the project or are of undue duration or scope. Although international competition diminishes the need for antitrust law to preserve the competitive relationship among domestic venturers, it does not necessarily follow that such projects should be wholly exempt from antitrust scrutiny. To ensure the profitability of a joint venture, the parties will impose collateral restraints, at which point antitrust considerations become important. Those arrangements which are per se illegal under the Sherman Act will not be saved by the fact that they emanate from a joint venture.[138] As the *Research Guide* states:

> Collateral restrictions subject to the 'rule of reason' are lawful if they (1) are reasonably ancillary to a lawful main

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[134] *Id.*

[135] *Id.* at 10. *See* Comanor, *Market Structure, Product Differentiations, and Industrial Research*, 81 Q.J. ECON. 639, 656 (1967) (entry barriers may encourage research).

[136] RESEARCH GUIDE, *supra* note 126, at 10.

[137] *Id.* at 11–12. Examples of permissible industry-wide joint ventures would be a "crash" program to solve common problems that threaten an industry's very existence or an effort to meet government standards involving externalities such as pollution control. Ordinarily, however, these types of arrangements would be disfavored. The Justice Department has, in the past, challenged industry-wide joint research and patent pooling ventures. *See, e.g.*, United States v. Manufacturers Aircraft Ass'n, 1976-1 Trade Cas. (CCH) ¶ 60,810 (S.D.N.Y. 1975) (consent decree); United States v. Automobile Mfrs. Ass'n, 1969 Trade Cas. (CCH) ¶ 72,907 (C.D. Cal. 1969) (consent decree); *see also* Fugate, *The Department of Justice's Antitrust Guide for International Operations*, 17 VA. INT'L L.J. 645, 666 (1977) ("These cases reflect the Department's belief that industry-wide research and development dull the incentive to innovate.").

[138] RESEARCH GUIDE, *supra* note 126, at 14–15; *see also* Northern Pac. Ry. v. United States, 356 U.S. 1, 5 (1958); Timken Roller Bearing Co. v. United States, 341 U.S. 593 (1951).

> purpose of the agreement, (2) have a scope or duration no greater than necessary to achieve that purpose, and (3) are not part of an overall pattern of restrictive agreements that has unwarranted anticompetitive effects.[139]

The *Research Guide* attempts to elaborate upon these general principles in both the nonpatent and the patent and know-how areas.

The legality of collateral restraints in the nonpatent area is "largely a function of the proximity of their relationship to the essential purposes of the joint research venture, as well as their not having excessive scope or duration."[140] Among the collateral restraints that are seen as legitimate elements of the joint research venture are obligations to exchange any results from previous research relevant to the project, a duty not to disclose the results of the research to outsiders until patents have been obtained, and a division of research labor between the venturers.[141] Restrictions that preclude individual development, production, and marketing of the research results or that require the exchange of confidential information such as product introduction dates are seen as only remotely related to the legitimate purposes of the venture and are therefore disfavored.[142] Finally, the parties to a joint venture must use "special care" to ensure that the joint venture's activities are actually confined to its legitimate purposes.[143]

The patent laws are an explicit exception to the policies underlying the antitrust laws, because they grant the creator of the patent a monopoly over the invention. Collateral restraints involving patent and know-how arrangements, while not immune from antitrust scrutiny, are generally judged by the rule of reason.[144] If the restraints "are ancillary to a lawful main purpose, have a scope and duration no greater than that reasonably required to achieve that purpose . . . and are not part of an overall pattern of restrictive agreements that has unwarranted

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[139] RESEARCH GUIDE, *supra* note 126, at 15.
[140] *Id.* at 16.
[141] *Id.*.
[142] *Id.* at 16–19.
[143] *Id.* at 18. "In some circumstances, such as an ongoing, long-term venture, it may be desirable that the venture have separate personnel of its own, to reduce day-to-day contact among officials of the competitor-members." INTERNATIONAL GUIDE, *supra* note 126, at 20.
[144] RESEARCH GUIDE, *supra* note 126, at 5–6.

anticompetitive effects," they are not considered vulnerable to antitrust attack.[145]

In the final analysis, the antitrust picture regarding collateral restraints is a mixed one. If a patent exchange is designed to eliminate a research logjam caused by blocking patents rather than to immunize the participating firms from competition or otherwise to monopolize the relevant market, it is permissible under rule of reason analysis.[146] To the extent that the contemplated restraint involves activity traditionally condemned as per se violations of the antitrust laws (for example, price fixing) there is little or no uncertainty as to what is permissible. If the restraints do not fall within this category, however, the level of uncertainty increases tremendously, with legality being determined by a fact-specific analysis of the proposed restraints.

The final factor deemed relevant by the Justice Department in assessing the legality of a joint research venture involves access to membership in the joint venture or its results. If participation in the joint venture is the key to effective competition in the participants' markets, and if the research effort cannot be practicably or effectively duplicated elsewhere by the nonparticipating firms, open access to the venture may be required.[147]

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[145] *Id.* at 19. The patent licensing policies of joint research ventures will also be an important factor in determining their antitrust liability. Open pools which grant licenses to whomever requests them present no antitrust problems. *See, e.g.*, Baker-Cammack Hosiery Mills v. Davis Co., 181 F.2d 550, 568–73 (4th Cir. 1950); Cutter Laboratories, Inc. v. Lyophile-Cryochem Corp., 179 F.2d 80, 92–94 (9th Cir. 1949). The opposite is true, however, with exclusionary patent pools that refuse to license outsiders or that charge excessively high rates that accomplish the same result. *See* La Peyre v. FTC, 366 F.2d 117 (5th Cir. 1966). Yet if the research is so risky that it will be undertaken only if the venturers are permitted to reap substantial profits by excluding outsiders from the patent pool, then the exclusionary practices may be justified. Conversely, an agreement to create a worldwide patent pool of all present and future patents produced by the parties, coupled with an agreement to divide the world into exclusive territories within which each party would be confined both as to the patented *and* unpatented products, would violate the Sherman Act. *See* United States v. National Lead Co., 63 F. Supp. 513, 524 (S.D.N.Y. 1945), *aff'd*, 332 U.S. 319 (1947). Similarly, an exchange of patents among competitors cannot be used to dominate an entire market, and if this proves to be the case, the offending parties may be required to grant nonexclusive patent licenses to any applicants at uniform, reasonable royalties. *See* United States v. National Lead Co., 332 U.S. 319, 328–35 (1947).

[146] RESEARCH GUIDE, *supra* note 126, at 78. *See also* International Mfg. Co. v. Landon, Inc., 335 F.2d 723, 729 (9th Cir. 1964), *cert. denied* 379 U.S. 988 (1965) ("The pooling of the patents, licensing all patents in the pool collectively, and sharing royalties is not necessarily an antitrust violation. In a case involving blocking patents such an arrangement is the only reasonable method for making the invention available to the public."); Cutter Laboratories, Inc. v. Lyophile-Cryohem Corp., 179 F.2d 80, 92 (9th Cir. 1949) ("Patent pools . . . when formed in a legitimate manner for legitimate purposes, are not illegal in themselves.").

[147] RESEARCH GUIDE, *supra* note 126, at 21.

A collective decision to deny access to the venture's results may constitute a group boycott and can be justified only if it is legitimately related to the competitive interests of the parties. Otherwise, the joint venture may have such a market impact that outsiders will be unable to compete, a result condemned by the antitrust laws.[148] This concern will not apply if the participants in the venture do not possess substantial market power. Thus, all venture partners should be free to take a license in whatever technology is produced and then be free to sublicense individually, subject to the sharing of royalty proceeds.[149] Reasonable royalties may be imposed so that those gaining access bear their fair share of the burdens and expense of the project.[150]

The question of access is complex and difficult when considered in the context of international competition. There is no compelling reason to permit joint venturers to unreasonably exclude domestic competitors from their project or its results. Conversely, the goal of restoring America's international competitiveness would be ill-served by requiring that similar access be afforded to foreign competitors[151] unless their governments provided reciprocal privileges to American firms operating in their countries. It is by no means easy, however, to reconcile liberal access policies for domestic competitors with restricted ones for foreign concerns. Indeed, it may be unrealistic to think that these two approaches can be effectively reconciled. In any event, a distinction between foreign and domestic competitors cannot be drawn under the present antitrust laws and, for this reason, legislative action in this area may be warranted.

The Justice Department's criteria for evaluating the legality of joint research ventures are obviously quite general, especially when viewed in light of the fact-intensive analysis to which such ventures are generally subject. To alleviate this problem, the *Research Guide* contains several case studies applying these

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[148] *See* Worthen Bank & Trust Co. v. National BankAmericard, 485 F.2d 119 (8th Cir. 1973), *cert. denied*, 415 U.S. 918 (1974).

[149] RESEARCH GUIDE, *supra* note 126, at 22–23.

[150] *Id.* at 23.

[151] In United States v. Westinghouse Elec. Corp., 648 F.2d 642, 645–46 (9th Cir. 1981), the Justice Department challenged the validity of some Westinghouse licensing agreements which were said to prevent the Japanese from developing new products to compete with American companies. The Justice Department further claimed that Japanese penetration of the concentrated U.S. electronics market would increase competition. The court rejected the government's theory but the mere fact that such a case would even be brought is undoubtedly a matter of concern to American business in its struggle with foreign competition.

principles to specific situations. While the case studies are not legally binding, they do provide useful guidance to those contemplating ventures factually similar to those discussed in the *Research Guide*.[152]

Several general principles may be extracted from the case studies. Basic research joint ventures are generally permissible, even among competitors, so long as the research will be made available to the public within a reasonable time period and there is a strong likelihood that absent the venture the research would not proceed. If, however, the parties are fully capable of independently undertaking the research, the proposed venture will be closely scrutinized. Collateral restraints designed to maximize the effectiveness of the research and to enable the parties to derive some commercial benefit as a result of the venture will be permitted. Any restraints which inhibit individual research or the freedom of the parties to act independently regarding the patents or licensable know-how obtained as a result of the venture will likely run afoul of the antitrust laws. Unrestricted licensing or the publication of the research results in scholarly journals after the patent process has been completed may be required unless this seriously undermines the economic incentive of the parties to participate in such projects by destroying the competitive advantage which they hope will result.[153]

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[152] The first case study involves a venture proposed by twelve corporations to conduct basic research over a ten-year period concerning a particular metal which has the prospect of broad commercial exploitation. RESEARCH GUIDE, *supra* note 126, at 25. The second case study concerns the proposed development of two fuel efficient jet engines at an estimated cost of $900 million and $100 million, respectively, by a small company with a ten to fifteen percent market share of an industry consisting of three domestic firms. *Id.* at 32. The third case study involves a proposed joint venture between a large company and a smaller innovative company to conduct research on a new circuit breaker. *Id.* at 40. In the fourth case study, the Justice Department considers an extremely weak firm which had the necessary technology but was financially incapable of developing the product without entering into a joint venture. *Id.* at 46. In the fifth case study the relevant industry had over five hundred firms, the largest of which had but one percent of the market. Only if at least twenty-five percent of the industry members participated in the project would it become affordable. The industry trade association proposed contracting the project out to an independent research company. *Id.* at 51. In the sixth case study the Justice Department made clear its position that govenment participation in or endorsement of a particular joint venture does not immunize it from the antitrust laws absent a specific statutory exemption. *Id.* at 56. In the scenario for the seventh case study presented in the *Research Guide*, five firms possessing fifty percent of the relevant market were to fund a nonprofit joint venture which would conduct the necessary research through a university for up to two years. *Id.* at 67. The final case study presents a situation in which a small pharmaceutical manufacturer, with research and development and production facilitites devoted exclusively to North American sales, decided to engage in an extensive research program to develop a new drug with significant market potential. *Id.* at 73.

[153] *Id.* at 25.

Despite its hard-line position on enforcement of the antitrust laws when ventures reduce competition, the *Research Guide* acknowledged that if foreign competition was eroding the market power of the partners, rendering their technology obsolete, or otherwise necessitating large-scale joint efforts to develop new or improved technology, this situation would be considered in analyzing the competitive consequences of the proposed joint venture.[154]

IV. THE ANTITRUST POLICIES OF OUR FOREIGN COMPETITORS

To the extent that America's principal foreign competitors operate under antitrust constraints similar to those imposed in the United States, American industry is not disadvantaged by the failure of the Congress to liberalize current antitrust laws.

However, major differences between the United States and its trading partners exist. The antitrust authorities in Western Europe and Japan appear to have far greater authority to grant antitrust exemptions to promote technological innovation. Parties to a joint research venture in Europe or Japan can also determine whether their proposed venture is legal before undertaking any extensive commitments. Even if no exemption is granted the likelihood of a private damages action is remote by U.S. standards, and whatever damages that ultimately may be recovered are limited to actual, not treble, damages. Whether these differences actually encourage more research than would otherwise take place is difficult to determine given the effect of differences in cultures, the tax structure, intellectual property laws, government subsidies, and procurement policies.[155] Nonetheless, the proponents of legislative change in the United States have incorporated several of these foreign experiences into their legislative proposals.

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[154] *Id.* at 44–45.

[155] According to one observer:

> The substantial subsidization of research and development in the TRI [Technical Research Institute of the Japan Society for the Promotion of Machine Industry] example illustrates the interrelationship between the Japanese Government's tolerance and encouragement of a Japanese machine tool cartel and use of funding arrangements to nurture it, and the cartel's concerted anticompetitive activity, faithful to MITI guidelines. This combination resulted in the successful achievement of research and development goals, which in turn, paved the way for the extraordinary penetration of the U.S. market in NC machine tools by Japanese manufacturers.

Copaken, *The Houdaille Petition: A New Weapon Against Unfair Industry Targeting Practices*, 17 GEO. WASH. J. OF INT'L L. & ECON. 211, 267 (1983).

A. *Western Europe*

Following World War II, Western European countries adopted antitrust laws modeled to a considerable degree on their American counterparts. For example, article 85(1) of the Treaty of Rome that governs the European Economic Community ("EEC") declares illegal all agreements and concerted practices "which have as their object or result in the prevention, restriction or distortion of competition within the Common Market."[156] Similarly, article 86 prohibits practices including "the limitation of production, markets or technical development to the prejudice of consumers."[157] If a joint research venture is found to limit rather than promote innovation, it conceivably could be found to violate article 86.[158]

The EEC has a well-established procedure to enable the parties to "any agreements, decisions or practices" to determine in advance whether such arrangements violate either article 85(1) or article 86.[159] A party may petition the Commission of the European Communities ("Commission") to issue a "negative clearance" certifying that, based on the facts submitted, a proposed agreement does not contravene either article 85(1) or article 86.[160] Alternatively, the agreement may be allowed if the parties notify the Commission of the agreement and petition for an exemption.[161] Specifically exempted from the general prohibition contained in article 85(1) are agreements or concerted practices "which contribute to the improvement of the production or distribution of goods or to the promotion of technical or economic progress while reserving to users an equitable share in the profit resulting therefrom . . . ."[162] To qualify for an exemption, such agreements also must be no more restrictive than necessary to achieve their principal purpose and must not result

[156] Treaty Establishing the European Economic Community, March 25, 1957, art. 85(1), 298 U.N.T.S. 11. Joint research and development ventures can fall within the prohibition of article 85(1). Henkel/Colgate, 15 O.J. EUR. COMM. (No. L 14) 14 (1972), [1970–1972 Transfer Binder] COMMON MKT. REP. (CCH) ¶ 9491.

[157] Treaty Establishing the European Economic Community, *supra* note 156, art. 86(b).

[158] Enforcement of the EEC's antitrust laws is the task of the Commission of the European Communities, which consists of thirteen commissioners appointed by the member states. *See generally* B. HAWK, UNITED STATES, COMMON MARKET AND INTERNATIONAL ANTITRUST: A COMPARATIVE GUIDE chs. 7, 12 (1982).

[159] *See* Council of Europe Reg. 17/62, 5 J.O. COMM. EUR. (No. 1) 204 (1962), [A: EUR. COMM.] COMPETITION L. IN W. EUR. & U.S.A. CM.L.II-1.

[160] *Id.* art. 2.

[161] *Id.* arts. 4 & 5.

[162] Treaty Establishing the European Economic Community, *supra* note 156, art. 85(3).

in the elimination of a substantial portion of the competition in the relevant market.[163] Thus, to receive an exemption under article 85(3), the parties must objectively demonstrate that the advantages of the agreement outweigh the competitive disadvantages and that the agreement will benefit the economy as a whole.[164] Prior to issuing either a negative clearance or an exemption under article 85(3), the Commission must afford interested third parties with an opportunity to comment on the proposed arrangement.[165] Exemptions are granted for specified periods of time and the Commission may attach conditions as a prerequisite to its approval.[166]

The EEC's rules on competition preempt or supercede any conflicting antitrust laws of the member states, but in any event there is little disagreement between the EEC and its members over the occasional need to foster cooperation over competition. In 1973, the German law governing restraints of competition (the German Act) was amended to reflect the desire to encourage such cooperation by specifically exempting from the antitrust laws agreements "necessary to promote the efficiency of small or medium-sized enterprises."[167] The Bundestag also amended the German Act to foster better "quality of competition" by permitting trade associations to establish rules and regulations to prevent "competitive conduct which violates the principles of fair competition . . . ."[168]

Despite this more tolerant attitude towards cooperation, cartels are not automatically exempted from the prohibitions of the German antitrust laws. Information concerning the proposed cartel's operation, purpose, and duration must be registered and filed with the Federal Cartel Authority which has three months to object to its formation. Interested parties must be given the opportunity to comment on the proposed arrangement. Once granted, the cartel's exemption may be subsequently revoked

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[163] *Id.* art. 85(3)(a)–(b).

[164] *See* Treeck, *Joint Research Ventures and Antitrust Law in the United States, Germany and European Economic Community*, 3 N.Y.U. J. INT'L. L. & POL. 18, 31–32 (1970).

[165] Council of Europe Reg. 17/62, *supra* note 159, art. 19.

[166] *Id.* art. 8(1). The Commission may also revoke or modify any exemption based on changed circumstances, the breach of any obligations or conditions, or if the parties abuse the exemption. *Id.* art. 8(2).

[167] Gesetz gegen Wettbewerbsbeschraen Kungen, 1957 BUNDESGESETZBLATT, TEIL I [BGBI] 1081 (as amended) (German Act of 1957 against restraints of competition (amended 1973)) § 5(b) [hereinafter cited as GERMAN ACT].

[168] *Id.* § 28.

only if it abuses its market position. Unlike in the United States, in Germany there is no "incipiency" doctrine, so proof of an actual and substantial detrimental effect on competition is required to enjoin the formation of the cartel.[169]

Western Europe in general and West Germany in particular have developed special exemptions for interfirm cooperation in the area of research and development in the belief that "in this field the traditional categories of competition do not apply."[170] This philosophy traces its origins to Schumpeter's hypothesis that cooperation rather than competition is the most efficient way to foster technological advances. Perhaps because large firm size is seen as conducive to technological innovation, Western Europe antitrust officials in nations such as West Germany have been unconcerned with joint research ventures which have no immediate impact on the marketplace.[171]

In 1968 the Commission announced that joint ventures purely for research and development "do not affect the competitive position of the parties" and therefore do not fall within the purview of article 85(1).[172] To qualify for this exceptional treatment, the research joint venture agreement must make the results of the joint research available to all members in proportion to their participation and not restrict the individual research efforts of the participants or their exploitation of the research results.[173] Third parties cannot be excluded from the venture or its results, but licenses may be granted only upon a majority vote of all the participants.[174] Such joint ventures may proceed regardless of the size of the participants, who need not confine their activities to basic research but may undertake all necessary activities up to the stage of industrial application.[175] If the co-

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[169] *International Antitrust Hearings*, *supra* note 29, at 59–64 (statement of Prof. Ernst-Joachim Mestmacker, Universitat Bielefeld, Fakultat fur Rechtswissenschaft). *See also* GERMAN ACT, *supra* note 167, §§ 2–14. Cooperation in buying, advertising, research and development, and joint utilization of plants is widely permitted, as are cartels designed to mitigate "structural crisis" due to a decline in sales caused by a permanent change in demand. *Id.* § 4.

[170] *International Antitrust Hearings*, *supra* note 29, at 65 (statement of Prof. Ernst-Joachim Mestmacker).

[171] *See Concentration of Enterprise in the Common Market*, BULL. EUR. ECON. COMM. (No. 2) 16 (1966), COMMON MKT. REP. (CCH) No. 26, ¶ 58, at 22 (1966).

[172] *See* 1968 Communication concerning agreements, decisions and concerted practices in the field of cooperation between enterprises, ¶ 3, *reprinted in* B. HAWK, *supra* note 158, at 840, 843, app. D.

[173] *See* Second Report on Competition Policy, [B: EUR. COMM.] COMPETITION L. IN W. EUR. & U.S.A. 195 (1972).

[174] *See* Treeck, *supra* note 164, at 45, 51–52.

[175] Second Report on Competition Policy, *supra* note 173, at 47–48.

operation embodied in the joint venture, however, is likely to spill over into other areas not covered by the agreement, the venture may not be approved.[176]

Despite their recognized advantages,[177] some joint research and development ventures have been found to be restrictive in nature and therefore illegal. For example, in one case, two large manufacturers created a joint research subsidiary to which each transferred its existing know-how and technology. Future technological advances were to be transferred to the joint venture as well, even though each party retained the right to conduct individual research. The Commission found that this arrangement precluded either party from gaining a competitive advantage over the other, thereby effectively eliminating any research competition. As a result, the venture was found to violate article 85(1).[178] Similarly, in another decision the Commission found a joint venture between potential competitors that contained a covenant not to compete in violation of article 85(1).[179]

If a joint venture is found to violate article 85(1), the Commission may still grant an exemption so long as certain specified conditions are met. In *Henkel/Colgate* the Commission granted the venture an exemption pursuant to article 85(3) because of the high risks and costs involved in the research.[180] Exemptions have also been granted to facilitate penetration into new markets.[181] Indeed, in only three reported instances has the Commission refused to grant a joint venture such an exemption.[182]

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[176] As in the United States, in both the EEC generally and in Germany particularly, agreements to fix prices or to divide markets are illegal, regardless of whether they constitute part of a joint venture. Treeck, *supra* note 164, at 38.

[177] *See generally id.* at 61; Metro SB-Grossmarkt GmbH & Co. v. Commission, 1977 C.J. Comm. E. Rec. 1875, [1977–1978 Transfer Binder] COMMON MKT. REP. (CCH) ¶ 8435.

[178] *See* Henkel/Colgate, 15 O.J. EUR. COMM. (No. L 14) 14 (1972), [1970–1972 Transfer Binder] COMMON MKT. REP. (CCH) ¶ 9491.

[179] *See* KEWA, 19 O.J. EUR. COMM. (No. L 51) 15 (1976); *see also* Vacuum Interrupters, Ltd., 20 O.J. EUR. COMM. (No. L 48) 32 (1977), [1976–1978 Transfer Binder] COMMON MKT. REP. (CCH) ¶ 9920 (venture prohibited because it was formed "on such terms that [the parents] deprive[d] themselves of the possibility of developing and selling that product independently of, and in competition with each other").

[180] Henkel/Colgate, 15 O.J. Eur. Comm. (No. L 14) 14 (1972), [1970–1972 TRANSFER BINDER] COMMON MKT. REP. (CCH) ¶ 9491; *see also* Vacuum Interrupters, Ltd., 20 O.J. EUR. COMM. (No. L 48) 32 (1977), [1976–1978 Transfer Binder] COMMON MKT. REP. (CCH) ¶ 9926.

[181] *See, e.g.*, DeLaval-Stork, 19 O.J. EUR. COMM. (No. L 215) 11 (1977), [1976–1978 Transfer Binder] COMMON MKT. REP. (CCH) ¶ 9972; Sopelem/Vickers, 19 O.J. EUR. COMM. (No. L 70) 47 (1978), [1976–1978 Transfer Binder] COMMON MKT. REP. (CCH) ¶ 10,014.

[182] *See* Spinks, *The Contemporary Antitrust Regulation of Joint Ventures in the European Economic Community*, 11 VAND. J. TRANSNAT'L LAW 373, 417 (1978).

The exemption system, while administratively complex, results in much less formal antitrust litigation than in the United States. For example, in 1977, only seventeen official decisions were rendered on article 85 or article 86, with the majority of matters being resolved in informal negotiations between the parties and the Commission.[183] If the matter does proceed to a formal resolution, the Commission may impose fines or issue cease and desist orders. Criminal liability and private treble damages actions are not part of the Western European remedial scheme,[184] although private parties may recover actual damages if permitted to do so under their national laws.[185]

B. *Japan*

Japan, like the EEC and West Germany, has adopted a flexible, pragmatic approach in enforcing its Anti-monopoly Law of 1947,[186] which was patterned after the American antitrust laws.[187] The Anti-monopoly Law was designed to provide the nation with the necessary statutory tools to create a competitive, decentralized economy. Monopolization, price fixing, output restrictions, and restrictions on technology were outlawed,[188] and the Japanese Fair Trade Commission ("JFTC"), charged with enforcing the law, was given considerable power to pass on the validity of proposed mergers.[189] Cartels were deemed per se illegal under the law.[190]

Beginning in 1953, the Japanese Government began to relax the law, to encourage greater cooperation in the economy. The Ministry of International Trade and Industry successfully argued that the Anti-monopoly Law had led to "the excessive fragmentation of industries and stood in the way of capital accumulation

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[183] B. HAWK, *supra* note 158, at 419.
[184] *See id.* at 427.
[185] *See* A. GLEISS, COMMON MARKET CARTEL LAW 248 (1978).
[186] DOKUSEN KINSHŪ HŌ (ANTI-MONOPOLY LAW), Law No. 54 of 1947, art. 1, *translated as amended in* 2 E.H.S. No. 2270 [hereinafter cited as ANTI-MONOPOLY LAW OF JAPAN].
[187] *See* C. JOHNSON, MITI AND THE JAPANESE MIRACLE: THE GROWTH OF INDUSTRIAL POLICY, 1925–1975, 175 (1982). The actual draft of the Anti-monopoly Law was prepared under the direction of General Douglas MacArthur and then forwarded to the Japanese Government for adoption.
[188] ANTI-MONOPOLY LAW OF JAPAN, *supra* note 186, arts. 3–4. Article 4(3) on unreasonable restraints of trade includes agreements to limit or unduly restrict the adoption of new technology. *See* H. IYORI, ANTIMONOPOLY LEGISLATION IN JAPAN 52 (1969).
[189] ANTI-MONOPOLY LAW OF JAPAN, *supra* note 186, art. 15.
[190] *Id.* art. 5.

in order to enhance international competitiveness."[191] The 1953 amendments eliminated the per se approach to restrictive practices such as price fixing, and only those cartels which "undertake any unreasonable restraint of trade" were prohibited.[192]

The 1953 amendments not only relaxed the ban on cartels, but also encouraged their creation in certain circumstances. For example, depression cartels are authorized to assist declining industries. To create such a cartel, industry members must demonstrate the following to the JFTC: that the prevailing market price was below the average cost of production; that several companies would probably go out of business were the cartel not approved; that the cartel would take no actions beyond those necessary to ensure the survival of the industry; that the interests of consumers would not be unduly jeopardized; and that cartel membership would be open and voluntary.[193] Rationalization cartels are also permitted, with prior JFTC approval, if they are particularly necessary to advance technology, improve product quality, reduce costs, increase efficiency, and otherwise rationalize production.[194] Before approval, the JFTC determines whether the rationalization cartel will damage the interests of consumers, unjustly discriminate, unreasonably restrict admission to or withdrawal from the cartel, or concentrate production in any one enterprise.[195] Joint research and development ventures can specifically qualify for this type of an exemption.[196]

In 1956 another form of cartel began to emerge, as MITI sponsored industry-specific cartels under a series of "industry laws," which provided less restrictive exemptions from the Antimonopoly Law.[197] These cartels, which can be validated by

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[191] C. JOHNSON, *supra* note 187, at 225.

[192] ANTI-MONOPOLY LAW OF JAPAN, *supra* note 186, art. 3.

[193] *Id.* art. 24-3.

[194] *Id.* art. 24-4. *See also* Dziubla, *International Trading Companies: Building on the Japanese Model*, 4 NW. J. INT'L L. & BUS. 422, 450 (1982); C. JOHNSON, *supra* note 187, at 225 ("Such 'cooperative behavior' was to include the sharing of technologies . . . .").

[195] ANTI-MONOPOLY LAW OF JAPAN, *supra* note 186, art. 24-4(3).

[196] *International Antitrust Hearings*, *supra* note 29, at 146 (statement of James N. Nicholson on behalf of the U.S. Chamber of Commerce); *see also Science and Technology Hearings*, *supra* note 16, at 67–68 (statement of Allan Mendelowitz, Assoc. Dir., NSIAD).

[197] C. JOHNSON, *supra* note 187, at 226. Article 22 of the Anti-monopoly Law provides that "[t]he provisions of this Act, where there exists a special law concerning a specific industry, shall not apply to legitimate acts . . . based upon such law." ANTIMONOPOLY LAW OF JAPAN, *supra* note 186, art. 22. For an intriguing case study of one such law, the Extraordinary Measures Law for Promotion of the Machinery Industry, see Copaken, *supra* note 155, at 211. This act authorized MITI to prepare a "basic rationali-

MITI without the approval of the JFTC, have been formed in sectors characterized by small enterprises, subject to government regulation or exposed to foreign trade.[198] They are the principal means by which the Japanese Government fosters collaborative efforts within its economy.[199]

Finally, in addition to the general and industry-specific statutory exemptions from the Anti-monopoly Law available to Japanese industry, the Japanese Government promotes cooperation through an informal system of administrative guidance. Under this system, firms voluntarily comply with rationalization plans promulgated by MITI, without being formally "instructed to do so."[200] Although these voluntary arrangements are not accorded de jure immunity from the Anti-monopoly Law,[201] there is apparently little risk of antitrust prosecution so long as MITI guidelines are followed, "regardless of how anticompetitive that guidance may be."[202]

Japanese antitrust law differs from American antitrust law in procedure as well as substance. Although the JFTC may issue cease and desist orders against enterprises found in violation of the Anti-monopoly Law, the criminal penalties which may be imposed are quite mild—five million yen or approximately $22,000.[203] There is no treble damages provision in the Anti-monopoly Law, and a private party may sue only after the JFTC has found a violation of the Anti-monopoly Law.[204] This is a rare scenario: in the decade from 1966 to 1975 only twenty-one cases proceeded to an administrative judgment.[205] By definition,

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zation plan" for the industry and to "instruct" firms to act in concert with the plan. Concerted actions pursuant to such instructions are given express immunity from the Antimonopoly Act. *Id.* at 235–36.

[198] Caves & Uekusa, *Industrial Organization*, in ASIA'S NEW GIANT: HOW THE JAPANESE ECONOMY WORKS 485–86 (H. Patrick & H. Rosovsky eds. 1976).

[199] *See* Yamamura, *Success That Soured: Administrative Guidance and Cartels in Japan*, in POLICY AND TRADE ISSUES OF THE JAPANESE ECONOMY: AMERICAN AND JAPANESE PERSPECTIVES 81–82 (K. Yamamura ed. 1982).

[200] Copaken, *supra* note 155, at 235.

[201] *Id.* at 236, *citing* Judgment of Sept. 26, 1980, TOKYO HIGH COURT 33 KAKYŪ KEISHŪ 359 (cartel activity engaged in by the oil industry violated Anti-monopoly Law even though the activity was undertaken pursuant to MITI guidance).

[202] *Id.* at 237 n.139.

[203] Dziubla, *supra* note 194, at 449; Rabinowitz, *Antitrust in Japan*, in CURRENT LEGAL ASPECTS OF DOING BUSINESS IN JAPAN AND EAST ASIA 106, 111 (J. Haley ed. 1978).

[204] ANTI-MONOPOLY LAW OF JAPAN, *supra* note 186, art. 26 ("The right to claim indemnification of damages . . . may not be exercised in court until the decision [of the JFTC] . . . becomes final and conclusive.").

[205] If one adds consent decrees and administrative proceedings that were dropped prior to final judgment, the total number of cases rises to thirty. Not only are JFTC

no more than an equal number of private suits could have been filed during this period. As of 1978, only four private actions had ever been instituted under the Anti-monopoly Law, and except for one reported out-of-court settlement, damages have never been recovered.[206]

V. Possible Solutions

Regardless of whether the antitrust laws actually inhibit the formation of joint research ventures, the Reagan Administration, as well as several members of Congress have introduced legislation that addresses this concern.[207] The House Committee on Science and Technology and the House Judiciary Committee have endorsed different versions of this legislation by wide margins.[208] While these committee votes do not necessarily presage eventual House or Senate approval, the chances of some affirmative legislative action in this area are very good. These proposals express varying approaches to the problem, but there is also much agreement as to the specific steps that need to be taken.

These bills accept the assumption that uncertainty surrounding the interpretation of antitrust law discourages cooperative research and development.[209] A related assumption is that absent such cooperation, the great costs of undertaking research

proceedings rare, but the Japanese Supreme Court rendered only three antitrust opinions during this same period. As a result, many of the provisions of the Antimonopoly Act have never been judically construed. *See* Rabinowitz, *supra* note 203, at 108–11.

[206] The paucity of formal decisions has been explained as a result of "law enforcement by bargaining." Haley, *Antitrust in Japan: Problems of Enforcement*, in Current Legal Aspects of Doing Business in Japan and East Asia, *supra* note 203, at 125.

[207] *See, e.g.*, H.R. 4043, 98th Cong., 1st Sess., 129 Cong. Rec. 7846 (1983) (introduced by Rep. Fuqua (D-Fla.)); H.R. 3975, 98th Cong., 1st Sess., 129 Cong. Rec. 7432 (1983) (introduced by Rep. Lungren (R-Cal.)); H.R. 3878, 98th Cong., 1st Sess., 129 Cong. Rec. 6815 (1983) (supported by the Administration); H.R. 3641, 98th Cong., 1st Sess., 129 Cong. Rec. 5551 (1983) (introduced by Rep. Fish (R-N.Y.)); H.R. 3393, 98th Cong., 1st Sess., 129 Cong. Rec. 4330 (1983) (introduced by Rep. Sensenbrenner (R-Wisc.)); H.R. 1952, 98th Cong., 1st Sess., 129 Cong. Rec. 887 (1983) (introduced by Rep. Synar (D-Okla.)); H.R. 108, 98th Cong., 1st Sess., 129 Cong. Rec. 42 (1983) (introduced by Rep. Edwards (D-Cal.)); S. 1561, 98th Cong., 1st Sess., 129 Cong. Rec. 9344 (1983) (introduced by Sen. Dole (R-Kan.)). H.R. 1952 and S. 737 are identical, as are H.R. 108 and S. 1383; S. 1383, 98th Cong., 1st Sess., 129 Cong. Rec. 7555 (1983) (introduced by Sen. Glenn (D-Ohio) & Sen. Kennedy (D-Mass.)); S. 737, 98th Cong., 1st Sess., 129 Cong. Rec. 2436 (1983) (introduced by Sen. Mathias (R-Md.) and Sen. Hart (D-Colo.)); S. 568, 98th Cong., 1st Sess., 129 Cong. Rec. 1532 (1983) (introduced by Sen. Tsongas (D-Mass.)).

[208] *See* H.R. Rep. No. 571, pt. 1, 98th Cong., 1st Sess. 8 (1983).

[209] *See, e.g.*, H.R. 1952, *supra* note 207, § 2(a)(8); S. 737, *supra* note 207, § 2(a)(8); S. 568, *supra* note 207, §§ 2 & 3; H.R. 4043, *supra* note 207, § 2(a)(b).

and development projects, coupled with a lack of adequate technical personnel, will prevent many firms from conducting the research and development necessary "for the United States to remain competitive in global markets."[210] Moreover, the policies of America's foreign competitors in "selectively subsidizing [and] sponsoring cooperation of industry members, or otherwise coordinating industrial research and development programs" has further contributed to the deterioration of America's competitive position both at home and abroad.[211] To remedy this problem, the government must actively encourage joint research and development ventures "as a means of augmenting the total amount of research and development performed . . . ."[212] Furthermore, this legislation rejects the current distinction between basic and applied research, and would permit, for example, "practical application for experimental and pilot demonstration purposes, up to the stage of industrial application, including the production, testing and licensing of models, devices, equipment, materials, and processes."[213]

Before a joint research venture could qualify for special treatment under many of the proposed amendments to the antitrust laws, it would have to open up participation in the project to all parties, which in turn would be required to pay a proportional share of the common expenses incurred.[214] While American

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[210] H.R. 1952, *supra* note 207, § 2(a)(2)-(3); S. 737, *supra* note 207, § 2(a)(2)-(3); *see* H.R. 4043, *supra* note 207, § 2(a)(5), (a)(7).

[211] H.R. 1952, *supra* note 207, § 2(a)(5); S. 737, *supra* note 207, § 2(a)(5); H.R. 4043, *supra* note 207, § 2(a)(5) ("The need for United States firms to share risks has been greatly magnified by reason of activities of foreign governments in selecting, subsidizing, sponsoring cooperation of industry members, or otherwise coordinating industrial research and development projects to enhance the position of foreign firms in the United States and global markets.").

[212] H.R. 1952, *supra* note 207, § 2(b)(3); S. 737, *supra* note 207, § 2(b)(3); *see also* H.R. 108, *supra* note 207, § 2; S. 1383, *supra* note 207, § 2; H.R. 4043, *supra* note 207, § 2(a)(7), (a)(8); H.R. 3393, *supra* note 207, § 2(a). H.R. 3393 differs slightly from these other proposals by specifically eschewing increased direct support for research and development in favor of federal actions "to encourage long-term private investment in research and development." *Id.*

[213] H.R. 1952, *supra* note 207, § 3(2)(B); S. 737, *supra* note 207, § 3(2)(B); *see also* H.R. 108, *supra* note 207, § 14(4)(B) ("practical application for experimental and demonstration purposes"); S. 1383, *supra* note 207, § 14(4)(B) (same); S. 568, *supra* note 207, § 4(2)(C) ("a systematic application of knowledge toward the production of useful materials, devices, and systems or methods"). H.R. 4043, § 12(5), defines "research and development project" as including "basic research, applied research, exploratory development, demonstration development, but does not include the manufacturing or marketing of products developed for commercial use." According to the Science and Technology Committee, this definition would permit a joint venture to operate a pilot plant and to sell its product as a necessary incident to the development of process technology. *See* H.R. REP. No. 571, pt. 1, *supra* note 208, at 16.

[214] H.R. 1952, *supra* note 207, § 4(b)(1), (b)(3); S. 737, *supra* note 207, § 4(b)(1), (b)(3).

firms would be provided with relatively free access to the venture, some of the legislative proposals explicitly distinguish between foreign and domestic firms. Under some of the legislative proposals, American subsidiaries of foreign firms would be entitled to participate in joint research ventures only if their countries provide opportunities for U.S. firms to participate in joint research ventures equivalent to the access provided domestic firms in those nations.[215]

The legislative proposals also tend to limit the rights of a firm to participate in a joint research venture based on a market share. For example, if a firm had twenty-five percent or more of the world market, and its participation in the venture would cause the venture's combined market share to exceed fifty percent, the Attorney General, as a prerequisite to granting the venture an antitrust exemption, would have to find that "(i) the results of such a program are not likely to be directly applicable to the future production of such a product; or (ii) such participation is critical to the success of the program and is in the national interest."[216] Alternatively, the Science and Technology Committee's compromise measure, H.R. 4043, provides that the size of the venture cannot be so large so as to preclude the existence of at least two other competing research projects of equal or greater financial capabilities.[217] A venture may exceed this size limitation, however, if the participants agree to issue licenses to nonparticipants upon such terms as the Attorney General deems "fair and reasonable."[218]

To the extent that these bills contain mandatory access provisions, they have been criticized on two grounds. First, mandatory access can reduce the incentives to engage in joint research activity by permitting "free riders" to join successful ventures, while the original participants bear the entire risk of

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[215] S. 568, *supra* note 207, § 5(d)(1)(A); H.R. 1952, *supra* note 207, § 3(5); S. 737, *supra* note 207, § 3(5).

[216] H.R. 1952, *supra* note 207, § 4(b)(4)(A); S. 737, *supra* note 207, § 4(b)(4)(A). The Attorney General would be authorized to issue guidelines relevant to the procedures to be employed in making such findings and the circumstances under which a favorable finding will be made. H.R. 1952, *supra* note 207, § 4(b)(4)(i)–(iii); S. 737, *supra* note 207, § 4(b)(4)(i)–(iii); *see also* H.R. 3393, *supra* note 207, § 3(b)(1)(A)–(C) (aggregate market share of parties may not exceed 25% unless it can be demonstrated that is is likely that the project will succeed in developing a marketable product, participation of all the parties is critical to the project's success, and the project will improve competition, enhance the national economy, promote national security, or is necessary to achieve compliance with federal environmental laws).

[217] *See* H.R. 4043, *supra* note 207, § 3(c)(2).

[218] *Id.* § 6(b)(2).

failure.[219] The proposals do, however, permit the imposition of "catchup" charges for firms wishing to participate in already existing programs.[220] Second, open access may lead to industry-wide joint ventures that could have serious anticompetitive consequences.[221] A possible solution is to limit the size of the joint venture according to the market share of the participants, for example, to twenty-five or thirty-three percent of the market, thus allowing for several research ventures in any given area.[222] This solution reduces but does not eliminate the need for liberal licensing requirements to protect nonparticipants.

Although the attempt to limit the access rights of foreign firms operating in the United States represents a significant departure from current antitrust law, it has drawn little criticism. Indeed, one former Assistant Secretary of Commerce has argued that any legislation passed by Congress ought to exclude "foreign firms, foreign-owned subsidiaries or other U.S. divisions or entities that would merely served [sic] as a conduit to foreign companies for the results of that joint research and development."[223] Linking reciprocity to actual open access provisions in other countries rather than to nondiscrimination between U.S. and foreign firms would fairly and effectively deal with this delicate problem. The explicit recognition of the competitive policies of our foreign competitors as a legitimate factor to be considered in interpreting U.S. antitrust laws is, however, a significant step.

In addition to setting membership criteria for the joint venture, many of the legislative proposals suggest detailed criteria to govern the operation of the venture itself. For example, in

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[219] *See Hearings Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary*, 98th Cong., 1st Sess. (1983) (in press) (statement of William F. Baxter, Ass't Att'y Gen., Antitrust Div., Dep't of Justice) [hereinafter cited as *Monopolies Hearings*].

[220] *See* H.R. 1952, *supra* note 207, § 4(d)(5)(C); S. 737, *supra* note 207, § 4(d)(5)(C); H.R. 3393, *supra* note 207, § 3(a)(6) ("a reasonable amount based on the cost and value of the research and development projects then being carried out").

[221] *See Science and Technology Hearings*, *supra* note 16, at 164–65 (statement of William Baxter, Ass't Att'y Gen., Antitrust Div., Dep't of Justice); *see also id.* at 332 (statement of Prof. Douglas H. Ginsburg, Harvard Law School) ("[M]andatory sharing rights will diminish the probability that competing centers of joint research will be established [and] risk collusion without any off-setting reason to think that collaboration would result in the firms pursuing research that they would not pursue independently.").

[222] H.R. 4043 adopts this rationale by eliminating all mandatory licensing provisions except in those situations where the venture exceeds specific size limitations. *See* H.R. Rep. No. 571, pt. 1, *supra* note 208, at 18.

[223] *Science and Technology Hearings*, *supra* note 16, at 215 (testimony of Dr. Jordan J. Baruch).

one proposal, participants cannot be required as a condition of membership to restrict their own independent research activities, provide the venture with the results of previous or future research, refrain from exploiting the technology produced by the venture, or restrict their subsequent marketing or manufacturing activities.[224] They can, however, be required to commit themselves to the joint venture for a minimum period of time to participate in at least one of the venture's programs, and they can be expelled from the venture for failing to live up to their legitimate obligations.[225]

Restraints imposed in connection with a joint research venture must be "necessary to the lawful main purpose of the agreement to form the joint research and development venture . . . have a scope and duration no greater than is necessary to achieve that purpose [and not constitute] an overall pattern of restrictive agreements that have unwarranted anticompetitive effects . . . ."[226] Thus, joint venturers could provide the venture with access to previous and future research necessary to the success of the venture and refuse to disclose the results of the research "for a reasonable period of time."[227]

Several of the provisions in these bills concerning the licensing of the venture's technology are quite controversial. For example, H.R. 1952 requires the management of the joint venture to "seek to encourage the widest possible dissemination of the venture's technology [albeit] with due regard to the risks assumed and resources expended by participants in the program that created the technology."[228] Typically, these bills provide that each venturer will be afforded exclusive access to the venture's technology under royalty-free licenses or licenses at rates commensurate with the risk of the project and the size of their investment, for periods ranging anywhere from three to six years.[229] Once this time period has expired, nonparticipating U.S. firms become entitled to acquire licenses to the venture's

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[224] *See* H.R. 1952, *supra* note 207, § 4(c)(2)(A)–(C); S. 737, *supra* note 207, § 4(c)(2)(A)–(C).

[225] *See* H.R. 1952, *supra* note 207, § 4(d)(5); S. 737, *supra* note 207, § 4(d)(5); H.R. 4043, *supra* note 207, § 3(b)(2)(A)–(D).

[226] S. 568, *supra* note 207, § 5(d)(1)(C); *see also* H.R. 4043, *supra* note 207, § 3(c)(1).

[227] H.R. 1952, *supra* note 207, § 4(c)(3)(A)–(D); S. 737, *supra* note 207, § 4(c)(3)(A)–(D).

[228] H.R. 1952, *supra* note 207, § 4(d)(6); S. 737, *supra* note 207, § 4(d)(6); *see also* H.R. 3393, *supra* note 207, § 3(a)(5)(C).

[229] *See* H.R. 1952, *supra* note 207, § 4(e)(4)(A)–(C); S. 737, *supra* note 207, § 4(e)(4)(A)–(C); S. 568, *supra* note 207, §§ 5(d)(1)(B), 7(a)(4).

technology under fair, reasonable, and nondiscriminatory terms.[230]

Former Assistant Attorney General William Baxter has criticized these provisions as requiring mandatory licensing and therefore creating a disincentive to the formation of research joint ventures.[231] These provisions, however, provide the venturers with exclusive access for several years,[232] which in the high technology area can be tantamount to eternity, and this exclusive use period may be extended, if necessary, in light of the "risks assumed and resources expended by the participants."[233] Moreover, mandatory licensing will enable smaller, innovative companies to secure access to and utilize technology produced by these large joint ventures. As one corporate official has argued, it is "highly desirable national policy to make technology created by R&D joint ventures readily available to others—with reasonable rewards to the creators."[234] One can quarrel with whether three or six years is adequate time to enable a joint venture participant to recoup its investment and whether requiring mandatory licensing once a venture exceeds certain size limitations affords adequate protection to smaller companies that do not have the resources to participate in the venture. Still, the bills offer a reasonable approach to reconciling the difficult issue of exclusive access versus wide dissemination, as well as providing some certainty in an otherwise ambiguous area of the law.[235]

To ensure that a "qualified" joint venture does not engage in any anticompetitive activities, several of the proposals have spelled out areas of both forbidden and permissible activity. H.R. 1952 and S. 737 propose to control the joint research venture by requiring it to establish a management board which,

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[230] *See, e.g.*, H.R. 1952, *supra* note 207, § 4(d)(6)(e)(5); S. 737, *supra* note 207, § 4(d)(6)(e)(5); H.R. 3393, *supra* note 207, § 3(a)(7)(D).

[231] *Science and Technology Hearings*, *supra* note 16, at 164 (statement of William Baxter); *see also id.* at 333–34 (statement of Douglas Ginsburg) (Mandatory licensing "further diminishes the rewards that those firms that do participate will be allowed to reap for their efforts. And it puts joint research on a disadvantageous footing compared to independent research."). *But see* Scherer, *The Economic Effects of Compulsory Licensing* in NEW YORK UNIVERSITY MONOGRAPH SERIES IN FINANCE AND ECONOMICS 63 (1977) (compulsory licensing has no negative effects on R&D efforts).

[232] S. 568, *supra* note 207, § 5(d)(1)(B).

[233] S. 568, *supra* note 207, § 7(a)(4).

[234] *Monopolies Hearings*, *supra* note 219 (statement of Robert Price, Pres. & Chief Operating Officer, Control Data Corp.).

[235] *Id.* (Mandatory licensing is "simply a price to be paid by the venturers for a degree of antitrust certainty.").

in addition to having one representative of each participant, must also have at least three outside directors selected from academe, nonprofit organizations, public agencies, or nonparticipating firms.[236] This management board would select the chief executive officer of the venture, establish criteria for choosing specific research programs, allocate common costs among programs, develop criteria for licensing the venture's technology, and determine standards for admission of new members and the withdrawal of existing ones.[237] In administering the venture, the management board would consider factors such as the importance of a proposed project to the national economy or defense, the long-term needs of U.S. industry, and the intellectual significance of the project, as well as the specific needs of and risks to the participating firms.[238]

Surprisingly, this far-reaching proposal has received little if any criticism in the legislative debate. Certainly, outside directors are commonplace in the corporate world and the presence of individuals with divergent interests and perspectives on a joint research venture's management board could have a very salutary effect. Yet, under H.R. 1952 and S. 737, if there were only two parties to the joint venture agreement, control would rest with the outside directors. Indeed, even if the outside directors are in the minority, they are required to approve the venture's licensing policies as fair, reasonable, and nondiscriminatory.[239]

If a proposed joint venture is confident that it can satisfy the criteria contained in these bills, it may obtain a certificate from the Attorney General granting it protection from antitrust liability. Under one bill, the venture must notify the Attorney General of its formation, identify the parties to the venture, describe the research to be undertaken and the participants in this research, disclose any agreements relating to the venture, and certify that it is in compliance with the detailed criteria set forth in the statute.[240] Under the self-certification procedures of two other bills, antitrust immunity attaches upon the filing of

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[236] H.R. 1952, *supra* note 207, § 4(d)(2)(A)–(B); S. 737, *supra* note 207, § 4(d)(2)(A)–(B).

[237] H.R. 1952, *supra* note 207, § 4(d)(3)(A)–(E); S. 737, *supra* note 207, § 4(d)(3)(A)–(E).

[238] H.R. 1952, *supra* note 207, § 4(d)(4)(A)–(D); S. 737, *supra* note 207, § 4(d)(4)(A)–(D).

[239] H.R. 1952, *supra* note 207, § 4(d)(6)(e)(5); S. 737, *supra* note 207, § 4(d)(6)(e)(5).

[240] H.R. 1952, *supra* note 207, § 5(a)(1)–(5); S. 737, *supra* note 207, § 5(a)(1)–(5).

the notice.[241] H.R. 108 and S. 1383 slightly modify the self-certification approach, providing that the Attorney General must issue a certificate of review which confers such immunity within sixty days of the receipt of the notice, unless he affirmatively determines that the conduct specified in the notice will violate the antitrust laws.[242] Both the Administration bill, H.R. 3878, and S. 1561 require the filing of essentially the same information as called for under the other bills and provide that protection attaches immediately upon filing of the notice.[243] The self-certification and negative clearance approaches are combined in H.R. 4043, enabling the joint venture to choose either option.[244] For those joint ventures that for whatever reason cannot comply with all of the requirements for self-certification, the negative clearance provides a workable alternative. Under this approach, detailed information concerning the venture is submitted to the Attorney General, who has ninety days to disapprove the venture. No affirmative response is required.[245] Still, even under the negative clearance approach, a venture must comply with some of the more critical self-certification requirements.[246] Finally, S. 568 requires affirmative approval from the Attorney General before an antitrust exemption can be granted.[247] The Attorney General is required to issue his decision within sixty days, and this decision must be favorable if he finds that (1) participation in the venture is open to all U.S. firms, (2) the results of the research will be made available within six years to nonparticipants on fair, reasonable, and nondiscriminatory terms, and (3) the ancillary restraints imposed in connection with the venture are no greater than are necessary to achieve the success of the project and do not have any "unwarranted anticompetitive effects."[248] The Attorney General may disapprove the venture if he determines that it will "lessen existing or potential competition between firms to such an extent as to

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[241] H.R. 1952, *supra* note 207, § 6(1); S. 737, *supra* note 207, § 6(1); H.R. 3393, *supra* note 207, § 3(a).
[242] H.R. 108, *supra* note 207, § 5(b)(2); S. 1383, *supra* note 207, § 5(b)(2).
[243] H.R. 3878, *supra* note 207, § 204(a); S. 1561, *supra* note 207, § 2.
[244] H.R. 4043, *supra* note 207, §§ 3(b), 3(c), 5(a).
[245] *Id.* §§ 4, 5; *see also* H.R. REP. No. 571, pt. 1, *supra* note 208, at 19–20.
[246] H.R. 4043, *supra* note 207, § 5(a). For example, the venture participants cannot agree to restrict their own independent research activities or restrict the marketing or manufacturing of any product resulting from the research.
[247] S. 568, *supra* note 207, § 5(a).
[248] *Id.* § 5(d).

foreclose existing or potential competitors from participating in such market."[249]

This latter bill places a heavy burden on the Attorney General. Either the review process will become perfunctory or joint research ventures seeking an exemption will find themselves participating in full-blown administrative proceedings, a situation which may well discourage companies from utilizing the exemption procedure. Conversely, the complete self-certification approach, although administratively simple, veers toward the opposite extreme by allowing for little, if any, input from the Attorney General. A middle ground that does not require an affirmative decision based on detailed findings, but which also does not confer an automatic exemption without any opportunity for deliberation, would seem to be preferable to either alternative. In any event, whether a self-certification, negative determination, or a combination approach is ultimately chosen, it is essential that joint research ventures be viewed as presumptively valid and that the procedure be simple, fast, and nonadversarial.

If a comprehensive regulatory approach to the certification process is not appropriate, then some provision must be made for correcting mistakes. Therefore, the legislative proposals authorize the Attorney General to conduct an investigation at any time to determine whether information submitted by the venture is accurate and whether a qualified joint research venture is complying with the substantive criteria contained in the legislation.[250] Upon a determination that the venture is not in compliance, the Attorney General must so notify the parties and inform them as to what specifically needs to be done to remedy the noncompliance.[251] If the venture does not take appropriate action within sixty days to bring itself into compliance, the Attorney General may bring an action in court to dissolve the venture.[252] Alternatively, if the Attorney General determines that the venture is violating the antitrust laws, he may either modify or revoke the certificate of compliance, which decision the venturers may challenge in court.[253] A determination that

[249] *Id.* § 5(d)(2).

[250] H.R. 4043, *supra* note 207, § 6; H.R. 1952, *supra* note 207, § 7(a); S. 737, *supra* note 207, § 7(a); H.R. 108, *supra* note 207, § 7; S. 1383, *supra* note 207, § 7; H.R. 3393, *supra* note 207, § 5(a).

[251] H.R. 1952, *supra* note 207, § 7(b)(2); S. 737, *supra* note 207, § 7(b)(2).

[252] H.R. 1952, *supra* note 207, § 7(b), (c); S. 737, *supra* note 207, § 7(b), (c).

[253] H.R. 108, *supra* note 207, § 7; S. 1383, *supra* note 207, § 7; *see also* S. 568, *supra*

the venture is not in compliance, however, is not admissible as evidence in any subsequent antitrust proceeding.[254]

Once a joint research venture has been qualified or has received a certificate of review, it becomes entitled to some degree of protection against antitrust liability.[255] Some proposals provide absolute immunity against civil or criminal antitrust liability for conduct "undertaken in connection with the operation of a qualified joint research and development venture."[256] Others also grant absolute immunity against criminal liability, but still permit civil antitrust actions seeking actual damages.[257] H.R. 3393, H.R. 3878, and S. 1561 also provide that even noncertified joint research ventures are immune from the threat of treble damages and can be liable only for actual damages,[258] a position which H.R. 1952, S. 737, H.R. 108, and S. 1383, for example, do not endorse. To the extent that private civil actions are permitted under H.R. 3878, H.R. 4043, and S. 1561, the challenged conduct, if specified in the notice filed with the government, must be judged under the rule of reason and not the per se rule.[259] Finally, in an effort further to dissuade potential plaintiffs from initiating actions against qualified joint research ventures, all of the proposed legislation permits the venture to recover reasonable attorneys' fees, if the court finds that the alleged violation arose in connection with the operation or con-

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note 207, § 5(g)–(i). Except under these circumstances, private parties are not entitled to seek judicial review regarding any decision to issue or not to issue a certificate of immunity. *Id.* at § 8. See also *Science and Technology Hearings*, *supra* note 16, at 330 (statement of Douglas Ginsburg):

> If a proposed research joint venture would be procompetitive rather than anticompetitive, and if subjecting the collaborators to the risks and costs of private litigation would prevent them from going forward, then private rights of action would frustrate the public interest in competition. The risks, costs, and delay inherent in judicial review proceedings could have almost the same effect—chilling the parties' interest in collaborative research—as would a de novo antitrust suit.

[254] H.R. 4043, *supra* note 207, § 6(d).

[255] *See Research and Development Hearings*, *supra* note 24, at 57 (statement of Peter F. McCloskey, Electronics Industries Ass'n) (The immunity would provide a "'zone of certainty' within which private industry can make important decisions about its research activities with immunity from future antitrust attack by either DOJ or private antitrust litigants.").

[256] H.R. 1952, *supra* note 207, § 6(3); S. 737, *supra* note 207, § 6(3).

[257] H.R. 108, *supra* note 207, § 9(b)(1); S. 1383, *supra* note 207, § 9(b)(1); S. 1561, *supra* note 207, § 3(c); *see also* H.R. 4043, *supra* note 207, § 5(e)(2).

[258] H.R. 3393, *supra* note 207, § 7; H.R. 3878, *supra* note 207, § 203; S. 1561, *supra* note 207, § 3.

[259] H.R. 3878, *supra* note 207, § 202; H.R. 4043, *supra* note 207, § 9; S. 1561, *supra* note 207, § 3.

duct of the joint venture and, in fact, did not violate the antitrust laws.[260]

The Administration is critical of several aspects of these proposals. One criticism of the certification requirements of some proposals is that they might result in unnecessary regulatory burdens and a Justice Department transformed "from its traditional role as enforcer of the antitrust laws [in]to a regulatory bureaucracy."[261] The Administration opposes bills requiring the Attorney General to certify joint research and development ventures, because the result would be too great an intrusion into even innocuous ventures and too high an expenditure of departmental resources.[262] Former Assistant Attorney General Baxter argues that access provisions requiring openness to American firms would impair competition, and mandatory licensing would remove an incentive to innovate.[263]

The Administration's response to these proposals is an overreaction. S. 568 might increase government intervention, but others, providing for self-certification, are administratively simple. Moreover, the certainty provided by legislative standards would be a major benefit to American business.[264]

An alternative to these regulatory proposals is to reform the antitrust laws to reduce the incentives to litigate.[265] A former Deputy Assistant Attorney General has suggested that requiring rule of reason analysis for research ventures, allowing only actual damages and compensatory interest, and awarding attorneys' fees to successful defendants of research joint ventures, would sufficiently reduce the risks to business of unfounded litigation.[266] An automatic antitrust exemption for research and development joint ventures not only would be inappropriate because temptations to form cartels will always exist, but, moreover, it fails to address the central issue of preventing unfounded litigation related to conduct at the fringes of the exemption.[267]

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[260] *See, e.g.*, H.R. 1952, *supra* note 207, § 6(2)(A)–(B); S. 737, *supra* note 207, § 6(2)(A)–(B); H.R. 108, *supra* note 207, § 9(b)(2); S. 1383, *supra* note 207, § 9(b)(2); S. 568, *supra* note 207, § 6(c); H.R. 3393, *supra* note 207, § 8. H.R. 4043, *supra* note 207, § 11, differs slightly in its approach by limiting recovery of attorney's fees only to those situations in which the claimant is found to have acted in bad faith.

[261] *Science and Technology Hearings*, *supra* note 16, at 155, 162 (statement of William Baxter); *see also id.* at 188 (statement of Ky Ewing, former Deputy Ass't Att'y Gen., Antitrust Div., Dep't of Justice).

[262] *Id.* at 163 (statement of William Baxter).

[263] *Id.* at 164–65.

[264] *Id.* at 35 (statement of John Lacey).

[265] *Id.* at 190 (statement of Ky Ewing).

[266] *Id.* at 185.

[267] *Id.* at 189 (statement of Ky Ewing).

Not all the experts have joined the call for reform. For example, Professor Joseph Brodley is critical of any assumption that government "antitrust enforcement has stymied research joint ventures."[268] Although Brodley opposes eliminating private treble damage actions, to the extent that private enforcement is a problem, limiting relief to injunctions and actual damages will still have a chilling effect.[269] Opposing "radical antitrust surgery" as both unneeded and undesirable, Brodley favors industry-specific exemptions based on findings that "socially vital research requires the joining of research effort in a particular industry," with the scope of the exemption tailored to the specific research need.[270] So far, this approach has gathered little legislative support.

VI. Conclusion

The United States needs to take affirmative steps to improve its competitiveness in the world economy. Legislation to encourage the formation of joint research ventures would be a step in the right direction, although it is by no means clear that America's economic problems can be attributed solely to declining levels of research and development.[271] Indeed, while the proportion of gross national product spent on research and development has been in decline since 1966, the United States still spends more both in relative and absolute terms on research and development than its principal trading rivals.[272]

The federal government funds approximately fifty percent of all research and development in the United States, mostly in defense and energy related areas.[273] Although defense related research and development can provide important spin-offs for the nondefense sector of the economy, emphasizing this type of research places America at a disadvantage vis-a-vis its economic rivals who concentrate their efforts on the civilian economy.[274] America's current lead in research and development expendi-

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[268] *Monopolies Hearings*, *supra* note 219 (statement of Prof. Joseph Brodley, Boston Univ. School of Law).

[269] *Id.*

[270] *Id.*

[271] *See* L. Thurow, The Zero-Sum Society 85–86 (1980). Productivity in the United States began its decline well before the downturn in R&D expenditures. *Id.*

[272] *See* I. Magaziner and R. Reich, Minding America's Business: The Decline and Rise of the American Economy 53 (1982) (reduced public expenditures on defense and space programs are the principal cause of this decline in percentage of GNP devoted to research).

[273] *Id.* at 228, 350.

[274] *Id.* at 322, 350.

tures may therefore be illusory and, in any event, its competitors are not standing still in this area. For example, West Germany provides substantial and direct government support to private commercial efforts to develop new products and processes.[275] Similarly, the Japanese government, while relying less on direct financial support, also promotes and organizes long-term, large-scale research projects by private corporations and universities to develop commercial products and processes. Tax incentives, loan programs, and exemptions from Japan's Anti-monopoly Law provide an important stimulus to these endeavors.[276]

The pending legislative proposals seek to clarify the application of the antitrust laws to joint research and development ventures and to reduce their impact. Critics of these proposals have pointed out that the antitrust laws are already clear and also are quite tolerant of joint research ventures. The critics are correct that, empirically speaking, the antitrust laws have not treated joint research ventures harshly. On the other hand, business's perception that the antitrust laws inhibit the formation of joint research ventures is significant, regardless of the accuracy of that perception.

Of course, the great unsettled issue that underlies this entire debate is whether a relaxation of the antitrust laws in order to encourage joint research ventures will in practice promote technological innovation. On the one hand, cooperation is required because the great expense and risks of many research projects place them beyond the reach of most individual companies. On the other hand, there is the danger that the displacement of individual centers of initiative in favor of large research conglomerates will promote an ineffective, monolithic approach. Moreover, if cooperation becomes the vogue, the incentive to innovate and thereby secure a competitive advantage over one's rivals will be diluted.[277]

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[275] *Id.* at 279–82.

[276] *Id.* at 282–84. According to Magaziner and Reich:

> Increasingly, in Germany, Japan, and France, projects are funded at the initiation of companies that put up a share of the total budget. Consideration is given to the international competitive environment for the products that might be generated from the research efforts. Funds are often divided among companies so that each can pursue a different technological solution to a common problem and then share the information with the others. Commercialization of the innovation, however, is competitive.

Id. at 322.

[277] *See Science and Technology Hearings*, *supra* note 16, at 269 (statement of Steven J. Olson) ("[W]e should be looking for ways to achieve the integrated, high volume operations we need without sacrificing the diversity we value.").

There is little likelihood that joint research ventures will negatively affect research efforts. In today's international economy, if American companies purposefully seek to retard the pace of technological innovation, they will fall easy prey to their foreign competitors. As the prominent liberal economist Lester Thurow has written, "[i]n markets where international trade exists or could exist, national antitrust laws no longer make sense. If they do anything, they only serve to hinder U.S. competitors who must live by a code that their foreign competitors can ignore."[278]

The proposed legislation can hardly be said to abolish the antitrust laws. It essentially codifies existing case law, although with some significant changes. For example, the legislation does not recognize the distinction in the Justice Department's *Research Guide* between basic and applied research. This change is highly appropriate in light of the purpose of the legislation—to promote the competitiveness of American industry—because it maximizes the potential commercial utility of such ventures. As the Japanese have convincingly demonstrated, applied research is at least as important to competitive success as basic research. Indeed, only if basic research can be successfully converted into marketable technology will economic incentives exist for private firms to invest in research and development.

The private sector cannot be expected to invest substantial sums in research if it is not permitted to profit from the results. Although widespread dissemination of research information can have a very salutory effect on the rate of innovation, the opposite may also hold true, as the existence of patent laws implicitly acknowledges. From a public policy perspective, the restoration of America's international competitiveness is of paramount concern. Open access for foreign firms may work against this goal, particularly when foreign countries do not reciprocate with similar access. While American businessmen complain that they are forced to adhere to unduly restrictive antitrust constraints at home, our major trading partners are actively encouraging collaboration in research and development within their borders.

The legislative proposals are innovative in distinguishing foreign firms from domestic ones in terms of access rights; access rights are conditioned on the foreign firm's parent nation offering American companies equivalent rights. While this is a step in

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278 L. THUROW, *supra* note 271, at 146.

the right direction, the legislation should instead provide that foreign firms will not be entitled to access to the joint venture or its results unless the parent nation accords similar opportunities to American firms operating in its country. Otherwise, the purpose behind this type of provision would be entirely frustrated if it turned out that the foreign country afforded no mandatory access rights to its own companies. The rights of the venturers to secure their just rewards, and the general benefits which ensue from the widespread dissemination of technology, should both be recognized. For the former, a specific time period during which the participants will be entitled to exclusive use of the venture's technology should be set. This should then be followed by relatively liberal licensing requirements, unless circumstances dictate an extension of the exclusive use period.

Placing market share restrictions on the size of the venture, subject to exceptions based on pressing national needs, accomplishes two important goals. First, it ensures that there will be competing sources of initiative in any research area, while at the same time permitting the realization of necessary economies of scale. Second, in allowing for exceptions based on national need, it provides a flexibility, that the current law lacks, as well as a useful targeting mechanism. In principle, the size of joint ventures could be unrestricted, provided that the participants committed themselves to pursuing different avenues of investigation, to maintaining substantial independent research efforts, or to placing a certain number of outside directors on the venture's management board. The legislation should also facilitate the exchange of basic information between competing joint ventures, an approach consistent with the Japanese model.[279]

An important aspect of the legislation is that it provides joint research ventures with a "zone of certainty" or "safe harbor" if they certify that they are complying with the terms of the law. To implement this provision, the legislation specifies various types of procompetitive and anticompetitive standards to which the venture must comply. Clear legislative standards are a virtue if they can be identified. If the most egregious per se type violations, such as restrictions on research output or price fixing, are specifically prohibited in the legislation, the venture would know clearly what it could not do. Beyond that, it should

[279] I. MAGAZINER AND R. REICH, *supra* note 272, at 322.

otherwise be free to conduct its own affairs without outside interference.

Although the certification process should be nonadversarial and joint research ventures considered presumptively valid, the venture ought not receive immunity immediately upon filing the requisite notices. Nor, however, should the venture be required to await an affirmative determination of the Attorney General based on a lengthy investigation before receiving protection. Rather, the legislation should simply provide that if the Attorney General registers no objection within a specified time (thirty or sixty days), a certificate of immunity will issue automatically. Such a provision would be administratively simple, cause little inconvenience to the venturers, and afford the government an opportunity to scrutinize the venture before immunity attached. The issuance of a certificate should not be subject to judicial review, although the parties ought to have the right to challenge a negative determination which, of course, would not be tantamount to a finding of illegality under the antitrust laws. The Attorney General should have the right to conduct an investigation into the venture's activities at any time, subject to appropriate procedural safeguards, and to revoke or modify the certificate of immunity, subject to judicial review.

Furthermore, the legislation should afford the parties maximum protection against the disclosure of confidential business information submitted to the government so as to encourage use of the self-certification procedure.

Finally, if a joint research venture "qualifies," the immunity from civil and criminal prosecution that attaches should be absolute rather than limited. The per se rule should also be formally eliminated from joint research and development cases. Moreover, the awarding of attorneys' fees should be required if the joint venture is sued unsuccessfully in connection with activities specified in its certificate. Although these measures constitute substantial changes in the present system, they are highly consistent with a policy of encouraging the formation of joint research ventures. Whether nonqualified joint research ventures should be entitled to protection from treble damages actions is more problematic. While such a provision might make sense under the Administration's simple notice approach, it could undermine the utility and effectiveness of the self-certification process contained in the other proposals. The self-certification process also renders such a proposal superfluous for procompetitive joint research ventures that resort to the system. Still, if joint research and development ventures are as necessary and desirable as they appear, eliminating the threat of treble damages would not be inappropriate.

Regardless of whether nonqualified joint research ventures are exempted from the threat of treble damages, the statute should mandate rule of reason analysis and provide these ventures an affirmative defense for meeting foreign competition. While such a defense is less desirable than the general grant of immunity afforded qualified joint ventures, at least it explicitly recognizes and addresses the very problem which sparked the legislative debate in the first place. There is precedent for such a defense. The Bank Merger Act of 1966 permits otherwise anticompetitive mergers to proceed if these efforts "are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served."[280] Thus, a nonqualified joint research venture could be given carefully tailored, limited protection in its efforts to meet the threat of foreign competition.

Legislation along these lines will not be a panacea. In the words of Harvey Brooks, "I doubt whether this measure alone is an adequate response to the Japanese challenge, but it seems almost certain that its effects will be positive."[281] Competitive success requires more than research and development. These legislative proposals are merely one component of what must be a larger effort to restore America's competitive advantage.

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[280] 12 U.S.C. § 1828(5)(B) (1982). Joint newspaper operating ventures can also receive an exemption from the antitrust laws if the venture is necessary to the survival of one or both papers. *See* 15 U.S.C. § 1803 (1982).

[281] *Science and Technology Hearings*, *supra* note 16, at 19 (statement of Prof. Harvey Brooks).

ARTICLE

PUBLIC PREFERENCE AND THE RELICENSING OF HYDROELECTRIC PROJECTS

MARC R. POIRIER*
JANE HARDIN**

Privately owned utilities hold most of the licenses to major hydroelectric projects. As these licenses begin to expire, however, the publicly owned utilities will have the opportunity to bid for these same projects and others. Current law gives the publicly owned utilities a preference over privately owned utilities in relicensing proceedings. H.R. 4402 has been introduced to change this preference, so that the privately owned utilities would be almost certain to obtain a new license. This Article explores the justifications for this bill and the main policy reasons for maintaining the current public preference.

Congress is currently considering a bill, House of Representatives Bill No. 4402 (H.R. 4402),[1] which would revise Part I of the Federal Power Act (FPA)[2] to ensure that existing licensees of hydroelectric generating projects receive consideration ahead of all competing applicants in the renewal of their licenses. Under present law, if the federal government chooses not to take over a hydroelectric project, a publicly owned utility is given preference over an existing licensee in obtaining the new license. As licenses for the major privately owned hydroelectric projects begin to expire, the privately owned, investor-owned utilities and publicly owned electric systems have been drawn into an increasingly angry controversy over whether and to what extent the granting of preference to publicly owned utilities applies at the relicensing stage. The investor-owned utilities have taken the issue to Congress and are now promoting the passage of H.R. 4402.

This Article examines the policy reasons for rejecting H.R. 4402 and for continuing to support the public preference that is now law. The leading counter-arguments put forward by the

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[1] H.R. 4402, 98th Cong., 1st Sess., 129 CONG. REC. E5708 (daily ed. Nov. 18, 1983).
[2] 16 U.S.C. §§ 791–823 (1982).

investor-owned utilities are also explored. The Article suggests that the present controversy is part of a larger movement to reverse this country's traditional support of public preference in the allocation of hydroelectric power.

I. BACKGROUND

A. *The Current Public Preference Provision*

The right of publicly owned utilities to a mandatory preference in competitive relicensings is part of the general licensing scheme established by Part I of the Federal Power Act,[3] which is administered by the Federal Energy Regulatory Commission.[4] Licenses to develop or operate hydroelectric projects are issued for a term which by statute may not exceed fifty years.[5] When the original license expires, the federal government may take over the project;[6] if it decides not to do so, a new license is issued pursuant to section 15(a) of the FPA.[7] Generally, whenever an investor-owned utility and a publicly owned electric system compete for a particular license, the current law provides

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[3] Part I of the FPA was originally the Federal Water Power Act of 1920, ch. 285, 41 Stat. 1063. In 1935, when the FPA was introduced as Title I of the Public Utility Act of 1935, the Federal Water Power Act was revised slightly and incorporated into the FPA. Public Utility Act of 1935, ch. 687, §§ 201–213, 49 Stat. 803, 838–47 (codified as amended at 16 U.S.C. §§ 791–823 (1982)).

[4] FPA § 4(e), 16 U.S.C. § 797(e) (1982), authorizes the Commission

> [t]o issue licenses to citizens of the United States, or to any association of such citizens, or to any corporation organized under the laws of the United States or any State thereof, or to any State or municipality for the purpose of constructing, operating, and maintaining dams, water conduits, reservoirs, power houses, transmission lines, or other project works necessary or convenient for the development and improvement of navigation and for the development, transmission, and utilization of power across, along, from or in any of the streams or other bodies of water over which Congress has jurisdiction under its authority to regulate commerce with foreign nations and among the several States, or upon any part of the public lands and reservations of the United States (including the Territories), or for the purpose of utilizing the surplus water or water power from any Government dam.

[5] *Id.* § 6, 16 U.S.C. § 799.

[6] *Id.* § 14(a), 16 U.S.C. § 807(a). Any federal department or agency may recommend, between two and five years before the license expires, that the United States take over the project. Procedures Relating to Takeover and Relicensing of Licensed Projects, 18 C.F.R. § 16.8 (1983). The Commission in turn may make a recommendation to Congress, *id.* § 16.9, which ultimately may enact legislation, *id.* § 16.11. In fact, we are not aware of any such proceedings under this section in the more than 60 years since the Federal Water Power Act was enacted. The provisions of § 14 do not apply to licenses held by states and municipalities. 16 U.S.C. § 828(b) (1982) (not codified as part of the FPA).

[7] FPA § 15(a), 16 U.S.C. § 808(a) (1982).

that the Commission must choose the application of a state or municipality[8] over the application of any other entity, as long as the state's or municipality's plan is or can be made to be equally well adapted to "conserve and utilize in the public interest the water resources of the region."[9]

B. *Current Litigation on the Application of the Public Preference Provision in Relicensing*

Whether the section 7(a) public preference applies to relicensing has become a current subject of litigation. In 1978, two municipalities filed competing applications for two valuable projects whose licenses were expiring.[10] In a consolidated hearing, they asked the Commission for a declaratory order to clarify whether the FPA contained a public preference over all private applicants for the new license, including the original licensee.[11] Because of the importance of the declaratory judgment, some of the largest investor-owned utilities intervened in the *City of Bountiful* case.[12] The investor-owned utilities argued that

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[8] *Id.* § 3(7), 16 U.S.C. § 796(7), defines "municipality" to include cities, counties, irrigation districts, drainage districts, and other political subdivisions or agencies of the state, so long as they are competent under the laws of the state to carry on the business of developing, transmitting, utilizing, or distributing power. In this Article, "municipality" and "public system" will be used to refer to all such political subdivisions unless otherwise noted. Because states historically have not played a major role in developing hydroelectric power, we focus primarily on municipal systems. Rural electric cooperatives, an important type of nonprofit electric system, are not considered "municipalities" for purposes of § 7(a). Carolina Power & Light Co., 55 F.P.C. 1272, 1274 (1976).

[9] FPA § 7(a), 16 U.S.C. 800(a) (1982), provides:

> In issuing preliminary permits hereunder or licenses where no preliminary permit has been issued and in issuing licenses to new licensees under section 15 hereof the Commission shall give preference to applications therefor by States and municipalities, provided the plans for the same are deemed by the Commission equally well adapted, or shall within a reasonable time to be fixed by the Commission be made equally well adapted, to conserve and utilize in the public interest the water resources of the region . . . .

[10] The city of Bountiful, Utah, applied for the Weber River Project, and the city of Santa Clara, Cal., applied for the Mokelumne River Project. *See* City of Bountiful, Utah, 11 F.E.R.C. ¶ 61,337 (1980), *aff'd sub nom.* Alabama Power Co. v. FERC, 685 F.2d 1311 (11th Cir. 1982), *cert. denied*, 103 S. Ct. 3573, *cert. denied*, 103 S. Ct. 3574 (1983).

[11] The Commission stated the principal issue as: "Does the preference provided in Section 7(a) of the Act for a state or a municipality apply in a relicensing proceeding under Section 15 of the Act against an original licensee that is neither a state nor a municipality?" *Id.* at 61,710.

[12] In addition to Utah Power & Light Co. and Pacific Gas & Elec. Co., the old licensees, intervenors included Pacific Power & Light Co., Carolina Power & Light Co., the Montana Power Co., Wisconsin Power & Light Co., Georgia Power Co., Niagara Mohawk Co., and a Hydro-electric Utility Company Group formed specifically for the *Bountiful* proceeding, composed of 34 electric utilities. *Id.* at 61,710, 61,738 n.14.

Congress did not intend the public preference to apply against the *original* licensee. Following a full day of argument, the Commission interpreted the statute to grant publicly owned systems a full and mandatory preference.[13] The Eleventh Circuit affirmed the Commission's decision,[14] and the Supreme Court denied certiorari.[15]

The effect of the *Bountiful* decision was put in doubt by the *Merwin* decisions, the first of which, *Pacific Power and Light Co. (Merwin I)*,[16] was heard in September 1982. In that case, two utility districts formed a joint action agency and filed a license application for the Merwin project on the Lewis River near Mount St. Helens in the state of Washington. The proceeding presented several issues that had to be resolved before relicensing to a competing publicly owned system could occur, including (1) the elements of net investment and severance damages; (2) the definition of "public interest"; and (3) the effect of relicensing to a new licensee on the coordination of projects. The presiding administrative law judge held in favor of the municipal preference applicants on these three major issues in

The International Brotherhood of Electrical Workers also intervened in support of this group. *Id.* at 67,710.

Public power interests participating, in addition to the cities of Bountiful and Santa Clara, were the city of Shawano, Wis., the Clark-Cowlitz Joint Operating Agency (composed of two public utility districts from Washington State), the Northern California Power Agency (a group of California municipalities), and the American Public Power Association, a national service organization of more than 1400 consumer-owned utilities. *Id.*

[13] *Id.* at 61,711.

[14] Alabama Power Co. v. FERC, 685 F.2d 1311 (11th Cir. 1982), *cert. denied*, 103 S. Ct. 3573, 103 S. Ct 3574 (1983).

[15] Alabama Power Co. v. FERC, 103 S. Ct. 3573 (1983); Pacific Gas & Elec. Co. v. FERC, 103 S. Ct. 3574 (1983). Justices White and Blackmun would have granted certiorari. *Id.*

The Commission changed its mind while the case was on review. Its brief to the Supreme Court on certiorari stated, "the Commission now wishes to reconsider the case and . . . the majority of the Commissioners appear to be ready to overrule Opinion Nos. 88 and 88A [*Bountiful*] and adopt the contrary position." Brief of the Federal Energy Regulatory Commission at 9, Alabama Power Co. v. FERC, 103 S. Ct. 3573 (1983). The Commission asked the Court not simply to deny certiorari, but to remand the case to the Eleventh Circuit in order to allow that court to remand to the Commission "for a new order setting out and explaining the Commission's current views." *Id.* at 10. This brief, signed by the Solicitor General, tempered an even more extreme position reportedly taken by the Commissioners at a closed meeting, in which they instructed the Solicitor General to ask the Supreme Court to remand the case directly to the Commission. ELEC. UTIL. WEEK, May 2, 1983, at 1. The Commission's refusal to release the transcript of this meeting is now being challenged in court. Clark-Cowlitz Joint Operating Agency v. FERC, No. CA83-1842, slip op. (D.D.C. Sep. 14, 1983), *appeal docketed*, No. 83-2111 (D.C. Cir. Oct. 17, 1983).

[16] Pacific Power & Light Co., 23 F.E.R.C. ¶ 63,037 (*Merwin I*), *rev'd*, 25 F.E.R.C. ¶ 61,052 (1983) (*Merwin II*), *appeal docketed sub nom.* Clark-Cowlitz Joint Operating Agency v. FERC, No. 83-2231 (D.C. Cir. Nov. 29, 1983).

Merwin I.[17] The Commission, however, reversed the administrative law judge's decision in *Merwin II*.[18] Over strong dissents, three of the five commissioners explicitly reversed the statutory interpretation that had been established in the *Bountiful* decision and upheld by the courts.[19] In the second part of its *Merwin II* decision, the Commission held unanimously that, in any event, the application of the particular original investor-owned utility was superior to that of the competing utility district, so that there was no need to consider public preference as an additional factor.[20] The Commission also issued guidelines as to the "public interest" factors that should be taken into account in future proceedings involving competitive relicensing.[21] The Commission's *Merwin II* opinion is currently being appealed.[22]

C. *H.R. 4402: Proposed Amendment to the Public Preference Provision*

While the *Merwin II* litigation is continuing, the investor-owned utilities have turned to Congress and have mounted a campaign to promote H.R. 4402, the "Electric Consumers Protection Act of 1983."[23] The legislation, introduced by Represen-

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[17] *Id.*

[18] Pacific Power & Light Co., 25 F.E.R.C. ¶ 61,052 (1983) (*Merwin II*), *appeal docketed sub nom.* Clark-Cowlitz Joint Operating Agency v. FERC, No. 83-2231 (D.C. Cir. Nov. 29, 1983). In addition, the cities of Santa Clara and Bountiful have asked the Eleventh Circuit to enforce its mandate in *Bountiful* against the Commission, which overruled *Bountiful* in *Merwin II*. Alabama Power Co. v. FERC, No. 80-7641 (11th Cir. filed Dec. 2, 1983) (motion for enforcement of mandate).

[19] *Merwin II*, 25 F.E.R.C. at 61,175–85.

[20] *Id.* at 61,186–203. With regard to most factors the Commission was "unable to find any significant differences in the plans" of the two applicants. *Id.* at 61,196. It found that the public entities could buy power from the Bonneville Power Administration under the preference provisions of the Pacific Northwest Elec. Power Planning and Conservation Act, 16 U.S.C. §§ 839–839h (1982), whereas the investor-owned utility could not. The alternative cost of power was therefore higher than that of the public systems. The Commission concluded that on this basis the investor-owned utility's proposal was better adapted to serve the public's interest. *Merwin II*, 25 F.E.R.C. at 61,196–201.

[21] *See infra* note 74.

[22] Clark-Cowlitz Joint Operating Agency v. FERC, No. 83-2231 (D.C. Cir. filed Nov. 29, 1983). The appeal is being brought under FPA § 313(b), 16 U.S.C. § 825(b) (1982).

[23] H.R. 4402, *supra* note 1. For privately owned utilities' lobbying activities in connection with the original 1920 act, see J. KERWIN, FEDERAL WATER POWER LEGISLATION 153, 208 (1926). The most recent product of the private utilities' campaign in favor of H.R. 4402 is an impressive booklet, EDISON ELECTRIC INSTITUTE, IN THE PUBLIC INTEREST: THE BENEFITS TO CONSUMERS FROM HYDROELECTRIC PROJECTS OPERATED BY INVESTOR-OWNED UTILITIES NOW AND IN THE FUTURE (1983) (available from Edison Electric Institute, 1111 19th Street, N.W., Washington, D.C. 20036) [hereinafter

tative Richard Shelby (D-Ala.), would revise section 15(a) of the FPA so that if the federal government did not take over a hydroelectric project, the Commission would be required to reissue a new license to the original licensee unless the licensee's project would not be "best adapted to a comprehensive plan for . . . beneficial public uses."[24] H.R. 4402 would also change section 7(a) of the FPA so as to prevent it from being applied in any relicensing proceeding.[25] Because it would be difficult for a competing applicant to show that it could make better beneficial public use of an existing hydroelectric project, the bill would give a virtually unassailable preference to the original licensee. H.R. 4402 in effect allows the initial licensee to renew its license perpetually.

Congress must decide whether the control[26] and resulting benefit of currently licensed hydroelectric projects will remain in private hands or be subject to relicensing proceedings that offer the possibility of transfer of control of these projects to the

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cited as EEI PAMPHLET]. This pamphlet was produced in response to the decision in *Bountiful.*

Although the *EEI Pamphlet* portrays the public preference provision as constituting a serious danger to the provision of all hydroelectric power, it is useful to delineate what is actually at stake in this controversy. The public preference will immediately affect only 3000 megawatts, or 3.6% of the nation's total generating capacity. *Id.* at 42. This figure represents the sum of the generating capacity of all the projects whose licenses will expire between now and 1993, the period most immediately affected by H.R. 4402. In addition, not all of these projects are alike. Although the investor-owned utilities note that approximately 168 projects will be up for relicensing in this period, 10 of these projects account for half of the total capacity. *Id.* at 10. Thirty-two account for more than two thirds of the total capacity. *Id.* In other words, certain specific utilities are most affected by the public preference provision and have the most to gain from passage of H.R. 4402.

The American Public Power Association, the trade organization for municipal electric systems, produced a booklet in response to the private utilities' lobbying efforts. AMERICAN PUBLIC POWER ASS'N, CONSUMERS, COMPETITION AND THE PUBLIC INTEREST: THE CASE FOR PREFERENCE IN RELICENSING OF HYDROELECTRIC PROJECTS (1983) (available from American Public Power Ass'n, 2301 M Street, N.W., Washington, D.C. 20037). A group of municipally owned utilities that applied for two large projects now operated by Pacific Gas & Elec. Co. also produced a brochure. NEW BEGINNINGS: ROCK CREEK-CRESTA AND HAAS-KINGS RIVER HYDROELECTRIC RELICENSING (1983) (available from Northern Cal. Power Agency, 8421 Auburn Blvd., Suite 160, Citrus Heights, Cal. 95610).

[24] FPA § 10(a), 16 U.S.C. § 803(a) (1982); *see* H.R. 4402, *supra* note 1, § 3.

[25] H.R. 4402, *supra* note 1, § 2.

[26] Control and resulting benefit, not ownership, is the issue under H.R. 4402. The federal government *owns* the resource, including the mechanical power generated by the flow of water. United States v. Appalachian Power Co., 311 U.S. 377, 424 (1940); *see also* United States v. Twin City Power Co., 350 U.S. 222 (1956) (United States' interest in navigable waterways overrides any conflicting or competing interest, and requiring the United States to pay for the water power used would be to subvert the public domain nature of the waterways); United States v. Chandler-Dunbar Co., 229 U.S. 53 (1913) (the navigable waters of the United States are public property, and the use of such water for power and transportation is acceptable).

publicly owned utilities.[27] The main arguments for maintaining the current public preference provision are the following: (1) the public interest referred to in section 7(a) of the FPA was originally intended to result in ultimate public control of the water resource; (2) public control allows the benefits of hydroelectric projects to accrue directly to consumers; (3) public control will foster competition in the electric generating industry, which serves the public interest by lowering rates and improving company performance; and (4) competition at the relicensing stage produces a project more attuned to the public interest. The investor-owned utilities' main arguments against maintaining the public preference provision are the following: (1) it will increase costs to consumers; (2) it will be difficult to coordinate projects along a single river system if the owners differ; (3) there will be a reduction in the locality's tax base if the privately owned utility moves out; and (4) the public interest is best served if the largest utilities with the most customers are allowed to maintain control of the existing hydroelectric projects. These arguments are addressed in detail below.

D. *The Particular Value of Hydroelectric Generation*

Hydroelectric projects are a particularly desirable form of generation for electric utilities. A major benefit of hydroelectric projects is that they supply electricity at costs lower than the costs of fossil or nuclear generation. This lower cost results from several factors. First, hydroelectric projects are essentially insulated from fuel costs and the uncertainties of fuel supply. Second, once the capital costs of installing the plant are incurred, the projects are inexpensive to operate and maintain. Third, although some environmental issues may arise, such as the effect on anadromous fish populations, hydroelectric proj-

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[27] The existence of a public preference provision will not immediately affect all licensed hydroelectric projects. Also, it should not be assumed that all expiring licenses will be challenged by applicants entitled to preference. The *EEI Pamphlet* fails to mention the large number of new licenses already issued for which no competing application was ever filed. *E.g.*, Alabama Power Co., 13 F.E.R.C. ¶ 62,082) (1980) (100 megawatts); Southern Cal. Edison Co., 4 F.E.R.C. ¶ 61,147 (1978) (154 megawatts).

In the past, few licenses that have expired have been challenged. As public utilities become more aware of the opportunity to exercise their preference right, the number of challenges will undoubtedly grow. There is nothing, however, to suggest that there will be an overwhelming number of applications. Rather, a selected number of utilities that have depended on substantial amounts of hydroelectric generation from projects operated pursuant to federal licenses may expect a challenge as their licenses expire.

ects do not emit harmful environmental pollutants or generate radioactive waste storage and disposal problems. Fourth, the projects are generally safe, except for the risk of dam collapse. A different type of cost advantage is that hydroelectric projects can be turned on and off like a water tap. Other major types of electric generation are less flexible, requiring more time to become operational or to shut down. Hydroelectric generation thus allows an electric utility to meet the demand at peak periods of the day without investment in other, more costly peaking generation.

In addition to the general advantages of hydroelectric power, applying for a new license at a previously licensed site is particularly attractive. Even where a new site with potential for development exists, the risks of constructing a new project are greater than those of obtaining a license at a proven, developed site. In addition, the FPA strictly defines what the new licensee must pay the original licensee for the project.[28] Thus, it is possible, in the extreme case, to obtain a project in 1983 at 1933 prices. While this set formula may seem unfair to the original licensees, it was in fact a concession made to the private power interests at the time the original legislation was passed.[29]

II. Arguments for Maintaining the Public Preference Provision

A. *Public Preference Was an Integral Part of the National Water Power Development Plan.*

Legislative concern for a federal water power policy that would keep water resources in the hands of the public dates back to 1901.[30] A primary political concern of the early twen-

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[28] FPA § 14(a), 16 U.S.C. § 807(a) (1982), requires the federal government

> before taking possession [to] pay the net investment of the licensee in the project or projects taken, not to exceed the fair value of the property taken, plus such reasonable damages, if any, to property of the licensee valuable, serviceable, and dependent as above set forth but not taken, as may be caused by the severance therefrom of property taken.

Id. § 15(a), 16 U.S.C. § 808(a), requires any new licensee to make payment under the same standard. "Net investment" is defined in § 3(13) of the FPA, 16 U.S.C. § 796(13), as actual legitimate original cost, less certain items of depreciation.

[29] *See* J. Kerwin, *supra* note 23, at 257.

[30] Revocable Permit Act of 1901, ch. 372, 31 Stat. 790 (current version at 16 U.S.C. § 79 (1982)).

Two indispensable studies of water power legislation are S. Hays, Conservation tieth-century United States was to control the giant private monopolies, which were able to operate outside the competitive restraints of the free market. The same year that the federal water power debates began in 1914, Congress, believing that the Supreme Court had gutted the Sherman Act,[31] passed the Clayton Act,[32] its second major piece of antitrust legislation.[33] Only two years before, the Commissioner of the Bureau of Corporations (the predecessor to the Federal Trade Commission) issued a detailed report documenting the extent to which private monopolies controlled this country's developed water power and undeveloped water power sites.[34] This important study helped provoke congressional consideration of federal water power legislation.[35]

Congress's fear that private monopolies were seeking control of the United States' natural resources — oil, gas, coal, and water power — is expressed in an early House report:

> Experience has taught us that in the past the private monopolization of natural opportunities has not only deprived the general public of their natural right to a proper share of the benefit which should accrue from them, but such monopolization has given to those possessing it a preponderance of influence and of power in our industrial and civic life which is little short of a menace to our institutions.
>
> We have awakened none too soon to the necessity of preserving under public control these great natural opportunities for the creation of wealth, which belong to the public and which would constitute a serious source of danger to equal liberty and fair opportunity if transferred in perpetuity to private ownership.[36]

A unifying characteristic of the House antimonopolists of the early twentieth century was their sense of an obligation to posterity. They viewed the struggle for control of water power development as the nation's last opportunity to develop a natural resource for the public good. Representative John Esch

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AND THE GOSPEL OF EFFICIENCY, THE PROGRESSIVE CONSERVATION MOVEMENT, 1890–1920 (1959), and J. KERWIN, *supra* note 23.

[31] 15 U.S.C. §§ 1–7 (1982).

[32] Clayton Act, ch. 323, 38 Stat. 730 (1914) (codified as amended at 15 U.S.C. §§ 12–27 (1982)).

[33] *See* E. KINTNER, FEDERAL ANTITRUST LAW § 18.2 (1983); W. THORNTON, COMBINATIONS IN RESTRAINT OF TRADE §§ 481–484 (1928).

[34] U.S. BUREAU OF CORPORATIONS, REPORT OF THE COMMISSIONER OF CORPORATIONS ON WATER-POWER DEVELOPMENT IN THE UNITED STATES (1912).

[35] *See, e.g.*, H.R. REP. No. 842, 63d Cong., 2d Sess. 11–12 (1914).

[36] *Id.* at 11.

(R-Wis.), who was to give his name to the final version of the federal water power legislation, expressed the application of this sense of obligation to water resources:

> Already we have largely lost our heritage as a Nation in the coal, gas, oil, timber and mineral lands with which we were so bountifully blessed. These are already in private ownership or in the control of the syndicates with right to exact such prices as they see fit . . . . We have no right to rob the next generation of its rightful inheritance. We have no right to transmit to it a natural resource whose ownership in private lands may prove burdensome and oppressive.[37]

The antimonopolist Congressmen accepted the immediate necessity of the development of water power by private water power companies. They did not want licenses, however, to be granted to already established monopolies, and they specifically intended to create legislation that would induce new companies to enter the water power industry.[38] The heart of their legislative plan was a leasing arrangement under which the use of water power would be leased to private companies for a limited number of years and under strict public controls; it was envisioned that at the end of a lessee's term a municipal or state system would in all likelihood be the new lessee.[39] Almost none of these antimonopolist representatives believed that direct ownership of these systems by the federal government would be a feasible means of exercising federal control.[40] The establishment of a preference for publicly owned utilities was, therefore, essential to the actual working of the legislative plan for which the progressives fought. The public preference was the device that would assure publicly owned utilities the use of the resource

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[37] 53 CONG. REC. 1515 app. (1916) (statement of Rep. Esch).

[38] The progressives opposed the existing water power legislation, *supra* note 30, on the grounds that it was a "chief bar" to competitive development. *See* H.R. REP. NO. 16, 64th Cong., 1st Sess. 5 (1915). The progressives argued that the government should have discretion to choose between qualified license applicants, while the conservatives wanted to require that the license go to the first qualified applicant. The progressives realized that the already existing monopolies would be better prepared to apply quickly and were concerned that the government would therefore be forced to award licenses to monopolists. *See* 53 CONG. REC. 3176–86, 3741–51 (1916); 51 CONG. REC. 13,698 (1914) (statement of Rep. Ferris (D-Okla.)).

[39] *See* H.R. REP. NO. 842, *supra* note 35; 51 CONG. REC. 13,622–29 (1914) (statement of Rep. Ferris); *see also* Rainy River Veto Message, 42 CONG. REC. 4698–99 (1908) (outlining the concept of a lease for a limited term with strong governmental controls).

[40] *See, e.g., Water Power: Hearings Before the House Comm. on Water Power*, 65th Cong., 2d Sess. (1918) [hereinafter cited as *1918 Hearings*]. *But see* 56 CONG. REC 10,477 (1918) (statement of Sen. Borah (R-Idaho)).

despite the position of already entrenched privately owned systems.[41]

Because of the continuing impasse between the progressive House and the conservative Senate,[42] the Wilson administration introduced its own bill,[43] which was based on earlier bills introduced by Representative Scott Ferris (D-Okla.).[44] Virtually every provision embodied the concepts for which the House antimonopolists had fought, including the provision establishing a public preference in relicensing. The administration's initial draft legislation contained the basic text of the public preference clause that is found in the law today.[45] Congress only strengthened and expanded the preference provision in subsequent deliberations.

A special House Water Power Committee, established at President Wilson's behest,[46] held extensive hearings in March and April of 1918 on the Wilson administration bill.[47] The hearings served primarily as a forum for the privately owned utilities to present their views. Without significant exception, the representatives of the major privately owned power companies accepted that the legislation would require the original licensee to reapply for a new license at the end of fifty years and that states and

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[41] Municipal preference was used as a device for providing competition in two earlier pieces of legislation. The Town Site Act of 1906, ch. 1631, 34 Stat. 116 (codified at 43 U.S.C. § 522 (1982)), authorized the Secretary of the Interior to "lease for a period not exceeding ten years" surplus electric power or power privileges from federally constructed dams, "giving preference to municipal purposes." *Id.* In 1913, Congress passed the Raker Act, ch. 4, 38 Stat. 242 (1913), which authorized the Hetch Hetchy hydroelectric development in Yosemite National Park and Stanislaus National Forest by the city of San Francisco. In making this grant, Congress required that hydroelectric power and water be made available directly to ultimate consumers through municipal agencies. *Id.* § 6, 34 Stat. at 245; *see* L. WHITE, THE RIGHT TO FEDERALLY GENERATED POWER, AN ANALYSIS OF THE PREFERENCE CLAUSE 7 (1979); *see also* United States v. City & County of San Francisco, 310 U.S. 16, 21–25 (1940) (discussing the legislative history of the public preference in the Raker Act).

[42] The basic concepts of the legislation were hammered out in these early years of debate. *See* H.R. REP. No. 16, 64th Cong., 1st Sess. (1915); H.R. REP. No. 842, 63d Cong., 2d Sess. (1914); 53 CONG. REC. 2572–84, 2635–53, 2689–702, 2805–08, 2861–87, 2960–84, 3057–66, 3121–40, 3169–91, 3225–44, 3282–307, 3346–78, 3412–26, 3429–31, 3487–90, 3520–42, 3599–620, 3664–87, 3724–58 (1916); 51 CONG. REC. 13,622–31, 13,671–704, 13,793–819, 13,931–58, 14,048–72, 14,138–54, 14,181–83 (1914).

[43] *See* S. 1419, 66 Cong., 2d Sess. §§ 7, 15 (1918); H.R. REP. No. 715, 65th Cong., 2d Sess. (1918) (text of both Wilson administration draft bills). See J. KERWIN, *supra* note 23, at 218–20, 223–40, for the curious history of the Wilson administration drafts.

[44] *See* H.R. REP. No. 408, 64th Cong., lst Sess. (1915); H.R. REP. No. 842, *supra* note 35; *see also 1918 Hearings*, *supra* note 40, at 450 (statement of Franklin K. Lane, Sec'y of the Interior) (describing Ferris bill as a direct forerunner of these bills).

[45] *See infra* note 54 for text of provisions.

[46] J. KERWIN, *supra* note 23, at 217–18.

[47] *1918 Hearings*, *supra* note 40.

municipalities would have a preference in that relicensing process. The statement of John Britton, vice president and general manager of Pacific Gas & Electric Company, reflected the prevailing attitude of the utilities. After suggesting several fairly minor changes in the bill, Britton noted:

> With these exceptions, may I say this, that after a study of water-power legislation, extending over many years, and having been more or less active before Congress in all of these matters, the bill as presented to you gentlemen, with such minor suggestions or changes as are required to encourage development, is as nearly a workable bill as I have ever seen, and I sincerely hope for the benefit of the United States in general, and power men in particular, who have been struggling to produce energy at the lowest possible cost, that a bill substantially of this nature be adopted by this Congress.[48]

None of Britton's changes related to municipal preferences.[49]

Representative Thetus Sims (D-Tenn.), chairman of the committee, expressed his fear that the fifty-year "licenses will all practically become perpetual" because the federal government would be unable to afford to purchase the plants from the original licensee.[50] Britton agreed that the federal government would not purchase and operate the project because:

> I think that at that time, 50 years from now, we will find that the Government will be very glad to take it [the project] over for the purpose of turning it over to a municipality . . . . The Government don't [sic] have to take it over and I don't believe it will, but I do believe that most of these plants erected under these licenses, where they are applicable to a growing community, will be taken over by municipalities and operated by them, and not by the lessees.
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> . . . .
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> . . . If he [the lessee, i.e., the original licensee] is making a paying business out of it the Government will undoubtedly give preference at the end of the time, if he is making a good profit on it, to a municipality or somebody else who might want it and whom the Government preferred . . . .[51]

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[48] *Id.* at 229 (statement of John Britton).

[49] *Id.* at 226–29.

[50] *Id.* at 239 (statement of Rep. Sims).

[51] *Id.* at 239–40 (statement of John Britton). When Rep. Sims introduced the water power bill on the House floor, he quoted from the testimony of C.F. Kelley, a representative of Montana Power Co., to provide the description of how the section 7 public preference would operate:

> It would simply be a question of business succession; therefore it seems to one upon a basis of fair legislative policy, unless for cause shown some disqualifying

The Wilson administration bill contained a discretionary public preference clause that applied only to licensing. The House Water Power Committee strengthened the preference by extending it to "preliminary permits" as well.[52] During House debate, the preference clause was further strengthened by Representative Frank Doremus (D-Mich.), who successfully proposed that the preference be made mandatory.[53] No further substantive changes were made to the public preference clause in either the House or the Senate.[54]

It seems clear from the legislative history that Congress in 1920 conceived of public use of hydroelectric projects as an integral part of water power development policy. In its view, public control would best serve the public interest. Congress should not overturn this well-established concept and practice unless convinced that public control is no longer in the public interest.

A license granted pursuant to Part I of the FPA extends the privilege of developing and operating a particular water resource to a utility for the generation of hydroelectric power. In choosing the grantee of a hydroelectric license, the federal government must make the choice on the basis of the public interest.[55] This is as true in relicensing as in initial licensing decisions. The initial licensee has no more legitimate or protected interest in

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> reason exists, the original licensee should have the preference so far as subsequent licenses are concerned unless the Government or a municipality wishes to take over the project.

56 CONG. REC. 9037 (1918).

[52] H.R. REP. No. 715, 65th Cong., 2d Sess. (1918).

[53] 56 CONG. REC. 9804–05 (1918).

[54] S. REP. No. 180, 66th Cong., lst Sess. 13 (1919). The Senate Committee on Interstate Commerce added the words "and in issuing licenses to new licensees under section 15 hereof" to § 7 so that it would read in pertinent part: "Sec. 7. That in issuing preliminary permits hereunder or licenses where no preliminary permit has been issued *and in issuing licenses to new licensees under section 15 hereof* the commission shall give preference to applications therefor by States and municipalities . . . ." *Id.* (emphasis in original). The Senate report contains no explanation of the wording, but it was evidently derived from a letter to Sen. Jones (R-Wash.) from Gifford Pinchot, a leading progressive and president of the largest proconservation lobby in the country, the National Conservation Association. None of the progressives who had fought since 1914 for public preference treated these changes as anything but minor clarifications of the bill. *See* Merrill, *Benefits Accruing to the Municipalities Through the Federal Water Power Act*, in THE AMERICAN CITY 476 (1920).

[55] Generally speaking, "the grant of a license, being a privilege from the sovereign, can be justified only on the theory of resulting benefit to the public." Northern States Power Co. v. FPC, 118 F.2d 141, 144 (7th Cir. 1941), *quoted in* Alabama Power Co. v. FPC, 128 F.2d 280, 288–89 (D.C. Cir. 1942); *accord* California v. FPC, 345 F.2d 913, 923 (9th Cir. 1965).

the power site than any other potential licensee.[56] Relicensing offers a new opportunity to evaluate the best way to allocate the publicly owned resource in the public interest.

B. *Public Ownership for Public Resources*

Privately owned utilities are owned by shareholders; publicly owned utilities are owned by local or regional government. Since the latter have no shareholders, these utilities are responsible only to their consumers and can pass on the benefits of hydroelectric power directly to them. Economists seem to agree that consumers pay less to municipally owned systems, although there is debate as to the underlying causes.[57]

Public control benefits the locality as well as consumers. Development of water resources under local control allows the people of the locality to profit from their immediate region. These people have, or should be seen to have, an inherent claim to these benefits. Certainly, these claims are stronger than those of a corporation whose headquarters are hundreds of miles away and which pays interest and dividends to investors scattered throughout the country. Local development of the water resource also means that local interests affected by the project, such as fishing or boating groups, may have greater influence on how the resource is developed and operated. In theory, the Federal Energy Regulatory Commission is mandated to be receptive to the concerns of all such interests.[58] Nevertheless, local interests are likely to achieve better results when dealing directly with the operator of the project.

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[56] *Cf.* Susquehanna Power Co. v. State Tax Comm'n, 283 U.S. 291, 294 (1931) ("[T]he distinction has long been taken between a privilege or franchise granted by the government to a private corporation in order to effect some governmental purpose, and the property employed by the grantee in the exercise of the privilege, but for private business advantage.").

[57] *See* De Alessi, *Some Effects of Ownership on the Wholesale Prices of Electric Power*, 13 ECON. INQUIRY 526 (1975); Meyer, *Publicly Owned Versus Privately Owned Utilities: A Policy Choice*, 57 REV. ECON. & STATISTICS 391 (1975); Neuberg, *Two Issues in the Municipal Ownership of Electric Power Distribution Systems*, 8 BELL J. ECON. 303 (1977).

[58] An example of Congress's intent to protect local interests is found in FPA § 4(f), 16 U.S.C. § 797(f) (1982). This section requires that the Commission, before it grants a preliminary permit, give four weeks notice to any state or municipality likely to be interested in the project and to publish notice of such application in newspapers of the geographic area likely to be affected by the proposed project.

C. *Public Preference Fosters Competition in the Electric Utility Industry*

Competition is generally recognized in American economic theory as the preferred method of promoting economic efficiency. In some circumstances and industries, however, traditional competition is not effective. One such situation occurs when the economies of scale create a "natural" monopoly.[59] The retail sale of electric power involves such economies of scale because duplicating distribution lines is prohibitively expensive and disruptive. In this situation, regulation is commonly viewed as an alternative to competion. According to traditional ratemaking theory, the regulatory body sets a price for electricity that provides a rate of return sufficient to cover the utility's costs of operations plus a reasonable rate of return on the investment. This prevents monopoly pricing of electric service. Although rate regulation may keep prices below the monopoly level, however, it may not maximize a utility's efficiency. Because the utility is allowed to recover all of its costs plus a return on the rate base, there is an incentive to overbuild or overspend.[60] It is in this regard that competition can continue to serve an invaluable function to all electric utility customers.[61]

The courts and federal regulatory agencies have applied antitrust laws and policies to the electric utility industry in order to promote competition.[62] In most instances, these cases have concerned competition between publicly owned and privately owned systems. It may appear that there is no competition at the retail level for sale of electricity. Customers can easily de-

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[59] A natural monopoly has been said to exist when duplication of facilities would be inefficient and there are economies of scale such that least cost production is only possible by one firm satisfying the entire demand. *See* Essential Communications v. American Tel. & Tel., 610 F.2d 1114, 1116–19 (3d Cir. 1979).

[60] *See, e.g.*, Averch & Johnson, *Behavior of the Firm Under Regulatory Constraint*, 52 AM. ECON. REV. 1052 (1962).

[61] Moore, *The Effectiveness of Regulation of Electric Utility Prices*, 36 S. ECON. J. 365, 374 (1970), concludes that regulation is not effective in reducing the price of electricity, although he points out that it serves other functions, such as diminishing the arbitrary power of a monopoly or allowing an easy and cheap method of dispute resolution with customers.

[62] *See, e.g.*, FPC v. Conway Corp., 426 U.S. 271 (1976); Gulf States Utils. Co. v. FPC, 411 U.S. 747 (1973); Otter Tail Power Co. v. United States, 410 U.S. 366 (1973); City of Mishawaka v. American Elec. Power Co., 616 F.2d 976 (7th Cir. 1980), *cert. denied*, 449 U.S. 1096 (1981); Florida Power & Light Co., 8 F.E.R.C. ¶ 61,121 (1979); Alabama Power Co., 13 N.R.C. 1027 (1981), *aff'd*, 692 F.2d 1362 (11th Cir. 1982); Toledo Edison Co., 10 N.R.C. 265 (1979); Consumers Power Co., 6 N.R.C. 892 (1977).

cide to change their brand of cigarettes, but they cannot, without moving, change the utility from which they buy electricity. Nevertheless, several types of competition generally exist in the retail electricity market. Consumers compare their electric rates and services with the rates and services offered by neighboring electric utilities. When they find the comparison unfavorable, they may put pressure on their utility to lower its rates or improve its service. This type of "yardstick competition"[63] creates pressure to perform efficiently. If enough dissatisfaction develops, there may be a move to change the utility serving an entire area, creating "franchise competition."

Competition can in theory occur between any two electric utilities in the same general geographical area. In practice, investor-owned utilities rarely compete with each other. In contrast, they frequently compete with municipal and cooperative electric utilities. Most investor-owned electric utilities are larger than publicly owned utilities in service area, customers, revenues, and generating capacity.[64] The privately owned utilities often regionally coordinate their energy dispatch, reserve management, and plans for power supply and transmission.[65] In many ways they function as regional oligopolies and are generally loathe to upset each other's apple carts by overt competition. Although changes in transmission technology have made interutility transfers of power, and hence competition, more economical,[66] less efficient utilities are often reluctant to cooperate with competitors who would take away their customers.[67]

In contrast, municipal and cooperative utilities usually represent small islands of service territory within or next to an investor-owned utility area. Active competition between the two systems in the border areas may occur. In addition, the threat of a takeover exists in competition between publicly owned and

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[63] The term "yardstick competition" is used to describe several interrelated, but distinct, phenomena. For example, it describes the phenomenon of a regulatory commission's using a public system's costs and rates in setting the rates for a private system. It may also describe consumers' comparisons of rates charged by different systems. It may also describe the moderating effect of potential public competition on the behavior of private firms. *See* Harrison, *Yardstick Competition: A Prematurely Discarded Form of Regulatory Relief*, 53 TULANE L. REV. 465, 467 (1979); 2 A. KAHN, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS 104–06, 319 (1971).

[64] OFFICE OF ELECTRIC POWER REGULATION, FERC, POWER POOLING IN THE UNITED STATES 5–6 (1981) [hereinafter cited as POWER POOLING].

[65] *Id.* at 6.

[66] 2 A. KAHN, *supra* note 63, at 318.

[67] *See* Comment, *A Proposal to Increase Access to Electric Transmission Services*, 20 HARV. J. ON LEGIS. 227, 229 (1983).

privately owned utilities. Customers who become disgruntled with the rates charged by a municipally owned or cooperative system can seek a voter referendum to sell the system. Disgruntled investor-owned utility customers may be able to change the utility to a publicly owned system, although they will face greater political and financial constraints.[68]

A history of antagonism strengthens competition between investor-owned utilities and publicly owned utilities. Publicly owned systems are frequently dependent on investor-owned utilities for power, backup, transmission, or other services.[69] Thus the publicly owned systems have often been subject to what they view as abuses designed to keep them as captive customers or weaken them so as to facilitate a takeover by the investor-owned utilities. In many instances, privately owned utilities view publicly owned utilities as problems, troublemakers, or threats.[70] The antagonism of the privately owned utilities toward the publicly owned systems is virtually as old as the industry itself.

Because publicly owned utilities serve as a source of competition to privately owned utilities, they fill a vital role for *all* customers. The threat of losing an area to another company, or alternatively, the prospect of gaining an area served by another system, creates an incentive to lower rates and to provide more efficient service. This state of affairs was described by Professor Alfred E. Kahn:

> [T]here is strong evidence in the public utility arena that *competition between* the two systems of organization [government-owned and private enterprise], is highly conducive to improved performance. It may take the form of direct rivalry (for the patronage of the same customers in the same market); or of competition-by-example (where comparisons may be drawn between the performances of private and public enterprises in serving their respective customers, in

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[68] The successful creation of a new publicly owned utility is a rare event. For example, the Town of Massena, N.Y., voted in 1975 to establish a municipal electric system. After years of litigation and negotiation, it finally established its system in 1981. *See* Town of Massena, N.Y. v. Niagara Mohawk Power Corp., 13 F.E.R.C. ¶ 63,036 (1980). In the service area of Otter Tail Power Co., 12 towns considered transferring to municipal service between 1945 and 1970. Otter Tail Power Co. v. United States, 410 U.S. 366, 370 (1973). Three succeeded in doing so. *Id.*

[69] *E.g.*, Otter Tail Power Co. v. United States, 410 U.S. 366, 370 (1973). Only about one fourth of all publicly owned utilities generate any of their own power. The remaining three fourths purchase their full power requirements. POWER POOLING, *supra* note 64, at 6.

[70] *See, e.g.*, EEI PAMPHLET, *supra* note 23.

> different markets); or by threat of total displacement (where the management of each is aware that voters are examining its performance with the possibility of substituting one system of control for the other).
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> . . . The fact is that the competition-by-example or by threat of displacement by public enterprise has greatly improved the performance of this industry. The competition of public with private power has probably been a much more powerful influence than regulation in this respect, particularly in bringing about dynamic price reduction, sales promotion, and extension of service.[71]

The benefits of competition or potential competition between publicly owned and privately owned utilities justify the public preference. Publicly owned systems are generally small and disadvantaged in contrast to most privately owned systems,[72] yet the presence of these publicly owned systems is of value to all consumers, because the investor-owned utilities respond to the challenge of their rates by operating more cheaply and efficiently. Preference in the allocation of hydroelectric licenses provides a valuable resource and support for these publicly owned utilities. A basic argument in support of preference, then, is that the resulting resource allocation ensures that a particularly valuable economic structure — publicly owned electric systems — will be able to continue to present a strong challenge to the dominant privately owned electric systems. All consumers will benefit from the efficiencies induced by the strengthening of competition in the industry.

D. *The "Bidding" Effect of Competition for New Licenses*

H.R. 4402 is fundamentally disruptive of the Federal Power Act because it vitiates the Act's use of limited-term licensing as a regulatory tool. H.R. 4402 would effectively eliminate competitive bidding at the relicensing stage of hydroelectric projects. The bill would require the Commission to issue the new license to the original licensee, provided that the original licensee is basically competent.[73] As a practical matter, that test would be hard to fail. Under the bill, the present licensee has the equivalent of a perpetual grant if it wants one.

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[71] 2 A. KAHN, *supra* note 63, at 104–06 (1971) (emphasis original) (footnotes omitted).
[72] *See, e.g.*, Toledo Edison Co., 10 N.R.C. 265, 327–85 (1979) (describing problems).
[73] *See* H.R. 4402, *supra* note 1, § 3.

The elimination of competitive bidding at the relicensing stage is not in the public interest. Competition for a finding that a particular proposal is "best adapted" to conserve, develop, and utilize the resource in the public interest encourages applicants to examine carefully how they can improve use of the resource and to negotiate with groups advocating particular interests.[74] In effect, they "bid" for the licenses by improving their proposals. Proceedings in recent competitive relicensings for two large California projects show how competitive bidding can operate well under the present section 15(a) and section 7(a). Competing municipal electric utilities proposed new developments that, in each case, increased the generating capacity of the projects by about one third (60 megawatts at each project).[75] Pacific Gas &

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[74] "Best adapted" is the standard applied by § 7(a) to the choice between applicants both of which or neither of which have preference status. FPA § 7(a), 16 U.S.C. § 800(a) (1982). "Equally well adapted" is the standard applied when one system relies on the public preference. *Id.*, 16 U.S.C. § 800(a). Although a public system technically has only to match an existing licensee's application for a new license, in specific relicensings they have done far more.

At the end of its opinion in City of Bountiful, Utah, 11 F.E.R.C. ¶ 61,337, at 61,735–36 (1980), *aff'd sub nom.* Alabama Power Co. v. FERC, 685 F.2d 1311 (11th Cir. 1982), *cert. denied*, 103 S. Ct. 3573, *cert. denied*, 103 S. Ct. 3574 (1983), the Commission discussed in dictum a number of factors that might go into a determination of the "public interest." Under § 7(a), the state or municipality will obtain a license under public preference only if its application is equally well adapted to conserve and utilize *in the public interest* the water resources of the region. *Id.* at 61,741 n.52. The Commission also stressed that comparison of competing proposals should include not only physical and technical factors, but also "consideration of broader social impacts such as economic costs and benefits, the distribution of the benefits of hydropower and similar pertinent potential impacts." *Id.* at 61,735. The "public interest" was not intended to be static as of 1920. *Id.* at 61,736. The Commission left further considerations of the "public interest" qualification to future decisions on specific licenses. *Id.*

The Commission discussed the public interest factor at great length in the second part of its *Merwin II* opinion, Pacific Power & Light Co., 25 F.E.R.C. ¶ 61,052, at 61,186–203, 61,205–07 (1983), *appeal docketed sub nom.* Clark-Cowlitz Joint Operating Agency v. FERC, No. 83-2231 (D.C. Cir. Nov. 29, 1983). This opinion focused on economic factors that would be a part of the public interest determination. The Commission awarded the new license to Pacific Power & Light on the basis of a determination that the alternative cost to the investor-owned utility and its customers of not getting a new license was greater than the alternative cost to the public preference applicants. *Id.* at 61,196–201. At the end of the opinion the Commission's discussion of "public interest" criteria again focuses on economic impacts. *Id.* at 61,205–06. All the same, it is clear that a number of additional factors are considered in the "public interest" determination. In *Merwin II*, the Commission did not discuss power production, flood control, or fish, wildlife, and recreational facilities, because it found the two proposals equivalent on these matters. *Id.* at 61,196. All of these factors are subject to the "bidding" effect of competition for licenses.

[75] *Compare* Application for License for Major Project — Existing Dam, Pacific Gas & Elec. Co., FERC Project No. 1962 (filed Sept. 28, 1979) (Rock Creek-Cresta Project), *and* Application for New License for Major Modified Project, Pacific Gas & Elec. Co., FERC Project No. 1988 (filed Mar. 26, 1982) (Haas-Kings River Project), *with* Application for Consolidation and Amendment of Applications for New License for Major Project — Existing Dam, Sacramento Mun. Util. Dist., FERC Project No. 3223 (filed Dec. 31, 1981) (Rock Creek-Cresta Project), *and* Application for New License for Major

Electric did not even suggest any improvements in its initial applications for new licenses.[76] It has since adopted proposals similar to those of the municipal utilities. No matter who ultimately receives the new license, more generating capacity will have been developed. The municipal groups have thus made a valuable contribution to development in the public interest through the competitive bidding process. This incentive to maximize the utilization of the generation site is likely to continue under the preference provision of the present law.

The benefits of competitive bidding are not limited to increased output. In another example, a competing municipality in California included in its application a number of environmental protection measures in its application — including purchasing mountain meadowland to replace land flooded out fifty years before — which the original licensee had refused to do.[77] Other competing municipal applicants have agreed to supply boating and fishing access in cases where the initial licensee refused these proposals.[78] Because of potential competition between applicants for the new license, each applicant may be particularly receptive to valid proposals from distinct segments of the community that are concerned with a specific issue. If one applicant accepts a proposal, the other is likely to accept it as well in order to keep its application equivalent.

III. The Investor-Owned Utilities' Arguments for H.R. 4402

The basic premise of the investor-owned utilities' arguments is that public preference is unfair to the privately owned utilities and to their consumers. The utilities advance four main argu-

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Modified Project, Sacramento Mun. Util. Dist., FERC Project No. 6729 (filed Sept. 30, 1982) (Haas-Kings River Project). *See also* American Public Power Ass'n, *supra* note 23, at 16.

[76] Application for License for Major Project — Existing Dam, Pacific.Gas & Elec. Co., FERC Project No. 1962 (filed Sept. 28, 1979) (Rock Creek-Cresta Project); Application for New License for Major Modified Project, Pacific Gas & Elec. Co., FERC Project No. 1988 (filed Mar. 26, 1982) (Haas-Kings River Project).

[77] *See* Letters from Susan T. Shepherd, Att'y for the City of Santa Clara, Cal., to Kenneth F. Plumb, Sec'y of FERC (Aug. 3, 1982; July 29, 1982) (regarding City of Santa Clara, Cal., FERC Project No. 2745 (Mokelumne Project)) (attaching agency agreements and comments).

[78] *See, e.g.*, Application for Consolidation and Amendment of Applications for New License for Major Project — Existing Dam, Sacramento Mun. Util. Dist., FERC Project No. 3223 (filed Dec. 31, 1981) (Rock Creek-Cresta Project).

ments in support of their position. First, they claim that consumers' rates will increase rather than decrease as a result of the public preference. Second, they argue that if a publicly owned system were to obtain a new license for a project that was one of a number of projects on a river system, the orderly coordination of all the projects on the river system would suffer. Third, they assert that removal of a privately owned utility from operation of the project will reduce the locality's tax base. Fourth, and most important, the utilities claim that the public interest will be best served if the utility with the most customers controls the hydroelectric projects. We address each of these arguments in turn.

A. *The Cost Argument*

The investor-owned utilities focus the preference dispute on the kinds and levels of costs that customers would experience if a project were to be relicensed to a publicly owned system.[79] If a privately owned utility is denied a new license, the cost to its consumers is likely to be the difference between low-cost hydroelectric power and the energy cost of other generation already available. This cost will be higher only if new generation facilities have to be built.

This cost crisis is likely to have a significant impact on the relatively small number of private utilities whose generation mix includes a substantial amount of hydroelectric power from projects subject to relicensing. These utilities may be forced to substitute more costly sources of generation for hydroelectric sources they will lose, causing their rates to increase and perhaps affecting their planned supply of generation. The publicly owned system can be expected to have access to generation (plants that it owns or from which it purchases electricity) that it no longer needs due to its newly acquired hydroelectric facilities. This existing generating plant, cheaper than new generation, should be available to the privately owned utility if it is able to negotiate successfully to purchase power from it. Thus, only on rare occasions will the customers of a privately owned utility have to pay the incremental cost of constructing new generation as the result of the exercise of public preference on relicensing.

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[79] *E.g.*, EEI PAMPHLET, *supra* note 23, at 20–23.

Nevertheless, the investor-owned utilities have argued that they should be compensated for the cost of replacing the generation lost upon relicensing. In the *Merwin* case,[80] Pacific Power & Light Co. argued that it should be compensated for the cost of the least costly alternative to baseload power — a large coal plant.[81] The statute, however, lends little support to an argument for this level of compensation. Compensation to the original licensee upon exercise of the public preference is limited to "net investment" and severance damages, if any.[82] The former term is narrowly defined in the statute and by Commission Order: it is the original value of the project (the cash paid) less certain depreciation accounts.[83] Severance damages are defined in section 14(a) as "reasonable damages, if any, to property of the licensee valuable, serviceable and dependent . . . but not taken, as may be caused by the severance therefrom of property taken."[84] This is the standard legal definition of severance damages, according an owner compensation for the diminution in property value resulting from condemnation of *part* of his or her property.[85] When *all* of the property connected with the project is taken, as would normally occur in relicensing, severance damages are not applicable.[86]

If the publicly owned utility were forced to repay the original licensee the level of compensation advocated by the investor-owned utilities, the publicly owned utility would be paying for hydroelectric generation at the price of new and more expensive coal or nuclear generation. Thus, it would be paying as if it had

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[80] Pacific Power & Light Co., 23 F.E.R.C. ¶ 63,037 (*Merwin I*), *rev'd*, 25 F.E.R.C. ¶ 61,052 (1983) (*Merwin II*), *appeal docketed sub nom.* Clark-Cowlitz Joint Operating Agency v. FERC, No. 83-2231 (D.C. Cir. Nov. 29, 1983).

[81] *See* Initial Brief of Pacific Power & Light Co. at 11–12, 99–100 (*Merwin I*).

[82] FPA §§ 14(a), 15(a), 16 U.S.C. §§ 807(a), 808(a) (1982). Section 14 also establishes a distinct and separate right of the United States, any state, or any municipality to take over a project at any time by condemnation proceedings. *Id.* § 14, 16 U.S.C. § 807. The measure of compensation would then be "just compensation."

[83] FPA § 3(13), 16 U.S.C. § 796(13) (1982); *see also* Hydroelectric Project Licenses: Calculation of "Net Investment" Under Section 3(13) of the Federal Power Act, 40 F.P.C. 938 (1968). The insertion of this formula into the statute was the key concession that won the support of the private power interests.

[84] FPA § 14(a), 16 U.S.C. § 807(a) (1982).

[85] *See, e.g.*, Sharp v. United States, 191 U.S. 341 (1903). *See generally* BLACK'S LAW DICTIONARY 1232 (5th ed. 1979).

[86] The presiding administrative law judge in *Merwin I* reasoned that because all of the property associated with a project is taken when the license is transferred, severance damages do not normally occur. Pacific Power & Light Co., 23 F.E.R.C. ¶ 63,037, at 65,123–24 (*Merwin I*), *rev'd*, 25 F.E.R.C. ¶ 61,052 (1983) (*Merwin II*), *appeal docketed sub nom.* Clark-Cowlitz Joint Operating Agency v. FERC, No. 83-2231 (D.C. Cir. Nov. 29, 1983).

effectively built the new plant itself instead of having obtained the reissued hydroelectric license. As a practical matter, the equivalent of economic benefit particular to the hydroelectric resource would have been paid to the shareholders of the original licensee. A major policy promoted by the public preference would thus be defeated. Furthermore, this approach would continue to compensate the original licensee for the loss of hydroelectric power even *after* its license expired and any legitimate claim it may have had to the use of that power no longer existed.[87] The likely result of such a compensation policy — even if the present public preference were to remain unchanged — would be to reduce dramatically the interest in competition for these projects.

The provision for compensation in H.R. 4402 provides that when an original licensee does not receive a new license, the new licensee would have to pay "just compensation in an amount that the Commission shall determine in accordance with due process of law."[88] This provision of the bill could thus destroy an essential part of the bargain that produced the first Federal Water Power Act formula.[89] Depending on how the Commission interpreted "just compensation," H.R. 4402 could provide an effective block to relicensing of hydroelectric projects to publicly owned entities by forcing them to pay for a more expensive alternative source of power.[90]

B. *The Coordination Argument*

A second argument advanced by the privately owned utilities for eliminating the public preference is that only the existing licensees can assure continued coordination of various projects on a single river system.[91] Operation of these projects needs to be coordinated so that the flow of water from each project

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[87] For example, Pacific Power & Light calculated its damages based on Merwin's estimated value for 50 years — the equivalent of at least one additional license term. Initial Brief of Pacific Power & Light Co. at 11, *Merwin I.*

[88] H.R. 4402, *supra* note 1, § 3(4).

[89] *See supra* notes 82–84 and accompanying text.

[90] *But cf.* Pub. Util. Dist. No. 1 of Pend Oreille County v. City of Seattle, 382 F.2d 666 (9th Cir. 1967). The court held that licensees condemning property under § 21 of the Act, 16 U.S.C. § 814 (1982), must pay for the "power site value," but that such value does not include the value due to operating a hydroelectric project, since the condemnee did not have a license for that purpose. This case also rejected a claim for "severance damages" based on possible savings from joint operation of two projects.

[91] EEI PAMPHLET, *supra* note 23, at 26–28.

produces the maximum amount of power at the most useful times. If multiple projects on a river are under one license, the whole system could be transferred at relicensing. In the typical situation, however, there are several different licenses, which will expire at different times.

Ideally, the Commission could require that the various licensees cooperate in order to coordinate operation of the projects. Any new license issued to a new system could incorporate a specific requirement for cooperation. Some existing licenses may, in fact, contain a standard provision that would allow a subsequent Commission requirement of coordination.[92] Most relicensing at issue, however, will be for projects with less standardized licenses issued before 1953. These may or may not contain an explicit article that would allow subsequent imposition of a condition requiring coordination.

A problem arises in cases in which an explicit article is missing. Section 6 of the FPA provides that licenses may be altered only with the mutual consent of the Commission and the licensee.[93] If read literally, section 6 raises doubts as to the authority of the Commission to impose operating conditions on existing licensees without their consent.[94] Thus, an existing licensee, in theory, may veto any new development proposed for the same stretch of river as its licensed project. The existing licensee could conceivably affect the relicensing of another project on the same stretch of river by simply refusing to coordinate its project still under license with the project it lost. As a result, in order to further the maximum development of a project, the Commission might have no choice but to give the resource back

[92] This was the approach taken in Pacific Power & Light Co., 23 F.E.R.C. ¶ 63,037, at 65,114–17 (*Merwin I*), *rev'd*, 25 F.E.R.C. ¶ 61,052 (1983) (*Merwin II*), *appeal docketed sub nom.* Clark-Cowlitz Joint Operating Agency v. FERC, No. 83-2231 (D.C. Cir. Nov. 29, 1983).

[93] FPA § 6, 16 U.S.C. § 799 (1982).

[94] Pacific Gas & Elec. Co. v. FERC, 720 F.2d 78 (D.C. Cir. 1983). Investor-owned utilities have relied on § 6 to claim that no further development on a river may occur without their consent and that their consent may be conditioned on any terms whatsoever. Thus, in Calaveras County Water Dist., 18 F.E.R.C. ¶ 61,124, *reh'g denied*, 20 F.E.R.C. ¶ 61,031 (1982), *aff'd sub nom.* Pacific Gas & Elec. Co. v. FERC, 720 F.2d 78 (D.C. Cir. 1983), Pacific Gas & Electric claimed it could withhold consent until it received compensation for its losses due to the construction of a new project. *Calaveras*, 18 F.E.R.C. at 61,236; 20 F.E.R.C. at 61,058. The municipal group argued that § 6 only requires that if the Commission determines that an existing project should be altered to develop a resource better, the Commission must provide for adequate compensation to the affected licensee. *Calaveras*, 20 F.E.R.C. at 61,058–59. The Commission took an intermediate position, finding that any *substantial* alteration requires consent of the existing licensee, but that an insubstantial alteration will be allowed as long as appropriate compensation is paid to the existing licensee. *Calaveras*, 18 F.E.R.C. at 61,243.

to the existing licensee. On the other hand, the Commission might determine that it has the authority under section 6 of the FPA to deal with the refusal of an existing licensee to cooperate in the most effective development of the water resource — perhaps by threatening to revoke the license.[95]

Determining the goals that coordination of two or more utilities should achieve is another general problem. When one electric utility controls a whole series of projects, it can maximize each project's value by matching use of the energy of each project to the system's need for peak generation. Where two or more electric systems must coordinate, the new licensee's peak times might differ from those of the existing licensee, or their alternative generating resources, operating at different costs, might dictate a different use of the resource. They then must resolve what plan of coordination to adopt. Coordination among different licensees requires an arrangement for making joint determinations on an ongoing basis. A joint agreement would probably include arrangements for compensation of some kind in the event that one party sacrifices its best use of the power for an unfair proportion of the time. In areas where a regional centralized dispatching system is already in place, as in New England, this is not a problem.[96] In other areas of the country, a system of agreements might have to be developed to coordinate the projects on a river system. The opposition of a particular licensee, however, may make the desired coordination arrangements difficult to achieve.[97]

Coordination is a desirable and necessary goal, and it can be

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[95] *See, e.g.*, Pacific Power & Light Co., 23 F.E.R.C. ¶ 63,037, at 65,114–17 (*Merwin I*), *rev'd on other grounds*, 25 F.E.R.C. ¶ 61,052 (1983) (*Merwin II*), *appeal docketed sub nom.* Clark-Cowlitz Joint Operating Agency v. FERC, No. 83-2231 (D.C. Cir. Nov. 29, 1983). In *Merwin I*, the administrative law judge held that § 6 of the FPA, when read with § 10(a) and the terms of the existing licenses held by the privately owned licensee, provided the Commission with sufficient authority to compel a losing privately owned licensee to continue to coordinate its other operations with a gaining publicly owned licensee. The judge went on to state that a refusal to coordinate would constitute grounds for the Commission to institute revocation proceedings. *See* FPA §§ 6, 10(a), 16 U.S.C. §§ 799, 803(a) (1982); *see also id.* § 26, 16 U.S.C. § 820 (revocation proceedings).

[96] A group of utilities establish a central dispatching system to coordinate their generating facilities. This system, typically run by computer, matches the moment-to-moment changes in demand with whichever generating unit can produce the electricity most economically. The electricity sold by each participating utility is also monitored so that the utility is compensated for the power provided. *See* POWER POOLING, *supra* note 64, at 34, 37.

[97] *See, e.g.*, Pacific Power & Light Co., 23 F.E.R.C. ¶ 63,037, at 65,100 (*Merwin I*), *rev'd*, 25 F.E.R.C. ¶ 61,052 (1983) (*Merwin II*), *appeal docketed sub nom.* Clark-Cowlitz Joint Operating Agency v. FERC, No. 83-2231 (D.C. Cir. Nov. 29, 1983).

attained under a public preference scheme. The effort that it might require should not be understood as a valid argument against public preference. Indeed, the kind of regional coordination of resources that would be required is likely to have a beneficial effect on the overall regional efficiency of electric generation.

C. *The Tax Base Argument*

The third argument for keeping the operation of licensed hydroelectric projects in the hands of privately owned utilities is that these utilities contribute to local tax bases. If the projects were turned over to nontaxable public entities, it is argued, these benefits would disappear.[98] In fact, this is not necessarily the case. Municipalities challenging existing licenses have been willing to make payments in lieu of taxes.[99] Although the Commission does not require this type of an arrangement,[100] publicly owned utilities have perceived that agreeing to such an arrangement helps ensure the neutrality of local entities during licensing proceedings. According to the American Public Power Association, publicly owned power systems in 1980 paid a larger percentage of their gross revenues to local governments than did privately owned utilities.[101]

Localities have access to other means of obtaining compensation from a publicly owned utility licensee. For example, if a publicly owned licensee is constructing a new project, the local jurisdiction may seek funds to cover the costs of additional burdens on public services, such as police and public schools. Localities might also seek compensation for specific services rendered to a publicly owned system operating a project in a locality during the term of the license.

The privately owned utilities also stress that publicly owned systems are, in effect, subsidized by the tax-exempt status given to the interest on municipal bonds.[102] Although this argument is

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[98] EEI PAMPHLET, *supra* note 23, at 28–30.

[99] *See, e.g.*, Pacific Power & Light Co., 23 F.E.R.C. ¶ 63,037, at 65,113 (*Merwin I*), *rev'd*, 25 F.E.R.C. ¶ 61,052 (1983) (*Merwin II*), *appeal docketed sub nom.* Clark-Cowlitz Joint Operating Agency v. FERC, No. 83-2231 (D.C. Cir. Nov. 29, 1983).

[100] It is not clear whether the Commission has the authority to require payments in lieu of taxes. It might interpret its duty and the "public interest" standard to include the power to require such arrangements. *See* FPA § 10(a), 16 U.S.C. § 803(a) (1972).

[101] AMERICAN PUBLIC POWER ASS'N, *supra* note 23, at 18 n.7.

[102] EEI PAMPHLET, *supra* note 23, at 29.

accurate on its face, it overlooks the host of tax advantages that investor-owned utilities receive directly or indirectly from the federal government. These include capital investment tax credits,[103] deferral of taxes through accelerated depreciation on capital investments,[104] the ability to issue pollution control bonds exempt from taxes on interest,[105] and the ability to sell stock through a dividend reinvestment program on which investors do not pay tax.[106]

D. *The Many Customers Argument*

The fourth argument made by utilities is that the utility with the most customers should get the benefit of the water resources. They portray public preference as a device that would allow systems with relatively few customers to take a valuable resource away from the many customers of larger, investor-owned systems. This, it is claimed, is contrary to the public's interest because a few benefit at the expense of many.[107]

In an industry with a tendency to monopolize a service area and that needs competition to avoid inefficiencies,[108] this approach to the "public interest" is unjustifiable. The argument embodies a conception of the "public interest" that is antithetical to the policies of public control and public benefit at the core of the FPA. The argument also encourages a public policy contrary to the American tradition of supporting small businesses and encouraging competition. The United States also has a tradition of being suspicious of monopolies, especially monopolistic utilities. Therefore, it is particularly troublesome to accept the argument of the large utilities that they should be favored simply because of their size.

Furthermore, it is misleading to assume that because a utility has more customers, each of these customers receives benefits from hydroelectric power. Some if not all of these benefits will go to the shareholders in the form of higher dividends rather than to the consumers in the form of lower rates.

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[103] 26 U.S.C. § 38 (1982)

[104] *Id.* § 167(a)(1)(*l*) (depreciation); *id.* § 168(a), (e)(3) (accelerated cost recovery system); *id.* § 169(a) (pollution control amortization).

[105] *Id.* § 103(b)(4), (f) (excluding from gross income interest on industrial development bonds used for air or water pollution control facilities).

[106] *Id.* § 305(e). *But see id.* § 305(e)(12) (terminating the subsection on Dec. 31, 1985).

[107] EEI PAMPHLET, *supra* note 23, at 11.

[108] *See supra* text accompanying notes 62–71.

Finally, an argument made in favor of the changes proposed by H.R. 4402 is that enactment of the bill would reward a licensee for good past performance.[109] This argument, however, cannot withstand close scrutiny. As discussed above, privately owned utilities have no property interest in the operation of a hydroelectric project pursuant to a federal license.[110] Water power is a public resource that should be disposed of in a manner that will maximize the public good. Hydroelectric licenses are issued for a period long enough to allow the recovery of initial investment.[111] Changing the licensee after thirty to fifty years is certainly not disruptive to operations. When the review occurs as infrequently as it does in the water power area, the licensee has already been rewarded for its good performance by the profits from the project.

It is also important to note that H.R. 4402's version of section 15(a) proposes an undefined and minimal standard of competence that would permit virtually any existing licensee to retain its license.[112] It does not reward particularly good past performance; it gives a reward to *any* initial licensee that meets the basic requirements of the bill. A thorough review of how an invaluable public resource is being used, and consideration of whether another entity might use it more effectively in the public interest, is certainly justified every thirty to fifty years. H.R. 4402 would foreclose even those rare opportunities for review.

IV. Conclusion

In the last few years, publicly owned utilities have successfully asserted their interests by forming groups and joint agencies to assert their collective interests and by pressing occasionally successful claims of anticompetitive activity by privately owned utilities before both government agencies and

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[109] *See* 129 Cong. Rec. E5708 (daily ed. Nov. 18, 1983) (section-by-section analysis of H.R. 4402).

[110] *See supra* note 26.

[111] The Commission typically issues an initial license for a 50-year term. When a license is reissued, the term will vary from 30 to 50 years, depending on the amount of reconstruction needed. *See, e.g.*, Montana Power Co., 56 F.P.C. 2008, 2013 (1976). For projects constructed years ago, the Commission has other standard policies for the licensing term, depending on the date of construction and the reason the project was not licensed earlier. *See, e.g.*, Bangor Hydro-Elec. Co., 6 F.E.R.C. ¶ 61,287 (1979); Pacific Power & Light Co., 56 F.P.C. 1804 (1976); Public Service Co. of N.H., 27 F.P.C. 830 (1962).

[112] H.R. 4402, *supra* note 1, § 3(3).

the courts.[113] An effective public preference in relicensing would further strengthen their interests. A victory for the privately owned utilities at this time would deflate the publicly owned utility movement and implicitly endorse the privately owned utilities' concept of "the public interest" as requiring a bias in favor of the biggest companies with the most consumers. That would represent a critical challenge to publicly owned systems and might well affect a range of other public resource allocation decisions.[114]

This issue is already presenting itself. Utah Power & Light has filed for allocations from the federal Western Area Power Administration for projects that must by law go only to preference customers.[115] It claims that its service to a large number of customers is in the public interest and thus justifies its request. This action suggests that the conflict described in this Article should be viewed as only a first step in the privately owned utilities' attempt to use their peculiar definition of the "public interest" to undermine all forms of public preference. All forms of publicly owned utilities have a considerable stake in this controversy. By providing what is in effect a perpetual grant of a substantial part of the nation's water power resources to private companies, H.R. 4402 would thus enact into law a policy that has been politically unacceptable since at least the first decade of this century.

When it enacted the Federal Water Power Act sixty-four years ago, Congress had in mind certain essential divisions within the electric utility industry, the industry's tendency towards monopolization, and the underlying difficulty of encouraging maximum development of public resources without giving the re-

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[113] *See supra* note 62 and accompanying text.

[114] A number of the largest hydroelectric developments in the country are federally owned and operated. The power is typically marketed pursuant to a preference provision. The first such preference in allocation of federally marketed hydroelectric power to public entities is found in the Town Site and Power Development Act of 1906, § 5, 43 U.S.C. § 522 (1976). Public preference recurs in the Reclamation Projects Act of 1939, § 9(c), 43 U.S.C. § 485h(c) (1976). The idea of public preference was refined in the Tennessee Valley Authority Act of 1933, § 10, 16 U.S.C. § 831i (1982), and the Bonneville Project Act of 1937, § 5, 16 U.S.C. § 832c (1982); *see also* Rural Electrification Act of 1936, § 4, 7 U.S.C. § 904 (1982); Water Conservation and Utilization Act of 1939, § 9, 16 U.S.C. §§ 590z–597 (1982); Flood Control Act of 1944, § 5, 16 U.S.C. § 825s (1982); Niagara Project Act of 1957, § 1(b), 16 U.S.C. § 836(b) (1982); Atomic Energy Act of 1954, § 44, 42 U.S.C. § 2064 (1976); Salt River Project Act of 1922, 43 U.S.C. § 598 (1976); Boulder Canyon Project Act of 1928, § 5, 43 U.S.C. § 617d (1976); Colorado River Storage Act of 1956, § 4, 43 U.S.C. § 620c (1976); Colorado River Basin Project Act of 1968, § 604, 43 U.S.C. § 1554 (1976).

[115] *See* ENERGY DAILY, Apr. 28, 1983, at 3.

sources away to private developers. The passage of time has changed neither the situation within the electric utility industry nor these basic concerns. The privately owned utilities undertook development of hydroelectric power under specific conditions set out in the Federal Water Power Act. They should not now be allowed to back out of a bargain that they made when conditions were more favorable to them.

It is to be hoped that a wide range of groups — in addition to public power, various consumer-oriented groups, unions, and environmental groups — will perceive the advantage of opposing the present H.R. 4402. The *Merwin* litigation, which is taking place at the same time as the congressional proposal, addresses the same policy question. If either of these challenges to public preference is successful, there will surely be challenges to public preference in initial licensing and in the allocation of federally generated power. This would be a threat to federal support of the major source of competition in the electric utility industry. Thus, although the loss of benefits of public preference on relicensing, as proposed in H.R. 4402, is not in itself cataclysmic, it would portend a weakening of competitive conditions in the electric utility industry.

STATUTE

LIMITING DEFENSIVE TACTICS IN TENDER OFFERS: A MODEL ACT FOR THE PROTECTION OF SHAREHOLDER DECISIONMAKING

THOMAS J. MCCORD*

The prevalence of tender offers has provoked management of target firms to resort increasingly to a wide range of defensive tactics to resist unfriendly offers. In this Note, Mr. McCord reviews the legal and economic rationales for limiting the use of defensive tactics. The author then examines why the present system of federal and state regulation is inadequate and scrutinizes existing proposals for reform. Based on this analysis, Mr. McCord presents a Model Act and commentary designed to implement a rule of managerial passivity. The proposed statute would increase the difficulty of enacting amendments to the corporate charter that discourage tender offers and would prohibit extraordinary transactions by a corporation during or immediately preceding a tender offer. The Model Act also would impose limited strict liability on corporate managers who make untrue or misleading statements in connection with a tender offer. In addition, Mr. McCord proposes amendments to the federal antitrust laws that would restrict the use of these laws as defensive tactics.

The dramatic increase in the number and size of tender offers over the last decade[1] has been matched only by the increase in the range of tactics employed by management of target firms to resist unfriendly offers.[2] This correlation is hardly surprising, since the first act of many acquirers is to fire the target corporation's management.[3]

Two developments promise to affect significantly the use of defensive tactics. First, in 1982 the Supreme Court held that an Illinois statute regulating tender offers violated the Commerce

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[1] In 1972 the number of interfirm tender offers commenced was 50. By 1982, the latest year for which data is available, the number had risen to 117, down from a high of 205 in 1981. SEC Advisory Comm. on Tender Offers, *Report of Recommendations*, FED. SEC. L. REP. (CCH), Special Report No. 1028, at 11 n.9 (July 15, 1983) [hereinafter cited as *SEC Advisory Comm. Report*]. The recent bids for Gulf Oil, Getty Oil, Marathon Oil, Bendix, and Martin Marietta demonstrate that tender offers are no longer confined to acquisitions of small companies.

[2] See *Merger Review--Takeovers: But Not For Us*, MERGERS & ACQUISITIONS, Winter 1983, at 8, 8 for a listing of the defensive tactics instituted in the last year.

[3] Gelfond & Sebastian, *Reevaluating the Duties of Target Management in a Hostile Tender Offer*, 60 B.U.L. REV. 403, 420 (1980).

Clause.[4] Enacted primarily in the mid-to-late 1970's, state tender offer statutes had both the intent and the effect of impeding hostile takeovers.[5] In their absence, the importance of the more traditional panoply of defensive tactics is likely to increase.[6] Second, over the past two years a number of commentators have attacked the legitimacy of defensive tactics. They have reached substantial agreement that the proper role for target management during a tender offer is to be passive.[7] This view is contrary to that of many practitioners[8] and judges.[9]

This Note will attempt to carry the debate one step further by addressing the question of how the goal of limiting defensive tactics might best be accomplished. This question assumes that some limitation is desirable. A full evaluation of the validity of the reasons for limiting defensive tactics is beyond the scope of this Note. Nevertheless, in order to determine how best to limit defensive tactics, it is necessary to ascertain the particular aspects of defensive tactics that commentators regard as undesirable, to examine why the present system of regulation is inadequate, and to scrutinize existing proposals for reform.

Accordingly, Part I of this Note reviews the legal and economic rationales for limiting the use of defensive tactics. It indicates that, from the viewpoint of traditional corporation theory, defensive tactics interfere with the ability of the true owners—the shareholders—to decide whether to sell their investment. From the viewpoint of free market economic theory, defensive tactics distort the market for corporate control and thereby serve to protect inefficient managers. Part II describes how the present system of federal and state regulation fails to provide a significant check on defensive tactics. It points out that federal regulation is narrow in scope, while state regulation suffers from faulty judicial analysis of both the nature of the problem and the effect of particular management tactics.

Part III analyzes some proposals for reform by commentators who agree that defensive tactics should be limited. It examines

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[4] Edgar v. MITE Corp., 457 U.S. 624 (1982).

[5] *Id.* at 634–40; *see Blue Sky Laws and State Takeover Statutes: New Importance for an Old Battleground*, 7 J. CORP. L. 689, 742–54 (1982) [hereinafter cited as *State Takeover Statutes*].

[6] *See* Gould & Jacobs, *The Practical Effects of State Tender Offer Legislation*, 23 N.Y.L. SCH. L. REV. 399, 402 (1978).

[7] *See infra* Part I.

[8] *See infra* notes 27–31 and accompanying text.

[9] *See infra* notes 49–53 and accompanying text.

the advantages and points out the inadequacies of these proposals, particularly as they would be applied in a preliminary injunction, the most common context for litigation of tender offers. Part IV draws lessons from the preceding analysis and suggests that the best solution to the problem of defensive tactics is a set of specific statutory prohibitions.

Finally, this Note presents a Model Act and commentary designed to implement a rule of managerial passivity. The Model Act seeks to limit defensive tactics on four levels. First, it restricts the ability of management to secure changes in the corporate charter that discourage the making of tender offers. Second, it prohibits extraordinary transactions by a corporation during or immediately preceding a tender offer. Third, it imposes limited strict liability on corporate managers who make untrue or misleading statements in connection with a tender offer. Fourth, it revises the federal antitrust laws so as to prevent them from being used as defensive tactics.

I. Justifying Limits on Defensive Tactics

A. *Conflicts of Interest*

The first justification for limiting defensive tactics is that tender offers produce a clear and obvious conflict between the interests of shareholders and the interests of management. A tender offer presents shareholders with an opportunity to sell their shares for a substantial premium over market price.[10] At the same time, however, the tender offeror frequently threatens management, implicitly or explicitly, with forcible removal from control. Thus, rather than viewing a tender offer as an opportunity to increase shareholder welfare, "management likely regards a potential new investor bent on acquisition as carcinogenic."[11] This interest in self-preservation creates a strong incentive for management to take action to defend against a tender offer regardless of the potential benefit to shareholders.[12]

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[10] In 1980 and 1981, 30% and 33% respectively of all tender offers involved a premium of 50% or more above the market price prevailing before the offer. Austin & Boucher, *Tender Offer Update: 1982*, Mergers & Acquisitions, Fall 1982, at 48, 50.

[11] Steinbrink, *Management's Response to the Takeover Attempt*, 28 Case W. Res. 882, 897 (1978).

[12] *See* Gelfond & Sebastian, *supra* note 3, at 420; Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 Stan. L. Rev.

Defensive tactics are designed in the first instance to discourage any offer from being made.[13] In the event of an offer, they are utilized to prevent shareholders from having a chance to accept the offer[14] or to increase the cost to the offeror in order to cause it to withdraw.[15]

Proponents of defensive tactics frequently argue that management has a duty to protect the best interests of the corporation.[16] Commentators, however, reject the notion that management can —let alone has a duty to—determine whether the tender offer is in the best interests of the corporation. Under state enabling statutes, this determination is left to the shareholders.[17] Indeed, the tender offer is designed to be an alternative to corporate combinations that require the approval of the board of directors.[18] The commentators analogize a tender offer to a sale of control by a sole owner. Defensive tactics are illegitimate because they interfere with the owner's (i.e., the shareholders') decision on whether or not to sell the investment.[19] Management acts in the best interest of the corporation when it freely permits the shareholders to decide whether an offer is acceptable. At most, only those actions that can help to overcome adverse

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819, 819 (1981) [hereinafter cited as Gilson, *A Structural Approach*]; *see also* Wachtell, *Special Tender Offer Litigation Tactics*, 32 BUS. LAW. 1433, 1437 (1977) (A lawsuit by target counsel is "obviously something that always gets done and it's axiomatic that he bring it.").

[13] Amendments to the target corporation's charter are the best examples of a tactic of this type. *See* Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775, 777 (1982) [hereinafter cited as Gilson, *Limitations on the Enabling Concept*].

[14] A suit to enjoin the offer on the grounds that a merger would violate antitrust laws is an example of a tactic of this type. *See* Easterbrook & Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 MICH. L. REV. 1155 (1982) [hereinafter cited as Easterbrook & Fischel, *Antitrust Suits*].

[15] Changes in dividend policy or repurchase of stock are examples of a tactic of this type. *See* E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL, 234–36, 245–46 (1973) [hereinafter cited as E. ARANOW & H. EINHORN, CORPORATE CONTROL].

[16] *See* Herzel, Schmidt & Davis, *Why Corporate Directors Have a Right to Resist Tender Offers*, 3 CORP. L. REV. 107 (1980); Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979) [hereinafter cited as Lipton, *Target's Boardroom*].

[17] *See, e.g.*, CAL. CORP. CODE §§ 181, 1201 (West 1977) (defining voluntary exchange offers so as to exclude target management role); MODEL BUSINESS CORP. ACT § 72A (1980) (expressly preserving the option of a traditional tender offer in which target management has no role). The Model Business Corp. Act has been adopted substantially in whole by 20 states and in large part by 10 additional states. 1 MODEL BUS. CORP. ACT ANN. 2D xiii (1971).

[18] *See* Gilson, *A Structural Approach*, *supra* note 12, at 845–48.

[19] *See* Cohn, *Tender Offers and the Sale of Control: An Analogue to Determine the Validity of Target Management Defensive Tactics*, 66 IOWA L. REV. 475, 510–13 (1981); Gilson, *A Structural Approach*, *supra* note 12, at 845–48.

effects of dispersed ownership should be permitted as exceptions to a general rule of management passivity.[20]

B. *Economic Efficiency*

The second basic justification for limiting defensive tactics relies on the argument that defensive tactics impose economic inefficiencies on society by interfering with the market for corporate control.[21] Under this view, tender offers are the best method for monitoring the performance of corporate managers.[22] Managers, like all employees and agents, have an incentive to consume perquisites or not to perform to full potential.[23] Moreover, even if management is performing to its full potential, it may not be as efficient as another set of managers.[24] Both these absolute and relative inefficiencies should be reflected in the

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[20] *See* Gilson, *A Structural Approach*, *supra* note 12, at 865–67.

[21] The "legal" and "economic" approaches are not completely distinct, because the conflict of interest emphasized in the legal approach is a conflict of economic interests. This overlap explains why Gilson, *A Structural Approach*, *supra* note 12, at 841–45, discusses how the market for corporate control benefits society and why Bebchuk, *The Case For Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23, 48–49 (1982) [hereinafter cited as Bebchuk, *Reply and Extension*], discusses a general framework based upon a sole owner analogy. The distinction between the approaches is important, however, if one considers that legislators and judges are more comfortable with arguments couched in legal terms rather than those couched in technical economic terms.

[22] *See* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1173 (1981) [hereinafter cited as Easterbrook & Fischel, *Management's Proper Role*].

One statutory mechanism by which shareholders can protect themselves against inefficient management is the right of shareholders to fire and replace directors and officers. Unfortunately, it is a widely acknowledged fact that managers consider proxy fights to be little threat to control. Proxy fights are procedurally difficult and expensive to bring, and once they are brought, scattered individual shareholders have little incentive to investigate the issues raised. *See generally* E. ARANOW & H. EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL (1968); Gilson, *A Structural Approach*, *supra* note 12, at 843.

A second mechanism is that any individual shareholder may bring a suit on behalf of the corporation against management for breach of fiduciary duty. Under typical common law standards, however, shareholders have no right to the most efficient management; they only have a right to one that is reasonably careful. *See id.* at 821–24; *infra* notes 49–53 and accompanying text.

[23] This is an inevitable result of the separation of ownership and control in the modern corporation. *See* Easterbrook & Fischel, *Management's Proper Role*, *supra* note 22, at 1169–74; Easterbrook & Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 BUS. LAW. 1733, 1736 (1981) [hereinafter cited as Easterbrook & Fischel, *Shareholders' Welfare*]; Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913, 918 (1982).

[24] Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1031 (1982) [hereinafter cited as Bebchuk, *Facilitating Competing Offers*].

price of the stock of the corporation. An acquirer can therefore afford to offer shareholders a premium and still be able to make a profit by introducing less venal or more capable management.[25] Tender offers thus economically benefit target shareholders by bringing them a premium over market price. More importantly, the threat of a tender offer benefits society by providing an incentive for managers to perform at full potential, while an actual tender offer benefits society by allocating resources to their most efficient use.[26] Defensive tactics are undesirable because their existence deters contemplated offers and their use frustrates actual offers. As a result, target managers can be more inefficient without fear of being ousted.

Proponents of defensive tactics deny that tender offers economically benefit either shareholders or society. They point to the fact that the stock price of a target company that successfully resists a tender offer frequently rises above the offer price.[27] Proponents also contend that the premium in tender offers accrues mostly to speculators rather than to long-term investors,[28] that they impede corporate planning,[29] and that they waste resources in the unproductive rearrangement of control over existing assets.[30] At the very least, proponents argue, defensive tactics can increase the premium paid to shareholders by facilitating competitive bids.[31]

Commentators generally reject these arguments. They point out that a comparison between the price offered by the acquirer and the price in the market after a period of time ignores other factors, such as changes in interest rates, inflation, or even increased management efficiency.[32] Indeed, the most recent empirical evidence indicates that the total combined market value of the target and acquirer increases significantly immediately after a takeover, suggesting that market analysts expect effi-

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[25] Easterbrook & Fischel, *Management's Proper Role*, *supra* note 22, at 1165–68.

[26] Bebchuk, *Facilitating Competing Offers*, *supra* note 24, at 1047; Easterbrook & Fischel, *Management's Proper Role*, *supra* note 22, at 1173–74.

[27] *See* Lipton, *Takeover Bids in the Target's Boardroom: An Update After One Year*, 36 BUS. LAW. 1017, 1025–26 (1981); Lipton, *Target's Boardroom*, *supra* note 16, at 106–09.

[28] *See* Lipton, *Target's Boardroom*, *supra* note 16, at 104.

[29] *See* Steinbrink, *supra* note 11, at 902–03, 906.

[30] *See* Williams, *Tender Offers and the Corporate Directors*, [1979–1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,445 (Jan. 17, 1980); *Analysis of the Business Judgment Rule in the Context of Takeover Cases*, 6 DEL. J. CORP. L. 546, 552 (1981) (panel discussion) (statement of Meredith M. Brown, member, Debevoise & Plimpton).

[31] Herzel, Schmidt & Davis, *supra* note 16, at 109–10.

[32] Easterbrook & Fischel, *Shareholders' Welfare*, *supra* note 23, at 1741–43.

ciency and synergistic gains to result from the combination.[33] There is also no reason to believe that the gains from new investment would be either quantitatively or qualitatively better. If an acquirer could obtain a greater rate of return by investing in new plant and equipment or in research and development, it would do so. The prevalence of tender offers and other corporate combinations suggests that the gain from increasing the efficiency of the existing organization of assets is, in many situations, greater than the gain from trying to create new assets.[34] Although the trading activity and price of the target stock frequently increase immediately before a tender offer, there is no evidence that this movement is attributable to speculators purchasing shares from unsuspecting target shareholders in order to usurp the gain from the premium. Rather, shareholders may rationally sell before an offer in order to avoid the risk that the offer will be defeated, oversubscribed, or never made.[35]

Commentators also note that the threat of a tender offer should encourage rather than discourage managers from engaging in long-term planning. Well-designed and potentially profitable plans raise the expected future earnings of the firm, which will be reflected in a higher stock price that in turn acts to discourage takeovers.[36]

Finally, commentators argue, although for different reasons, that a need to facilitate competing bids does not justify defensive tactics. Some commentators believe that even if the premium is increased in a particular case, the facilitation of competing bids will hurt society in the long run by increasing costs to the acquirers, thereby discouraging the search for suitable targets.[37] Other commentators accept that facilitating competing offers is beneficial, but argue that this justifies only a few specific management actions rather than the broad range of defensive tactics

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[33] *See* Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. BUS. 345, 348 (1980); Easterbrook & Fischel, *Shareholders' Welfare*, *supra* note 23, at 1739–40; Jarrell & Bradley, *The Economic Effects of Federal & State Regulation of Tender Offers*, 23 J.L. & ECON. 371, 404 (1980); Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983).

[34] *See* Easterbrook & Fischel, *Management's Proper Role*, *supra* note 22, at 1184 n.62.

[35] *See* Easterbrook & Fischel, *Shareholders' Welfare*, *supra* note 23, at 1744.

[36] *See id.* at 1743.

[37] *See* Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982) [hereinafter cited as Easterbrook & Fischel, *Auctions and Sunk Costs*]. They also note that such "auctions" permit potential offerors to wait until a suitable target has been identified without incurring the costs of an investment "search."

now employed.[38] Even if competing tender offers would produce a higher premium, they suggest that a rule that gives management the power to resist a tender offer is not appropriate. Management may well use such power not to bargain for a higher premium, but to avoid a takeover altogether or to extract personal benefits from the offeror in return for abstaining from the use of its power.[39]

In sum, a large body of recent commentary suggests that the use of defensive tactics by target management in a tender offer is harmful both to shareholders and to society at large.[40] Nevertheless, the management of target firms, relatively unchecked by current law, vigorously employ a wide variety of these defensive tactics.

II. Current Limits on Defensive Tactics

A. *State Law*

State law affects the actions of corporate management in two ways: statutory enabling law grants the corporation the power to engage in transactions, while common law restricts the way in which management may exercise that power. Consequently, state limits on the actions of management during a tender offer are based almost entirely on common rather than statutory law.[41] Corporate common law is derived from the notion that management stands in a fiduciary relationship to the corporation and shareholders. But, as Justice Frankfurter pointed out, "to say that a man is a fiduciary only begins analysis."[42] Indeed, the fiduciary duty of corporate management is composed of two more specific duties: the duty of care and the duty of loyalty.[43]

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[38] Bebchuk, *Reply and Extension*, *supra* note 21; Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 Stan. L. Rev. 51 (1982) [hereinafter cited as Gilson, *Seeking Competitive Bids*].

[39] *See* Bebchuk, *Facilitating Competing Offers*, *supra* note 24, at 1039 n.54.

[40] While believing that the economic data is "problematic," the SEC Advisory Committee nevertheless states that shareholder protection and market efficiency should be the goals of tender offer regulation. *See SEC Advisory Comm. Report*, *supra* note 1, at 8–9, 15 (Recommendations 1, 3).

[41] Note, Panter v. Marshall Field & Co.: *Unbridled Discretion of Management to Resist Hostile Tender Offers*, 33 Mercer L. Rev. 647, 649 (1982) [hereinafter cited as Note, *Unbridled Discretion*].

[42] SEC v. Chenery Corp., 318 U.S. 80, 85–86 (1942).

[43] Gilson, *A Structural Approach*, *supra* note 12, at 821–31.

The duty of care requires managers to act responsibly in directing the plans and operation of the corporation's business.[44] Its traditional formulation is in the business judgment rule.[45] The rationale of the business judgment rule is that even ordinary business projects involve some risks and that these risks will sometimes lead to losses. Directors need to be insulated from liability for business losses that result from good-faith errors in judgment in order to encourage the risk-taking necessary for ordinary business operation.[46]

The duty of loyalty requires managers to act for the benefit of the corporation and not for their own self-interest. This duty recognizes that where ownership and management are separated, the interests of shareholders and management may diverge.[47] In the context of tender offers, the most common formulation of the duty of loyalty is the primary purpose test. Under this standard, courts ask whether the principal or primary purpose behind the particular management action in question was to retain control or whether it was to further a valid business purpose. The primary purpose test thus focuses directly on the central issue of conflict of interest and resolves it according to the subjective intent of management.[48]

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[44] Note, *Tender Offer Decisions: Effect of the Business Judgment Rule*, 45 ALB. L. REV. 1122, 1124–27 (1981) [hereinafter cited as Note, *Tender Offer Decisions*].

[45] Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979). The American Law Institute, in its PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 4.01 (Tent. Draft No. 1, 1982), stated the business judgment rule as follows:

> (a) A corporate director or officer has a duty to his corporation to perform his functions in good faith, in a manner that he reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.
>
> . . . .
>
> (d) A corporate director or officer shall not be subject to liability under the duty of care standards . . . with respect to the consequences of a business judgment if he:
>
> (1) informed himself and made reasonable inquiry with respect to the business judgment;
>
> (2) acted in good faith and without a disabling conflict of interest; and
>
> (3) had a rational basis for the business judgment.

[46] *See* PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 4.01 comment (Tent. Draft No. 1, 1982); *see also* Note, *Tender Offer Decisions*, *supra* note 44, at 1125.

[47] *See* Gilson, *A Structural Approach*, *supra* note 12, at 824–31, 835–36; Note, *Tender Offer Decisions*, *supra* note 44, at 1125.

[48] *See* Note, *Tender Offer Decisions*, *supra* note 44, at 1129.

Recently, a few courts have applied a fairness test. This test considers whether the action was, on balance, fair to the stockholders of the corporation. *See, e.g.*, Klaus v. Hi-Shear Corp., 528 F.2d 225, 234 (9th Cir. 1975); *see also* Gelfond & Sebastian, *supra*

The greatest defect in current state law regulation of tender offers is that few courts have recognized that tender offers create an inherent conflict of interest implicating management's duty of loyalty, not its duty of care. As a result, most courts applying state law have evaluated the legitimacy of target management tactics under the standard of the business judgment rule. Because the business judgment rule is protective and its formulation deferential, virtually all management actions have been upheld. If the action is within the power of the corporation authorized by the enabling statute, then courts have refused to examine the effect of the action.[49]

Even those courts that have recognized that tender offers create a conflict of interest sufficient to trigger scrutiny of management's duty of loyalty have failed to condemn management's defensive tactics. This failure results from problems with the implementation of the standards of the duty of loyalty. Courts have frequently misallocated the burden of proof.[50] Under a fiduciary standard, when the facts of a conflict of interest are alleged, the burden of proof traditionally has been on the defendant.[51] But in a tender offer, courts have usually put the burden on plaintiffs to show that management was solely or primarily motivated by a desire to retain control. Plaintiffs seldom have been able to overcome this burden because of the difficulty in

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note 3, at 443–49; Lynch & Steinberg, *The Legitimacy of Defensive Tactics in Tender Offers*, 64 CORNELL L. REV. 901, 925–26 (1979) ("business purpose" test); Note, *The Misapplication of the Business Judgment Rule in Contests for Corporate Control*, 76 NW. U.L. REV. 980, 1010 (1982) [hereinafter cited as Note, *Misapplication of the Business Judgment Rule*]. The fairness test is similar to the "fair dealing" requirement that has been applied in the context of freeze-out mergers in that it suggests that courts should evaluate an action in terms of its effect upon the shareholders' vote. The fairness test in tender offers, however, is less strict because the court may balance an action's adverse effects against its possible benefits to the corporation. *See* Gelfond & Sebastian, *supra* note 3, at 444; *see also* Weinberger v. UOP, Inc., 457 A.2d 701, 711–12 (Del. 1983) (construing fair dealing requirement).

[49] *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir. 1981); Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980); Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980); *see also* Harrington, *If It Ain't Broke, Don't Fix It: The Legal Propriety of Defenses Against Hostile Takeover Bids*, 34 SYRACUSE L. REV. 977, 1005 (1983); Note, *Tender Offer Decisions*, *supra* note 44, at 1137; Note, *Misapplication of the Business Judgment Rule*, *supra* note 48, at 1013.

The SEC Advisory Committee also adopted the view "that the business judgement rule should be the principal governor of decisions made by corporate management including decisions that may alter the likelihood of a takeover." *SEC Advisory Comm. Report*, *supra* note 1, at 34 (Recommendation 33).

[50] *See, e.g.*, Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690 (2d Cir. 1980); *see also* Note, *Misapplication of the Business Judgment Rule*, *supra* note 48, at 1003–06.

[51] *See, e.g.*, Sinclair Oil Co. v. Levien, 280 A.2d 717 (Del. 1971); *see also* Note, *Unbridled Discretion*, *supra* note 41, at 651.

proving subjective intent where management's motives appeared mixed.[52] Even where the burden of proof has been on management, courts have been excessively inclined to find a valid business purpose for defensive tactics.[53]

B. *Federal Law*

In contrast with the emphasis in state regulation on common-law fiduciary duty, federal regulation of tender offers is strictly statutory.[54] Federal regulation is based upon the Williams Act.[55] Two provisions of the Williams Act impact on the role of target management: section 14(d), which defines the procedures for a tender offer and requires certain disclosures,[56] and section 14(e), which is a general antifraud provision.[57] The effect of section 14(d) on defensive tactics is mainly indirect. For example, the relatively brief time that offers are required to be open restricts the type of defensive tactics available, since management actions must occur within that time.[58]

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[52] *See, e.g.*, Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690, 702–04 (2d Cir. 1980); *see also* Harrington, *supra* note 49, at 1005, 1022–23; Note, *Defensive Tactics and the Fiduciary Obligations of the Target Board of Directors*, 7 J. CORP. L. 579, 597–600 (1982).

[53] *See* Gelfond & Sebastian, *supra* note 3, at 438–40.

For example, courts have accepted management's assertions that its actions were intended to prevent a change in sales methods, *see, e.g.*, Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (1964), to forestall looting of the corporation, *see, e.g.*, Fixman v. Diversified Indus., 1 DEL. J. CORP. L. 171 (Del. Ch. May 5, 1975), or even to reject an "inadequate" premium over market price, *see, e.g.*, Northwest Indus. v. B.F. Goodrich, 301 F. Supp. 706 (N.D. Ill. 1969).

The SEC Advisory Committee adds to the list of legitimate business purposes "a self-tender, a counter tender offer, the sale of assets or stock to a preferred acquiror or the sale of significant assets to a third party . . . ." *SEC Advisory Comm. Report*, *supra* note 1, at xxv. The Committee concludes that "such actions can benefit shareholders" and argues that state corporate law will prohibit such transactions where they "would constitute a breach of the directors' fiduciary duties to their shareholders." *Id.* But the cases above demonstrate that state law does not prohibit such transactions precisely because they "can benefit shareholders." In short, state courts do not attempt to distinguish between management actions that benefit and actions that harm shareholders because, like the Committee, they overlook the fact that these actions all involve inherent conflicts of interest.

[54] Lynch & Steinberg, *supra* note 48, at 903.

[55] Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968). The Williams Act added §§ 13(d)–(e), 14(d)–(f), 15 U.S.C. §§ 78m(d)–(e), 78n(d)–(f) (1982), to the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78hh (1982).

[56] Williams Act § 14(d), 15 U.S.C. § 78n(d) (1982); *see State Takeover Statutes*, *supra* note 5, at 731–33; Note, *The Federal Scheme of Tender Offer Regulation*, 7 J. CORP. L. 525, 534–41 (1982) [hereinafter cited as Note, *Federal Tender Offer Regulation*].

[57] Williams Act § 14(e), 15 U.S.C. § 78n(e) (1982); *see State Takeover Statutes*, *supra* note 5, at 733–34; Note, *Federal Tender Offer Regulation*, *supra* note 56, at 541–44.

[58] Note, *Federal Tender Offer Regulation*, *supra* note 56, at 534–36.

Section 14(e) renders it unlawful to make a misleading statement or omission, or to engage in a fraudulent, deceptive or manipulative act in connection with a tender offer.[59] Unlike section 14(d), section 14(e) is a substantive regulation, supplementing but not replacing state law.[60] This federal provision differs in an important respect from state fiduciary standards: it focuses on the effect of management's action rather than on the purpose behind it. The federal standard thus correctly suggests that courts need to examine the impact of management's actions.

Yet, three factors limit the effectiveness of federal law in restricting defensive tactics by target management. First, the procedural requirements do not prohibit any tactics; at most, they merely avoid concealment of a defensive action. Target managers, however, do not need to conceal their actions, because defensive tactics are authorized under state enabling law and have usually been held not to violate any fiduciary duty.[61]

Second, the substantive provisions are inadequate because section 14(e) is sharply limited in scope. The limited nature of federal substantive regulation was indicated by the Supreme Court in *Santa Fe Industries v. Green,* a Rule 10b-5 case in which the Court held that the federal securities law only reached conduct that was fraudulent or manipulative.[62] Nothing in the

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[59] Williams Act § 14(e), 15 U.S.C. § 78n(e) (1982).

Rule 14e-2, 17 C.F.R. § 240.14e-2 (1983), regulates target management directly. It requires management to take a position on the offer — for, against, or neutral — and to provide a statement of reasons for its position. *See also* Rule 14d-9, 17 C.F.R. § 240.14d-9 (1983) (filing and transmittal of recommendation statement). In addition, Rule 13e-1, 17 C.F.R. § 240.13e-1 (1983), prohibits a target company from buying any of its equity securitites during a tender offer unless it makes certain disclosures with respect to such purchases.

[60] Lynch & Steinberg, *supra* note 48, at 905.

[61] *See supra* notes 49–53 and accompanying text.

[62] 430 U.S. 462 (1977). Although this case involved an action under Rule 10b-5, the general federal securities antifraud provision, *see infra* note 64, its holding has been extended to actions under § 14(e). *See* Berman v. Gerber Prods. Co., 454 F. Supp. 1310 (W.D. Mich. 1978); Altman v. Knight, 431 F. Supp. 309 (S.D.N.Y. 1977). This extension is not surprising, for the language of Rule 10b-5 is virtually identical to that of § 14(e), *see infra* note 64, and the two rationales for the *Santa Fe* holding apply equally to § 14(e).

The minority shareholders in *Santa Fe* alleged that a freeze-out merger lacked business purpose and was offered at an unfair price. In *Santa Fe,* as in most tender offers, there was no deception because management disclosed to the shareholders all relevant information. Furthermore, the Court stated that manipulation "refers generally to practices . . . intended to mislead investors by artificially affecting market activity." 430 U.S. at 476. The Court held that unfairness or lack of business purpose was not "manipulative" under the Securities Exchange Act of 1934. *Id.* The Court rested its holding on its belief that disclosure rather than regulation was the primary purpose of language of section 14(e) precludes management actions during a tender offer from being regulated as fraudulent or manipulative practices. Under the narrow Supreme Court definition, however, most defensive tactics have not been characterized as fraudulent or manipulative.[63] Thus, claims against management, except for allegations of misleading statements or omissions, have been relegated to the inhospitable arena of state law.

Third, the broad language of section 14(e) creates problems. Although the provision is exclusively applicable to tender offers, its language is the same as that of the general antifraud provisions applicable to any securities transactions.[64] Furthermore, while the provision considers the effect of management's action, it focuses on the effect upon "market activity" instead of on the effect upon the ability of shareholders to decide freely whether to tender. A defensive tactic that interferes with a tender offer is actionable only if it is also "manipulative." Thus, section 14(e) can serve, at best, only indirectly as a means to regulate the role of target management.[65]

III. Proposed Reforms

In response to the harm to both shareholders and society caused by target management defensive tactics and the ineffectiveness of current law, several commentators have proposed

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the federal securities laws and that such allegations of breach of fiduciary duty traditionally were relegated to actions at state law. *Id.* at 478.

[63] *See* Gelfond & Sebastian, *supra* note 3, at 412–13. The Sixth Circuit in Mobil Corp. v. Marathon Oil, 669 F.2d 366 (6th Cir. 1981), did hold that a "lock-up" agreement violated § 14(e). Under the "lock-up" arrangement, Marathon granted U.S. Steel, a "White Knight," an irrevocable option to purchase 10 million authorized but unissued shares of Marathon common stock (equal to approximately 17% of Marathon's outstanding shares) and an option, in the event the U.S. Steel offer did not succeed and a third party gained control of Marathon, to purchase a valuable oil field at fixed prices. The court of appeals dealt with *Santa Fe* in only a summary fashion. As a result, its decision has been much criticized by commentators. *See* Prentice, *Target Board Abuse of Defensive Tactics: Can Federal Law be* Mobilized *to Overcome the Business Judgement Rule?*, 8 J. Corp. L. 337 (1983); Profusek, *Tender Offer Manipulation: Tactics and Strategies After* Marathon, 36 Sw. L.J. 975 (1982); Note, *Lock-Up Options: Toward A State Law Standard*, 96 Harv. L. Rev. 1068 (1983) [hereinafter cited as Note, *Lock-Up Options*]. *Marathon* has also been ignored, Schreiber v. Burlington Northern, Inc., 568 F. Supp. 197 (D. Del. 1983); Marshall Field & Co. v. Icahn, 537 F. Supp. 413, 422 (S.D.N.Y. 1982), or limited, Whittaker Corp. v. Edgar, 535 F. Supp. 933, 949 (N.D. Ill. 1982), by other courts. *But see* Data Probe Acquisition Corp. v. Datatab, Inc., 568 F. Supp. 1538 (S.D.N.Y. 1983).

[64] *See* Rule 10b-5, 17 C.F.R. § 240.10b-5 (1983).

[65] *See* Weiss, *Defensive Responses to Tender Offers and the Williams Act's Prohibition Against Manipulation*, 35 Vand. L. Rev. 1087 (1982).

reforms designed to restrict the use of defensive tactics by target management. The commentators substantially agree on the need to limit defensive tactics; they substantially disagree, however, in their conclusions as to how that reform is best accomplished.

Professors Easterbrook and Fischel of the University of Chicago and Northwestern University argue that management passivity is best ensured when tender offers are consummated in as short a time as possible.[66] In order to eliminate government-imposed delay, they would repeal both the disclosure and regulatory provisions of the Williams Act.[67] This approach presents three problems. First, their proposal would need to be supplemented by either a specific or a general statutory prohibition in order to prevent managers from shifting to pre-offer tactics. Even if "Saturday Night Specials" would effectively prevent defensive tactics during a tender offer, management could still try to prevent an offer from ever being made by enacting, for example, defensive charter amendments.[68]

Second, reducing both the level of disclosure by the offeror and the amount of time for consideration of the offer would impair the ability of target shareholders to make informed decisions. Without the Williams Act, the only information a typical shareholder would have is the price of the offer and the identity of the offeror. Easterbrook and Fischel argue that this is adequate because the offeror, who risks its search time and acquisition costs, is better qualified than apathetic shareholders to determine whether the merger will truly increase the efficiency and value of the firms.[69] They assume that shareholders are passive investors interested only in a return above market price.[70] This approach, however, neglects the view that the shareholders are also the owners of the corporation. Under state corporation law, the decision to sell is normally vested in the owners.[71] Easterbrook and Fischel's proposal would allow shareholders to make the decision to sell, but would deprive

[66] Easterbrook & Fischel, *Management's Proper Role*, *supra* note 22, at 1162.

[67] Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 37, at 17.

[68] Easterbrook and Fischel seem to acknowledge this fact implicitly when they state that unambiguous preventive defensive charter amendments "should be prohibited per se." Easterbrook & Fischel, *Management's Proper Role*, *supra* note 22, at 1203 n.122. They even suggest, contrary to their otherwise laissez-faire approach, that charter provisions affecting tender offers may have to be controlled by the state. *Id.* at 1181–82.

[69] *Id.* at 1200.

[70] *Id.* at 1161, 1171.

[71] *See supra* notes 17–19 and accompanying text.

them of the information that a true owner would desire and could obtain.

Third, the elimination of the Williams Act's pro rata rule and withdrawal rights would create a fairness problem. If an acquirer makes an offer for less than one hundred percent of the shares, target shareholders would have an incentive to sell quickly in order to avoid being left in a minority position.[72] The premium the acquirer pays would not be spread evenly among all the shareholders who wish to tender; instead it would go only to those who tender early. In addition, elimination of these shareholder protections would generate pressure for shareholders to tender without thought, further impeding their ability to make a reasoned decision.

On the other extreme, Professor Lowenstein of Columbia University not only rejects Easterbrook and Fischel's proposal that the period of tender offers be shortened, but proposes instead that the period be lengthened to a mandatory six months.[73] He argues that a six-month period would facilitate competing tender offers and permit shareholders to consider the offers in a less hurried fashion, much like a routine shareholder meeting.[74] He also would require a shareholder vote on specifically defined changes in the corporation's structure during a tender offer or when a tender offer appears imminent.[75]

The major drawback to this proposal is that, by its own admission, it would discourage tender offers.[76] Lowenstein does not find this entirely undesirable, because he believes that many acquisitions are not value-producing.[77] This belief, however, is at odds with the evidence that tender offers on the average result in efficiency gains, regardless of the accuracy of an acquirer's self-confidence in a particular case.[78] There is also no reason to believe that shareholders would significantly benefit by increasing the time for consideration by five months.[79] In

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[72] Bebchuk, *Reply and Extension*, *supra* note 21, at 46.

[73] Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 317 (1983).

[74] *Id.* at 322–24.

[75] *Id.* at 317.

[76] *Id.* at 324. *See also* Harrington, *supra* note 49, at 1018 n.209 ("[A]doption of the Lowenstein proposals will effectively end the tender offer.").

[77] Lowenstein, *supra* note 73, at 254.

[78] *See SEC Advisory Comm. Report*, *supra* note 1, at 116–18 (Separate Statement of Easterbrook & Jarrell).

[79] *See* Bebchuk, *Facilitating Competing Bids*, *supra* note 24, at 1051–53 (suggesting that shareholder decisionmaking would be adequately preserved by an offering period

effect, Lowenstein's proposal would produce a marginal benefit to shareholder decisionmaking at the risk of a significant decline in opportunity for economic gain. Lowenstein's restriction on specific structural changes is desirable.[80] It would not, however, affect types of defensive tactics, such as charter amendments, that are typically taken even before a tender offer is imminent.

Professor Gilson of Stanford University eschews any approach based upon specific statutory prohibitions. Instead, he proposes a general rule that would prohibit management from taking any action "which could interfere with the success of the offer or result in the shareholders of the target company being denied the opportunity to tender their shares."[81] Gilson would permit only two exceptions to this general rule: he would allow management to disclose information presenting its view of the offer and to seek out competing offers.[82]

The major problems with this proposal all flow from its generality. It does emphasize the proper question, forcing courts to focus on the effect of management's actions on the shareholders' ability to decide whether or not to tender their shares.[83] The rule, however, requires courts to answer this question on a case-by-case basis. Case-by-case analysis has two fundamental drawbacks. First, it permits substantial variation in the way different courts deal with the same tactic. State courts, which have traditionally refused to examine the effects of business judgments or have incorrectly analyzed actions under the fairness test, are particularly likely to overlook the defensive impact of transactions and permit undesirable actions.[84] Second, even if courts eventually agree on the correct outcome for a given tactic, case-by-case development is inefficient. The process of reaching consistent and accurate interpretations under such a general standard is likely to be quite gradual. In the interim, management

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of somewhat more than the current 15 days). The SEC Advisory Committee recommends a uniform 30 day minimum offering period for the initial bid of both cash and exchange offers. *SEC Advisory Comm. Report, supra* note 1, at 28 (Recommendation 17).

[80] *Cf. infra* Model Act § 3 and accompanying commentary.

[81] Gilson, *A Structural Approach, supra* note 12, at 878–79. Gilson's proposal is derived from the English City Code. *See infra* Model Act § 3 and accompanying commentary.

[82] Gilson, *A Structural Approach, supra* note 12, at 879.

[83] *Id.* at 879–81.

[84] *See supra* notes 49–53 and accompanying text. Similar inconsistent treatment has plagued the interpretation of the general anti-manipulation standard of federal law. *See supra* note 63 and accompanying text.

tactics would continue to subject society to years of costly inefficiencies and shareholders to interference with the ability to control their shares.[85]

Gilson also argues that his proposal is likely to deter more undesirable actions because a general rule cannot be evaded as easily as a series of prohibitions on specific tactics.[86] In practice, however, his general rule may have less of a deterrent effect than a specific prohibition. It is more difficult for managers prospectively to conform their actions to a general statutory standard than to a specific standard.[87] As a result, courts will be likely to punish in retrospect violations of a general statute less severely than violations of a clear statutory standard. Managers may well feel more free to tread the line between desirable and undesirable conduct knowing that the most likely relief a plaintiff would receive is merely a corrective injunction.

Moreover, any advantages of a general rule must be balanced against the cost of a general rule, namely, the increased likelihood that some desirable conduct will also be deterred.[88] Desirable conduct in this context is profit-maximizing activity taken in the ordinary course of business. This risk is especially great under Gilson's formulation, which prohibits any transaction that "could" interfere. Any action that increases profits "could" interfere by increasing the value of a corporation and the price of its stock, thereby rendering a tender offer more expensive.

Finally, the fact that Gilson's proposed rule is likely to be implemented during a preliminary injunction both increases its inherent disadvantages and further diminishes its advantages.

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[85] *See generally* Ehrlich & Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974); *see also* Lowenstein, *supra* note 73, at 315. This is the primary factor overlooked by commentators, such as Harrington, *supra* note 49, at 1019, who advocate a judicial rather than a legislative approach to regulation of defensive tactics.

[86] Gilson, *A Structural Approach*, *supra* note 12, at 883–87.

Another commentator, Lucian Bebchuk of Harvard University, accepts Gilson's proposal for a general rule against defensive actions, but would extend it in two ways. Bebchuk suggests slightly increasing the regulatory delay provided by the Williams Act in order to facilitate competing tender offers, Bebchuk, *Facilitating Competing Offers*, *supra* note 24, at 1053, and imposing on management a duty to seek out higher offers whenever feasible. *Id.* at 1054. To the extent that it adopts Gilson's rule, Bebchuk's proposal would have the problems associated with a general residual prohibition, *see supra* notes 83–85 and accompanying text; *infra* notes 87–93 and accompanying text; and to the extent that it increases regulatory delay, it would suffer from the problems noted in connection with Lowenstein's proposal. *See supra* notes 76–78 and accompanying text.

[87] *See* Ehrlich & Posner, *supra* note 85, at 262 (detailed rules as compared to a general standard increase the expected punishment cost of undesirable activity and reduce that of desirable activity).

[88] *See id.* at 268–69; Gilson, *A Structural Approach*, *supra* note 12, at 883.

The most common litigation context for actions against target management for engaging in defensive tactics is the preliminary injunction.[89] In a preliminary injunction, the interpretation of the statute is made in a hurried fashion with limited argument and evidence.[90] A general rule requires more argumentation by the plaintiff and analysis by the court in order to determine whether it should be applied to the particular set of facts. Therefore, a general rule is less likely to be decided correctly in a preliminary injunction than is a specific and objectively defined rule.[91] During a tender offer, the result of an erroneously decided preliminary injunction would be either to prevent desirable business conduct or to permit undesirable defensive conduct.[92] The litigation context in which Gilson's rule will be implemented thus increases its inherent disadvantage of deterring desirable business actions and further undercuts its claimed advantage of deterring more undesirable defensive actions.[93]

IV. Lessons

The preceding analysis of the literature and law provides three lessons that have been incorporated in the proposed statute.

First: Permitting managers to impede tender offers through the use of defensive tactics presents a problem for shareholders and society. From the perspective of traditional corporation theory, defensive tactics interfere with the shareholders' rights to decide whether to tender their shares. This right is secured explicitly or implicitly by the enabling laws of every state; defensive tactics constitute an attempt by management to expand

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[89] Wachtell, *supra* note 12.

[90] *See* Note, *Private Litigation Under the Williams Act: Standing to Sue, Elements of a Claim and Remedies*, 7 J. Corp. L. 545, 571–74 (1982) [hereinafter cited as Note, *Private Litigation Under the Williams Act*].

[91] *See* Sidak, *Antitrust Preliminary Injunctions in Hostile Tender Offers*, 30 U. Kan. L. Rev. 491 (1982).

[92] *See id.* at 496–98.

[93] The Bebchuk proposal to impose on management a duty to seek out higher offers, *see supra* note 86, would pose even more enforcement problems in the context of a preliminary injunction than would Gilson's general rule. A court would have difficulty, under the time pressure of a tender offer, determining what acts would facilitate competing offers without impeding the initial offers. Moreover, a duty to seek new offers appears unnecessary. If the regulatory delay is adequate, then potential acquirers should be alerted by the signal given by the first tender offer that the target may be a good acquisition. *See* Gilson, *Seeking Competitive Bids*, *supra* note 38, at 66 n.36. If the regulatory delay is inadequate, then target management would not have sufficient time to identify, approach, and negotiate with other potential acquirers.

its role over and above that provided by state enabling law.[94] From the perspective of free market economic theory, defensive tactics impede the market for corporate control. As a result, the effectiveness of one of the best checks on management self-dealing and inefficiency is reduced. Thus, both commentators who characterize shareholders as true owners and commentators who characterize shareholders as merely inactive suppliers of capital agree that the most appropriate role for management in a tender offer is to remain passive.

Second: The solution to the problem needs to be legislative. The common-law approach prevailing under state fiduciary standards has proven inadequate to the task of regulating defensive tactics. Courts have failed to recognize that tender offers present a conflict of interest that implicates management's duty of loyalty, have placed prohibitive burdens of proof on plaintiffs, or have incorrectly analyzed the effects of specific defensive tactics.

None of these problems is inherently beyond correction. Common-law courts could, with the aid of commentators, eventually agree upon a rule that would maximize shareholder and societal welfare. Courts, however, have been addressing the problem of management's duty during a tender offer for twenty years and are still in substantial disagreement, even by their own admission.[95] Many commentators still deny the existence of a problem,[96] and even those cognizant of the problem present proposals with conflicting solutions.[97] The history of judicial and academic thought in this area indicates that the development of a uniform rule will occur far in the future, if at all. Only legislative action can supply a uniform and immediate solution that could prevent the years of costs to shareholders and society that would result from continuing to allow management to interfere with the market for corporate control.

Third: The statute should consist of specific prohibitions of narrowly defined actions. An approach based primarily upon the purpose of the management action is unsatisfactory because

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[94] *See supra* notes 17–19 and accompanying text.

[95] *E.g.*, Treadway Cos. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980) ("The law in this area is something less than a seamless web; some of the cases are not easily reconciled."); *see also* Note, *Unbridled Discretion*, *supra* note 41, at 649 ("However admirable this concept [of fiduciary duty] may be, decisions show that it is so ambiguous and ill-defined that it is practically meaningless.") (footnote omitted).

[96] *See supra* notes 27–31 and accompanying text.

[97] *See supra* Part III.

it would necessitate burdensome and problematical inquiry into the subjective intent of individuals.[98] An approach based primarily on a general residual prohibition of any management actions that interfere with tender offers is also unsatisfactory. It would be difficult for managers prospectively to conform their conduct to such a standard. Retrospective punishment would tend to be less severe, thus undercutting the deterrent effect of the statute.[99] In addition, a general standard would have to be interpreted on a case-by-case basis. This poses a greater risk that courts will continue to incorrectly analyze the adverse effects of certain transactions.[100] Moreover, a general statute would require more thought and analysis to determine its applicability to a particular set of facts, making it more difficult to implement during a preliminary injunction proceeding.[101]

A set of specific prohibitions, on the other hand, is more easily administered and may be tailored to facilitate judicial decisionmaking in the context of a preliminary injunction. This approach also has the advantage of eliminating the enumerated defensive tactics. Moreover, additional prohibitions could be enacted should managers develop new defensive tactics.

The disadvantages of a specific statutory approach are that some undesirable conduct may be undeterred and that management may change tactics, leading to a never ending statutory chase of management avoidance techniques.[102] These disadvantages, however, should be minimal if the current tactics are the most effective defensive measures and if the statutory provisions are sufficient in number and scope to eliminate those current tactics. Management today presumably employs the most effective defensive tactics that are within the power of the corporation. At the very least, prohibitions specifically drawn to eliminate these tactics would relegate management to second-best defensive tactics. Moreover, a specific legislative approach holds the promise both of being accurately enforced and of stopping the defensive tactics that cause the greatest interference with the rights of shareholders and society.

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[98] *See supra* notes 50–53 and accompanying text.

[99] *See supra* note 87 and accompanying text.

[100] *See supra* notes 83–85 and accompanying text.

[101] *See supra* notes 89–93 and accompanying text.

[102] A similar type of statutory "chase" has characterized the development of the Internal Revenue Code, without engendering serious proposals for its replacement with a general statutory standard.

A MODEL ACT FOR THE PROTECTION OF SHAREHOLDER DECISIONMAKING

SECTION 1.

(a) This Act may be referred to as the Protection of Shareholder Decisionmaking Act.

(b) This Act shall apply to every corporation organized under the laws of this state that on the last day of its fiscal year has total assets exceeding $3,000,000 and a class of equity security (other than an exempted security) held of record by five hundred or more persons.

(c) (Definitions of "equity security" and "exempted security.")

COMMENTARY: The criteria of subsection (b) are based upon the requirements under the federal Securities Exchange Act of 1934.[103] The criteria serve to exclude corporations that are substantially closely held. The rationales of the Model Act do not apply to closely held corporations, because ownership and control are much more tightly linked[104] and because there may be legitimate reasons for protecting the interests of minority shareholders through supermajority provisions in close corporations. Adoption of the federal criteria also facilitates coordination with the Williams Act, which supplies disclosure regulation for tender offers.

Subsection (c) is optional, for "equity security" and "exempted security" are defined under most existing state securities laws by incorporating the federal definitions.[105] Where a state has no such law, the federal definition should be adopted. All terms should be construed in accord with their federal definitions.

There are several common management actions that could be construed as defensive tactics that this statute does not attempt to regulate. One of these actions is the invocation of a state anti-takeover statute. The intention and effect of these statutes are to impede significantly the ability of foreign corporations to make a tender offer for a company incorporated in a state having

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[103] Securities Exchange Act of 1934, § 12(g)(1), 15 U.S.C. § 78l(g)(1) (1982); Rule 12g-1, 17 C.F.R. § 240.12g-1 (1983).

[104] *See* Brudney & Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997, 1001-06 (1981).

[105] *See, e.g.*, UNIF. SECURITIES ACT §§ 401(l), 402, 7A U.L.A. 628, 638 (1958). The Uniform Securities Act has been substantially adopted by more than 30 states. 7A U.L.A. 323 table (Supp. 1983).

such legislation.[106] The current validity of such statutes, however, is in serious doubt. In *Edgar v. MITE Corp.*, the Supreme Court held that one such statute violated the Commerce Clause because it imposed an excessive burden on interstate commerce.[107] Although the Court's decisions involved only one statute, the provisions the Court found offensive are common to virtually all state anti-takeover statutes.[108] In addition, there is a significant possibility that these statutes may be pre-empted by the Williams Act.[109]

This statute also does not regulate some activities that, while they could impede a tender offer, indistinguishably could be undertaken with the intention and effect of helping the corporation. For example, adoption of restrictive loan agreements or employment contracts may impede tender offers by giving a lender the right to accelerate or an employee the right to tenure if a change in corporate control occurs. Each of these actions, however, is also a normal business practice that might be necessary for a corporation to secure a loan or retain a key employee. If the actions are not taken in anticipation of an imminent tender offer, it is not possible to tell ex ante whether the actions will benefit or hurt shareholders. This statute therefore relegates regulation of these types of actions to existing methods.[110]

SECTION 2.

(a) **Any amendment to the articles of incorporation of any corporation subject to this Act that adds or changes a provision for the taking of any action by the shareholders so as to require a proportion of the vote of the holders of any class or series of shares greater than the minimum proportion specified by the laws of this state must be**

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[106] *State Takeover Statutes*, *supra* note 5, at 742–54.

[107] 457 U.S. 624 (1982).

[108] *See, e.g.*, UNIF. TAKE-OVER ACT, 1 BLUE SKY L. REP. (CCH) ¶ 5295 (North Am. Sec. Adm'rs. Ass'n, Inc. Oct. 14, 1981); *State Takeover Statutes*, *supra* note 5, at 752 (administrative hearings provisions).

[109] *See* Edgar v. MITE Corp., 457 U.S. 624, 630–34 (1982). A finding of pre-emption might also affect the constitutionality of this proposal as state law. In that case, Congress would clearly have authority to adopt this proposal as an amendment to the Williams Act.

[110] *See* Friedenberg, *Jaws III: The Impropriety of Shark-Repellent Amendments as a Takeover Defense*, 7 DEL. J. CORP. L. 32, 92–93 (1982) (arguing against a per se prohibition on the issuance of stock); Gilson, *A Structural Approach*, *supra* note 12, at 888–89 (arguing that pre-offer defensive tactics are less effective and can be dealt with adequately by traditional doctrines).

adopted by the same vote as would be required to take action under the provision to be adopted.

(b) Any corporation whose articles of incorporation include a provision for the taking of any action by the shareholders that requires a proportion of the vote of the holders of any class or series of shares greater than the minimum proportion specified by the laws of this state must have such provision approved by the same vote of shareholders as specified in subsection (a) at the time it becomes subject to this Act, either upon the date of enactment of this Act or upon fulfillment of the conditions specified in section 1. Any such provision that does not receive the requisite approval within six months of the corporation becoming subject to this Act shall be deleted from the articles of incorporation.

(c) Any other provision of law notwithstanding, a resolution of the board of directors shall not be required in order to amend the articles of incorporation so as to change or delete any provision of the articles of incorporation concerning the election, removal, or term of a director.

COMMENTARY: This section is designed to increase the difficulty of enacting amendments to the corporation charter that would substantially interfere with tender offers. Because charter amendments require a shareholder vote,[111] defensive amendments are usually proposed by management before shareholders are aware of any specific offer. The primary aim of such amendments is thus to discourage a tender offer from ever being made.[112] Charter amendments are particularly impervious to attacks under federal law, for the Williams Act has been interpreted to apply only if an offer has been made.[113] Many corporations that consider themselves vulnerable to takeovers have enacted such amendments.[114]

Charter amendments may interfere with tender offers in two ways. One type of amendment delays or prevents an acquirer

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[111] *See, e.g.*, MODEL BUSINESS CORP. ACT § 59 (1980) (majority vote); Hochman & Folger, *Deflecting Takeovers: Charter and By-law Techniques*, 34 BUS. LAW. 537, 542 (1979). Inserting defensive amendments in the bylaws would avoid the need for a shareholder vote. In most states, however, the bylaws may be changed by vote of the directors. *See, e.g.*, MODEL BUSINESS CORP. ACT § 27 (1980). An acquirer could easily eliminate defensive amendments in the bylaws after electing new directors. Therefore, the usual strategy is to insert defensive provisions in the charter. Hochman & Folger, *supra*, at 545.

[112] *See* E. ARANOW & H. EINHORN, CORPORATE CONTROL, *supra* note 15, at 259; Hochman & Folger, *supra* note 111, at 537.

[113] *See* Lewis v. McGraw, 619 F.2d 192, 193 (2d Cir.), *cert. denied*, 449 U.S. 951 (1980).

[114] *Takeovers: A Survey of Corporate Defense Strategies*, MERGERS & ACQUISITIONS, Spring 1980, at 21, 28 [hereinafter cited as *Survey of Strategies*].

from removing the management of the target. This delay impedes the ability of an acquirer to implement personnel, technological, or marketing changes that could increase the efficiency of the firm.[115] This type includes amendments to classify the board of directors, to abolish cumulative voting, to restrict the removal of directors, and to prevent the calling of a special shareholder meeting.[116] A second type of amendment discourages tender offers by increasing the total price that the acquirer must pay for the target. This second type includes "fair price" requirements, which grant target shareholders in a second-stage merger the right to receive a price above that of the tender offer.[117] It also includes mandatory redemption provisions that give nontendering shareholders the right to have their shares purchased at a fixed price by the corporation even if the acquirer chooses not to have a second-stage merger.[118] Finally, this type includes provisions to require supermajority approval for mergers of the target with "related persons."[119]

A common element of all these defensive charter amendments is that they need a "lock-in" provision to be effective. A lock-in clause provides that a supermajority vote is necessary to change the defensive provision. Without a lock-in provision, a successful acquirer can eliminate any defensive provision simply by amending the charter.[120] This method is available because state enabling laws typically require only a majority vote to amend a corporate charter.[121]

Defensive charter amendments create economic inefficiencies in that they discourage tender offers by increasing the price of acquisitions and by impeding the replacement of inefficient management. These provisions are also fundamentally unfair to pub-

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[115] *See* Friedenberg, *supra* note 110, at 36, 39–42.

[116] *See* A. FLEISCHER, TENDER OFFERS: DEFENSES, RESPONSES, AND PLANNING 10–51 (2d ed. 1983) [hereinafter cited as A. FLEISCHER, RESPONSES AND PLANNING].

[117] *See* Smith, *Fair Price and Redemption Rights: New Dimensions in Defense Charter Provisions*, 4 DEL. J. CORP. L. 1 (1978). A second-stage merger occurs when the tender offeror initially acquires less than 100% of the stock of the target company. To eliminate minority shareholders, the acquirer votes its target shares in favor of a merger with the acquirer at a price set by the acquirer.

[118] *Id.*

[119] "Related persons" is usually defined as any shareholders owning a substantial interest, typically anything above 10%. *See* A. FLEISCHER, RESPONSES AND PLANNING, *supra* note 116, at 26–30 ("interested shareholders"); Hochman & Folger, *supra* note 111, at 548–51 ("substantial stockholders").

[120] A. FLEISCHER, RESPONSES AND PLANNING, *supra* note 116, at 25–26; Gilson, *Limitations on the Enabling Concept*, *supra* note 13, at 790.

[121] *See, e.g.*, MODEL BUSINESS CORP. ACT § 59 (1980).

lic shareholders in that they bind a future majority in a situation where the interests of minority shareholders are likely to be adverse to those of the corporation.[122] In a widely held corporation, a restriction on the actions of a majority of shareholders usually presents little danger of minority abuse because both the majority and minority shareholders should be interested in the same fundamental goal: maximizing the corporation's value.[123] During a tender offer, however, management shareholders will be predictably more interested in preserving their control. Since the defensive provisions pertain only to a change in control, the power of majority public shareholders is limited at the very time when the interests of the minority management shareholders are adverse.[124]

This section will discourage defensive charter amendments by making the lock-in provision of such amendments more difficult to enact. Any amendment creating a provision that by its terms requires a supermajority vote to be altered must be adopted by the same supermajority vote. For example, a "fair price" amendment that would require a vote of eighty percent of the outstanding shares to change the amendment once adopted would have to be approved initially by an eighty percent vote, rather than by a simple majority.[125] The effectiveness of this section rests on the need for management to obtain an affirmative vote of the shareholders. In a public corporation it is rational for shareholders to be apathetic and not to exercise their right to vote.[126] In order to ratify a lock-in provision, management will therefore need the votes of many nonapathetic shareholders. Nonapathetic shareholders can be expected to consider the issue more carefully and are presumably less likely to vote for amendments that could deny them the chance to obtain a tender offer premium.[127] To combat the fact that some apathetic shareholders routinely vote for management, this sec-

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[122] *See* Gilson, *Limitations on the Enabling Concept*, *supra* note 13, at 831–33.
[123] *Id.*
[124] *Id.*
[125] *Cf.* Committee on Corporate Laws, Section of Corp., Banking & Business Law, American Bar Ass'n, *Changes in the Model Business Corporation Act--Amendment Respecting Increases in Proportion of Vote for Shareholder Approval*, 36 BUS. LAW 1899 (1981) (stating that when an amendment changes a shareholder voting provision with the result that a greater proportion would be required, this change must be adopted by the same vote as would be required to take action under the provision to be adopted or then in effect, whichever is greater) [hereinafter cited as *M.B.C.A. Amendment*].
[126] Gilson, *Limitations on the Enabling Concept*, *supra* note 13, at 822–27.
[127] *Id.* at 825.

tion relies upon coordination with a federal regulation requiring disclosure of the potential defensive effect of a charter amendment. Although such disclosure is now required under the proxy regulations, corporations that had enacted provisions before 1978 did not have to disclose.[128] This section would require a new vote, thus allowing those shareholders to make an informed decision. The increasing awareness of the defensive effect of such charter amendments, especially among institutional investors, suggests that they are now less likely to be adopted or ratified.[129]

The economic significance of tender offers to society as a whole, the inherent conflict of interest between management shareholders and public shareholders, and the lack of a need to protect minority interests outside of close corporations suggest that a majority of shareholders should always be able to amend the corporate charter.[130] This, however, is not the approach taken by many state enabling laws. Most states allow even public corporations to enhance the power of minority shareholders through supermajority provisions.[131] This section attempts to remain within the spirit of current law, while reducing the prevalence of defensive charter amendments that can adversely affect the interests of both shareholders and society.

The language of subsection (a) is derived from a proposed amendment to the Model Business Corporation Act.[132] While subsection (a) requires existing section 1 corporations without defensive charter amendments to gain supermajority approval if they propose such amendments in the future, subsection (b) requires existing section 1 corporations with previously adopted defensive charter amendments to obtain shareholder ratification of the supermajority provision within six months of enactment of this Act. In addition, this section potentially applies to exist-

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[128] Sec. Ex. Act Rel. 15,230, 15 SEC DOCKET 1311 (1978).

[129] *See* Gilson, *Limitations on the Enabling Concept, supra* note 13, at 826; Mestres & Gerlits, *Tender Offers: Considerations for the Defense*, 11 INST. ON SEC. REG. 74 (1980).

[130] *See* Friedenberg, *supra* note 110, at 64; Gilson, *Limitations on the Enabling Concept, supra* note 13, at 813–14.

[131] *See supra* note 111 and accompanying text.

[132] *M.B.C.A. Amendment, supra* note 125; *see also* Gilson, *Limitations on the Enabling Concept, supra* note 13, at 827–31 (suggesting that passage of supermajority provisions should require the same supermajority as the provision itself requires). The SEC Advisory Committee, which also has recommended requiring initial supermajority approval, suggests mandatory ratification of supermajority provisions every three years. *See SEC Advisory Comm. Report, supra* note 1, at 36–37 (Recommendation 36).

ing and future-organized corporations that adopt defensive charter amendments while they are closely held. These corporations must obtain shareholder ratification within six months after fulfilling the criteria of section 1. Should a corporation fail to obtain ratification of a lock-in amendment, the proportion necessary to amend the articles of incorporation will revert to the statutory minimum.

Subsection (c) eliminates any requirement that directors must approve amendments affecting their tenure. Some states require all proposed amendments to the corporate charter to originate as resolutions of the board of directors.[133] In these states, directors could frustrate an acquirer's attempt to remove management protected by a provision allowing removal only for cause by refusing to pass a resolution to change the provision.[134] Under this subsection, an acquirer may obtain a shareholder vote, without the approval of the incumbent board of directors, on an amendment to eliminate the substantive and lock-in charter provisions restricting removal of directors. If the acquirer is successful in replacing the incumbent directors, it will then be able to seek, without management opposition, the elimination of any other defensive provision.

SECTION 3.

(a) Unless the corporation affirmatively demonstrates that such transaction occurred in the ordinary course of business, a corporation may not, during the period described in subsection (b),

(1) issue any authorized but unissued shares or dispose of any treasury shares, issue or grant options in respect of any unissued or treasury shares, or create or issue or permit the creation or issuance of any securities carrying rights or conversion into or subscription for shares of the corporation, in excess of five percent of the fair market value of all shares outstanding, or

(2) sell, dispose of, or acquire or agree to sell, dispose of, or acquire assets in excess of five percent of the fair market value of all the assets of the corporation.

(b) Subsection (a) shall apply

(1) during the period beginning on the date on which an offer for the tender of any securities subject to section 12 of the Securities

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[133] *See, e.g.*, MODEL BUSINESS CORP. ACT § 59(a) (1980).
[134] Hochman & Folger, *supra* note 111, at 542.

Exchange Act of 1934 is announced, and ending when such offer expires or is withdrawn, and

(2) during the period beginning on the date when the officers or directors first believe or reasonably should believe that a bona fide tender offer by a particular corporation, group, or individual is imminent, and ending forty-five days thereafter.

COMMENTARY: This section is designed to discourage extraordinary transactions taken in anticipation of or in response to a specific tender offer. Extraordinary transactions can impede tender offers in three ways. First, some transactions, such as a repurchase of the corporation's own shares, increase the price of the target corporation's stock and thus raise the cost of the tender offer to the acquirer.[135] Other transactions are designed to place target stock in friendly hands, effectively removing the shares from the acquirer's reach at any price and therefore hindering an acquirer's ability to obtain majority control. This category of transactions includes the issue of shares to an employee stock ownership plan,[136] the issue of stock with restrictions on voting or transfer,[137] and "lock-up" agreements that assure that a specific corporation friendly to target management (a "White Knight") will obtain control.[138] Third, a target may create a need for regulatory approval, such as by acquiring a foreign corporation or a utility, or may create antitrust problems, as by merging with a competitor of the potential acquirer. Even if government approval would ultimately be granted, the delay involved substantially decreases the chance that a tender offer will succeed.[139]

All of these corporate transactions can serve valid business purposes that will increase shareholder welfare.[140] The problem is that they also have the effect of impeding changes in corporate control. This conflict has been overlooked by current state law, under which regulation of these practices is minimal or nonex-

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[135] *See* E. ARANOW & H. EINHORN, CORPORATE CONTROL, *supra* note 15, at 235–36.

[136] *See* Brecher, Lazarus & Gray, *The Function of Employee Retirement Plans as an Impediment to Takeovers*, 38 BUS. LAW. 503 (1983); Note, *Duties of Employee Benefit Plan Trustees Under ERISA in Hostile Tender Offers*, 82 COLUM. L. REV. 1692 (1982).

[137] *See* E. ARANOW & H. EINHORN, CORPORATE CONTROL, *supra* note 15, at 260–62.

[138] *See* Fraidin, *Lock-Ups*, in MECHANICS OF TENDER OFFERS: DEMYSTIFYING THE TENDER OFFER 597 (1981); Note, *Lock-Up Options*, *supra* note 63.

[139] *See* A. FLEISCHER, RESPONSES AND PLANNING, *supra* note 116, at 54–55.

[140] *See* Friedenberg, *supra* note 110, at 37.

istent.[141] The majority of courts uphold these practices because they are specifically within the powers authorized by state enabling laws. These courts argue that management's decision to exercise the authorized power of the corporation is protected by the business judgment rule.[142] Some courts have imposed a fiduciary duty on management not to exercise corporate power in order to retain control. But even this fiduciary standard requires the plaintiff to prove either the subjective intent of management or the absence of a valid business purpose—burdens which plaintiffs have seldom been able to overcome.[143]

This section creates a presumption that the adverse effects on shareholder rights of certain types of transactions at certain times outweigh any potential benefits from the transactions. The presumption operates through two criteria: the timing of the transaction and the size of the transaction. After a tender offer is announced, or after management knows or should know that a tender offer is imminent, extraordinary transactions must be deferred. The announcement of a tender offer under subsection (b)(1) is determined by the objective provisions of federal law.[144] The time under subsection (b)(2) at which target management should know a tender offer is imminent, while also objective, is less precise. It may be ascertained by reference to publicly available information, such as pre-offer statements by the acquirer or reports in business publications. The time at which management actually knows that a tender offer is imminent is necessarily subjective, though it may be ascertained by objective as well as subjective information obtained through discovery.

The temporal aspect of this presumption is limited in several ways so as to protect good-faith actions of management. First, the knowledge of the tender offer under subsection (b)(2) must be particularized to a specific offeror. Management is not prohibited from engaging in extraordinary transactions merely because it knows that the corporation is vulnerable to a takeover. Indeed, it is likely that such transactions may be necessary to improve the corporation's performance. Second, an offer must be thought to be "imminent." The boundaries of this term are relatively clear: it should not be construed in the sense of "im-

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[141] *See supra* note 49 and accompanying text.

[142] *See id.*

[143] *See supra* notes 50–53 and accompanying text.

[144] *See* Williams Act § 14(d)(1), 15 U.S.C. § 78n(d)(1) (1982).

mediate" nor in the sense of "possible." Rather, "imminent" should be construed in the sense of likely to occur, if ever, within approximately forty-five days.

Third, subsection (b) permits extraordinary transactions to be resumed after forty-five days if no tender offer is forthcoming. This limitation should prevent a potential acquirer from freezing a corporation's business activities for an extended period of time by repeatedly suggesting an intention to make a tender offer. Under this section, an acquirer may seek a negotiated transaction before making a tender offer, but it must make a tender offer within forty-five days or the corporation may resume unrestricted business transactions.[145] This limit should also reduce the uncertainty as to when management may resume extraordinary transactions.[146]

Finally, this section should not be construed to hold those individual managers who are reasonably unaware of an imminent tender offer liable for transactions engaged in by fellow officers and directors who are aware of an imminent tender offer.[147] The existing duty to inform fellow directors of material information should limit the period in which managers will remain ignorant. Of course, knowledgeable managers will be fully liable for actions in which they cause the corporation to engage.

The second criterion through which the presumption operates is the size of the transactions. Smaller transactions are less likely to interfere with a tender offer and are also more likely to be transactions resulting from the ordinary course of business of the corporation. Therefore, regulating larger transactions is more important because they are more likely to impede tender offers and to be motivated by a desire to retain control. Sub-

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[145] The effect of rules requiring management passivity on the prevalence of negotiated transactions is uncertain. Knowing that they cannot maintain independence, target management may bargain for the most perquisites that they can get. Gilson, *Seeking Competitive Bids*, *supra* note 38, at 66 n.36. On the other hand, knowing that target management can do little to interfere with a bid, potential acquirers will have little reason to deal with management. Bebchuk, *Reply and Extension*, *supra* note 21, at 25 n.8. In any case, one empirical study has found that pre-offer information leakage affects the price of a future target's stock for only 40 days before the offer. This suggests that acquirers search for and make their decision regarding an offer for a particular target within this period of time. Jarrell & Bradley, *supra* note 33, at 389 n.42.

[146] Of course, if management is unsure in retrospect of the time at which the provision took effect, then it will also be unsure of when the 45 days have passed. The net cost of any uncertainty, however, should be low, for the effect of uncertainty will be to deter management actions during a time when the risk of harm to the shareholders is still high. *See* Gilson, *A Structural Approach*, *supra* note 12, at 887.

[147] *Cf.* Bennett v. Propp, 41 Del. Ch. 14, 182 A.2d 405 (Del. 1962) (directors not liable under the twin circumstances of prior ignorance and immediate emergency).

section (a) sets five percent of the fair market value of the corporation as the presumptive dividing line between small and large transactions.[148] Smaller transactions are valid regardless of intent. Larger transactions are presumptively invalid, although management may justify an action by demonstrating that it occurred "in the ordinary course of business." This exception should be interpreted narrowly. It is not intended as a subjective test that is determined according to management's purpose in undertaking the transaction. Instead, management must demonstrate objectively that the action was unrelated to the existence of the tender offer, for example, by showing that the transaction was agreed to or authorized prior to awareness of a tender offer. Of course, this exception does not include transactions authorized prior to but conditioned upon the event of a tender offer.

The language of this section is drawn from the English City Code.[149] This section attempts to make the provision easier for a court to implement by employing the general phrase "the ordinary course of business" only as an exception to objective quantitative limits on the time and size of transactions, rather than as the operative standard.

SECTION 4.

(a) **It shall be unlawful for any officer, director, employee, or agent of a corporation that is the object of a tender offer 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, 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.**

(b) **Any person that violates this section shall be liable in an amount not to exceed $10,000 to the shareholders of the corporation that is**

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148 The securities laws already employ objective presumptions as surrogates for more subjective criteria. *See, e.g.*, Securities Exchange Act of 1934, § 16, 15 U.S.C. § 78p (1982) (six months distinguishes transactions by directors in their corporation's stock based on inside knowledge from those presumed not to be based on inside knowledge); NEW YORK STOCK EXCHANGE, COMPANY MANUAL A-284 (1978) (20% increase in outstanding common shares used to distinguish issues of stock in connection with a merger that substantially affect the nature of the company, and therefore require a shareholder vote, from issues of stock that do not).

149 CITY WORKING PARTY, THE CITY CODE ON TAKE-OVERS AND MERGERS 30 -31 (1976) (Rule 38). The City Code is not law; it is a set of guidelines established by England's self-regulating securities organizations.

the object of a tender offer or to any person that has made a tender offer. The amount of liability shall be determined in proportion to the materiality of the fact and the willfulness of the violation. No person shall be liable to more than one person under this subsection, but a failure to find liability under this subsection shall not be regarded as binding for the purposes of any other provision of law. Any person found liable under this subsection shall also be liable for expenses, including attorneys' fees, actually and reasonably incurred by the person bringing the action. This remedy shall be in addition to all other remedies, including those of section 5 of this Act, that may exist at law or in equity.

COMMENTARY: This section is designed to create a new nonexclusive cause of action against target management.[150] The section imposes limited strict liability against managers who disseminate false material information in connection with a tender offer. It contemplates that target management is not prohibited from communicating to shareholders management's position regarding a proposed tender offer and a statement of reasons for that position. Such communication is currently required by federal law.[151] Management can more quickly and completely gather financial information about the target and potential acquirer than can the dispersed individual shareholders. Such information is valuable to shareholders in evaluating the terms of the offer and the statements in the offeror's proxy statement. By centrally gathering and disseminating information relevant to the proposed offer, target management can overcome a problem of dispersed ownership and increase the efficiency of the shareholders' economic decisionmaking.[152]

The problem with this power is that the inherent conflict of interest that induces management to oppose tender offers that

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[150] "Cause of action" should be construed in the sense of a statement of a claim upon which relief can be granted. *See* FED. R. CIV. P. 12(b)(6).

[151] *See* Rule 14e-2, 17 C.F.R. § 240.14e-2 (1983); *see also supra* note 59.

[152] Gilson, *A Structural Approach*, *supra* note 12, at 865–67.

This statute does not prohibit litigation by a target against an acquirer for violations of state or federal securities laws in connection with representations made during a tender offer. Because such action occurs in the context of a specific tender offer, it is reasonable to presume that management's strong or primary motive is an interest in self-preservation. Such litigation, however, also serves as the primary means of ensuring that disclosure is complete and accurate. *See id.*

This statute does not prohibit litigation for misrepresentations on the assumption that such litigation on balance benefits target shareholders. The acquirer can avoid liability on substantial claims by its own efforts to make the proxy statement accurate, while harassing claims by the target are subject to dismissal in a preliminary injunction. Thus, in the absence of other defensive tactics, the mere threat of litigation is unlikely to interfere greatly with a tender offer.

would benefit shareholders also creates an incentive for managers to disseminate false information. False information obviously interferes with shareholder decisionmaking. The dissemination of false information is currently prohibited at the state level by statutes prohibiting fraud in the sale or purchase of securities[153] and at the federal level by the Williams Act.[154] The state and federal statutes authorize both injunctive relief and actions for damages as remedies for violations.[155]

These remedies, however, have proven in practice to be inadequate to deter dissemination of false information during a tender offer. Injunctive relief on either state or federal grounds is inadequate because of the limited time during which tender offers are open. An injunction ordering correction of the misstatement or omission is common, but the corrected information may not reach all the target shareholders before the tender offer expires. Moreover, if the court orders the offer held open to allow the information to disseminate and the shareholders to reconsider, this court-ordered delay itself will work to the disadvantage of the acquirer.[156] Actions for damages at the state level are inadequate because common law fraud requires tendering shareholders to prove reliance and causation and because the securities laws apply only to purchasers.[157] Actions for damages at the federal level are inadequate in that a defeated tender offeror lacks standing.[158] Although a nontendering shareholder has standing and reliance has been equated with materiality,[159] plaintiffs have had great difficulty in proving damages, perhaps because courts overlook the damages that can occur despite corrective injunctions.[160]

The language of subsection (a) is drawn from section 14(e) of the Williams Act.[161] The same language is also found in the

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[153] *See, e.g.*, UNIF. SECURITIES ACT § 101, 7A U.L.A. 568 (1958).

[154] Williams Act § 14(e), 15 U.S.C. § 78n(e) (1982).

[155] *See, e.g.*, Securities Exchange Act of 1934, §§ 28(a), 32(a), 15 U.S.C. §§ 78bb(a), 78ff(a) (1982); UNIF. SECURITIES ACT § 410, 7A U.L.A. 670 (1958).

[156] A. FLEISCHER, RESPONSES AND PLANNING, *supra* note 116, at 315.

[157] *See, e.g.*, UNIF. SECURITIES ACT § 410, 7A U.L.A. 670 (1958).

[158] Piper v. Chris-Craft Indus., 430 U.S. 1, 42 (1977); *see* Note, *Private Litigation Under the Williams Act*, *supra* note 90, at 563.

[159] TSC Indus. v. Northway, Inc., 426 U.S. 438, 444 (1976) (quoting Mills v. Electric Auto-Lite, 396 U.S. 375, 385 (1970)); Note, *Private Litigation Under the Williams Act*, *supra* note 90, at 567–71.

[160] E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL 140–41 (1977) [hereinafter cited as E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS]; Note, *Private Litigation Under the Williams Act*, *supra* note 90, at 574–78.

[161] *See* Williams Act § 14(e), 15 U.S.C. § 78n(e) (1982).

second clause of section 101 of the Uniform Securities Act.[162] The differences are that the Williams Act provides civil relief only for willful violations[163] and that only purchasers may recover under the civil liability provision of the Uniform Securities Act.[164] These considerations aside, the terms of this section should be construed in accord with the parallel federal and state definitions.

Subsection (b) attempts to overcome three problems common to actions for strict liability. The first is that the threat of liability without fault could deter managers from taking desirable actions.[165] This problem is significant here because the standard of material misstatement is somewhat vague and because management actions to correct an acquirer's proxy statement can substantially benefit shareholders. This section resolves the problem by imposing a limit of $10,000 on management's liability without proof of fault.[166] In addition, the provision that "liability shall be determined in proportion to the materiality of the fact and the willfulness of the violation" means that liability should be less for violations that have a relatively small impact on shareholder decisionmaking or are merely negligent.

The second problem is that an action for strict liability may conflict with the federal provision that limits recovery to "actual damages."[167] Some courts have held that the federal provision prevents recovery of punitive damages under state law for transactions also actionable under federal law.[168] In the event that federal law is definitively held to pre-empt any state law providing liability without fault, this section would have to be adopted as an amendment to federal law.

The third problem is how to allocate recovery and costs in order to provide adequate incentive for a person to bring the actions. This section provides that the plaintiff will recover for any liability imposed. Yet, costs, especially attorneys' fees, may

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[162] UNIF. SECURITIES ACT § 101(2), 7A U.L.A. 568 (1958).
[163] *See* Securities Exchange Act of 1934, § 32(a), 15 U.S.C. § 78ff(a) (1982).
[164] UNIF. SECURITIES ACT § 410, 7A U.L.A. 670 (1958).
[165] *See* Fischel, *supra* note 23, at 923.
[166] Of course, if $10,000 proved to be too small a sanction in light of the salaries and perquisites of major corporate managers, the amount could be adjusted to the degree indicated by experience.
[167] Securities Exchange Act of 1934, § 28(a), 15 U.S.C. § 78bb(a) (1982).
[168] *See, e.g.*, Schaefer v. First Nat'l Bank of Lincolnwood, 326 F. Supp. 1186, 1193 (N.D. Ill. 1970); *see also* Note, *The Availability of Variant State Remedies for Pendent State Fraud Claims Actionable Under the Federal Securities Acts*, 47 S. CAL. L. REV. 1213 (1974).

equal or exceed the amount of damages awarded.[169] The section contemplates that in order to induce suits a successful plaintiff must be awarded expenses including attorneys' fees.[170] This allocation of recovery and costs suggests that either unsuccessful acquirers or target shareholders are likely to bring suit under this section, quite possibly joined with an action for actual damages.[171]

The initial action for limited strict liability precludes any further suits under this section arising from the particular tender offer. This section, however, does not preclude an action under section 5 by the plaintiff or any other person for damages actually incurred. A failure to find liability under this section shall have no collateral effect as a defense in an action for actual damages under this Act or under any other law. The limitation is necessary because a plaintiff may not have the incentive fully to litigate the issue where the amount of liability involved is small, for example, if the action is brought for a negligent or minor violation. A court, on the other hand, may grant collateral effect to a finding of liability if necessary for the judgment and if the issue was fully and fairly litigated.

SECTION 5.

(a) **Any person, including the shareholder derivatively of any corporation sought to be acquired and any person making a tender offer, who is injured in business or property by reason of an act or transaction in violation of this Act shall be entitled to sue and recover damages therefore. Any person shall also be entitled to sue for injunctive relief against threatened loss or damage by violation of this Act, when and under the same conditions and principles as injunctive relief against threatened conduct that will cause loss or damage is granted by courts of equity, under the rules governing**

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[169] *See* Lynch & Steinberg, *supra* note 48, at 917.

[170] Of course, an award of costs would also have the effect of increasing the potential liability of management, thus increasing the deterrent effect of the provision.

[171] Moreover, a plaintiff might be able to use a judgment offensively in a suit for actual damages. This creates an extra incentive to first bring an action under this section. For example, if a plaintiff anticipated incurring $10,000 of costs for a suit in which he believed he only had a 25% chance of success, the plaintiff would not sue if net recovery (here, $10,000 recovery plus $10,000 mandatory award of costs to a successful plaintiff less $10,000 cost of suit) was limited to $10,000. The plaintiff would not sue because his expected cost (75% multiplied by $10,000 = $7500) exceeds his expected recovery (25% multiplied by $10,000 net recovery = $2500). However, the ability to use a favorable verdict offensively in a suit for higher actual damages in effect increases the expected recovery in a strict liablity suit by raising the possible net recovery above $10,000.

such proceedings. Upon the execution of proper bond against damages for an injunction improvidently granted and a showing that the danger of irreparable loss or damage is immediate, a preliminary injunction may issue.

(b) For the purpose of indemnification of any officer, director, employee, or agent of a corporation, any action taken in violation of this Act shall be deemed to be not in good faith and not in the best interest of the corporation. Nor shall a corporation have the power to purchase or maintain insurance on behalf of any officer, director, employee, or agent against any liability asserted against him or incurred by him for an action or transaction in violation of this Act. Any other provision of law notwithstanding, to the extent that a director, officer, employee, or agent has been successful on the merits or otherwise in defense of any action, suit, or proceeding under this section he may be indemnified against expenses, including attorneys' fees, actually and reasonably incurred by him in connection therewith.

COMMENTARY: The language of subsection (a) is drawn from the remedy provisions of the antitrust laws[172] and is designed to permit recourse to all the traditional remedies for violations of the Act. Because the most effective form of relief in connection with a tender offer is usually a preliminary injuction,[173] a strict liability remedy is not supplied for violations of sections 2 and 3 of this Act. Instead, the provisions of this Act have been drawn narrowly to facilitate decisions in the limited time available immediately before or during a tender offer. It is anticipated that the decision whether to grant an injunction would involve a straightforward determination of whether one of the specifically prohibited acts had occurred. A suit for ex post damages would have to fulfill the traditional conditions of proof of materiality and injury. These conditions should be construed in the same manner as the federal securities laws, rather than the common law. For example, the rule of *TSC Industries v. Northway, Inc.*,[174] equating reliance and causation with materiality, should be followed. This section, however, reverses the standing rule of *Piper v. Chris-Craft Industries*[175] in order to allow unsuccessful tender offerors to sue target management for damages. This change is adopted because the tender offeror is one

[172] Clayton Act §§ 4, 16, 15 U.S.C. §§ 15, 26 (1982).

[173] *See* Piper v. Chris-Craft Indus., 430 U.S. 1, 40 n.26, 42 (1977); Missouri Portland Cement Co. v. Cargill, Inc., 498 F.2d 851 (2d Cir. 1974); E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS, *supra* note 160, at 129.

[174] 426 U.S. 438 (1976).

[175] 430 U.S. 1 (1977).

of the persons most interested in effective enforcement of limitations on target defensive tactics and should not be denied standing merely because those defensive tactics may have been successful in frustrating the offer.[176]

Subsection (b) is designed to prohibit direct or indirect reimbursement by the corporation of target management for violations of this Act. Indemnification and insurance significantly reduce the in terrorem effect upon management. They thus undermine one significant purpose of imposing liability on individuals, that is, to discourage violations of the law.[177] Indemnification and insurance are traditionally justified as necessary to insulate directors from liability for losses resulting from good-faith errors in judgment in order to encourage the risk-taking that is inherent in business operations.[178] The presumption underlying this Act, however, is that the actions proscribed herein are on balance much more likely to harm than to help the shareholders, so that management action is more likely motivated by self-interest than by a good-faith judgment that the action is in the best interests of the corporation. There is no need to insulate directors from liability for losses incurred as a result of actions not taken on behalf of the corporation. State statutes already recognize this fact by authorizing indemnification or insurance only for actions in good faith and in the best interest of the corporation.[179] In addition, because the provisions are narrowly drawn and defined in objective terms, managers should have a high degree of certainty about whether their actions violate the law and, therefore, should not require protection in order to encourage lawful business activities.

This subsection coordinates with current state law by removing actions taken in violation of the Act from the purview of the indemnification authorizing statutes. This subsection does, however, specifically permit indemnification for expenses incurred by a manager who successfully defends a suit on either substantive or procedural grounds. It does not authorize indemnification of payments or costs of settlement.

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[176] *See* Note, *Private Litigation Under the Williams Act*, *supra* note 90, at 556–59.

[177] *See* Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1087–1103 (1968).

[178] *See* Note, *Indemnification of Corporate Directors: A Disincentive to Corporate Accountability in Indiana*, 17 VAL. U.L. REV. 229, 238 (1983).

[179] *See, e.g.*, N.Y. BUS. CORP. LAW §§ 722–723 (McKinney Supp. 1983–1984); MODEL BUSINESS CORP. ACT § 5 (1980).

SUGGESTED FEDERAL AMENDMENTS

Amend section 16 of the Clayton Act[180] by adding:

However, no preliminary or permanent injunctive relief shall issue against threatened loss or damage by violation of the antitrust laws occurring as a result of a tender offer for securities that are subject to section 12 of the Securities Exchange Act of 1934 from the time the offer or request or invitation is first published or sent or given to security holders until such time as the tender offer is withdrawn or expires. A party otherwise entitled to relief may obtain an order requiring the person making the tender offer to preserve the person acquired or any assets of the person acquired as a separate and independent entity, pending the trial and decision on the merits of such claim, under the conditions and principles granted by courts of equity.

Amend section 7A(b)(2) of the Clayton Act[181] by adding:

(B) The Federal Trade Commission and the Assistant Attorney General shall terminate the waiting period and issue notice that they do not intend to take any action within such period with respect to such acquisition in the case of a tender offer, upon agreement by the acquiring person to hold the person being acquired or the assets of the person being acquired as a separate and independent entity pending the trial and decision on the merits of any claim arising under the antitrust laws or upon notification by the acquiring person that a court of competent jurisdiction has entered such an order. The Federal Trade Commission and Assistant Attorney General may require the submission of additional information or documentary material relevant to the proposed acquisition from the acquiring person at any time prior to the time the waiting period would have expired under subsection (b)(1) of this section but for a termination order entered pursuant to this subparagraph.

COMMENTARY: These proposals are designed to restrict the use of the federal antitrust laws in defensive tactics against tender offers. There are three basic methods by which target management can utilize the antitrust laws to impede tender offers.

The first method is through defensive acquisitions. Management that anticipates a tender offer may compel the target corporation to acquire other companies in the same line of business as the potential acquirer. This action presents the potential acquirer with the prospect that acquisition of the target would increase horizontal concentration in the acquirer's industry. The defensive acquisition thus leaves the potential acquirer vulnerable to a suit to enjoin a tender offer as violative of the Sherman

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[180] Clayton Act § 16, 15 U.S.C. § 26 (1982).

[181] Clayton Act § 7A(b)(2), 15 U.S.C. § 18a(b)(2) (1982). Section 7A of the Clayton Act was added by the Hart-Scott-Rodino Antitrust Improvements Act of 1976, Pub. L. No. 94-435, § 201, 90 Stat. 1383, 1390.

or Clayton Acts.[182] Since courts have been unwilling to accept divestiture agreements as grounds for declining to issue a preliminary injunction,[183] a potential acquirer may decide not to attempt a takeover. This tactic is most appropriately dealt with at the state level because the acquisitions involved are traditionally governed by state law.[184]

A second method involves target management resort to a preliminary injunction. Target companies have been accorded standing to sue to enjoin tender offers by potential acquirers in the same line of business on the grounds of the threat of increased horizontal or vertical concentration.[185] Recent commentators have argued for both legal and economic reasons that preliminary injunctions are inappropriate.[186] First, target corporations lack the "antitrust injury" required for standing under the Supreme Court's decision in *Brunswick Corp. v. Pueblo Bowl-a-Matic*.[187] The target is more likely to benefit from than be injured by an antitrust violation (which by definition would raise prices and reduce competition for the target), and only the acquirer is liable for any fine.[188] Second, commentators note that if denial of a preliminary injunction does permit an anticompetitive merger to occur, the potential cost to society of that type of incorrect decision can be corrected adequately by a suit for damages or divestiture against the acquirer. On the other hand, a preliminary injunction that prohibits an efficient merger from occurring cannot be corrected ex post, for the delay imposed by the injunction causes the potential acquirer to withdraw its tender offer.[189] Therefore, eliminating preliminary injunctive relief for antitrust violations can facilitate efficient mergers without incurring any irreparable costs for society.[190]

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[182] *See* M. LIPTON & E. STEINBERGER, TAKEOVERS AND FREEZEOUTS 329–31 (1978); Fleischer, *Buy or Be Bought: The Antitrust Defense*, MERGERS & ACQUISITIONS, Fall 1983, at 50 [hereinafter cited as Fleischer, *The Antitrust Defense*].

[183] *See, e.g.*, Chemetron Corp. v. Crane Co., 1977-2 Trade Cas. (CCH) ¶ 61,717, at 72,930 (N.D. Ill. 1977); *see also* M. LIPTON & E. STEINBERGER, *supra* note 182, at 322; Fleischer, *The Antitrust Defense*, *supra* note 182, at 51.

[184] *See supra* Model Act § 3 and accompanying commentary.

[185] *See, e.g.*, Grumman Corp. v. LTV Corp., 665 F.2d 10 (2d Cir. 1981); *see also* M. LIPTON & E. STEINBERGER, *supra* note 182, at 329–31; Sidak, *supra* note 91.

[186] *See* Easterbrook & Fischel, *Antitrust Suits*, *supra* note 14; Sidak, *supra* note 91.

[187] 429 U.S. 477 (1977) (suit for treble damages); *see* Easterbrook & Fischel, *Antitrust Suits*, *supra* note 14, at 1165–66; Sidak, *supra* note 91, at 506–14.

[188] Easterbrook & Fischel, *Antitrust Suits*, *supra* note 14, at 1161; Sidak, *supra* note 91, at 501–06.

[189] *See* Sidak, *supra* note 91, at 492–93.

[190] *See* Easterbrook & Fischel, *Antitrust Suits*, *supra* note 14, at 1168–71; Sidak, *supra* note 91, at 496–506.

The proposed amendment to the Clayton Act would not prevent a target from suing to enjoin a complete combination with the acquirer. It would eliminate the power of a federal court to enjoin a tender offer on antitrust grounds, if the acquirer agreed to hold separate the portion of the target's business that posed an antitrust problem. Holding the assets separate would facilitate divestiture should the court find an actual antitrust violation after trial on the merits.[191] Under the amendment, the court may, of course, decline to issue a hold-separate order if it finds that the plaintiff has failed to prove a substantial likelihood of success on the merits. In addition, the court may award preliminary relief after the tender offer, such as enjoining removal of target management. Delaying preliminary relief until after the tender offer is appropriate for two reasons. First, the antitrust issues may be given more lengthy consideration and are therefore more likely to be correctly decided. Second, the extra time permits the acquirer to correct an antitrust problem by presenting more carefully crafted plans for divestiture.[192]

Finally, the Hart-Scott-Rodino Antitrust Improvements Act[193] has also been used as a defensive tactic by target management. The Antitrust Improvements Act requires a tender offeror with more than 100 million dollars in sales or assets to notify the Federal Trade Commission of an offer to acquire the securities of any corporation with more than ten million dollars of sales or assets.[194] The acquirer is required to wait thirty days, or fifteen days in the case of a cash tender offer, to complete the acquisition in order to allow the government to review the merger for potential antitrust violations.[195] Its purpose was to facilitate the government's ability to obtain judicial relief before the operations and assets of the firms were irrevocably merged.[196]

The administrative procedures of the Antitrust Improvements Act discourage tender offers in two ways. They require acquirers that offer stock or debt in addition to cash to keep the offer

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[191] *See* Missouri Portland Cement Co. v. Cargill, Inc., 498 F.2d 851, 869 (2d Cir. 1974); Sidak, *supra* note 91, at 505.

[192] *See* M. LIPTON & E. STEINBERGER, *supra* note 182, at 332.

[193] *See supra* note 181.

[194] Hart-Scott-Rodino Antitrust Improvements Act of 1976, § 201, 15 U.S.C. § 18a(a) (1982).

[195] Hart-Scott-Rodino Antitrust Improvements Act of 1976, § 201, 15 U.S.C. § 18a(b)(1) (1982).

[196] *See* Easterbrook & Fischel, *Antitrust Suits*, *supra* note 14, at 1163.

open for a longer period than that required by the Williams Act.[197] More importantly, the Federal Trade Commission or Attorney General may in the case of either a cash or combination offer extend the waiting period if they desire more information regarding the transaction.[198] This provision has imposed additional delay and costs on potential acquirers sufficient to cause withdrawal of the tender offer, not by a judicial determination, but by a mere administrative request for additional information.[199]

The proposed amendment would require the government to exercise its otherwise discretionary power to terminate the waiting period whenever the acquirer agrees to hold the target company as a separate entity. This procedure both allows an acquirer to proceed with a tender offer without delay and protects the government's interest in facilitating divestiture should an antitrust violation be determined after trial on the merits. The power of the Federal Trade Commission and Assistant Attorney General to obtain information about the transaction or to bring a suit for damages would not be affected by this amendment. The proposed amendment to the Clayton Act would, however, limit their power under subsection (f) of the Antitrust Improvements Act[200] to file a motion for a preliminary injunction.

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[197] *See* Profusek, *supra* note 63.

[198] Hart-Scott-Rodino Antitrust Improvements Act of 1976, § 201, 15 U.S.C. § 18a(e)(2) (1982).

[199] *See* M. LIPTON & E. STEINBERGER, *supra* note 182, at 329–40; *SEC Advisory Comm. Report*, *supra* note 1, at 56–57 (Recommendations 49 & 50).

[200] Hart-Scott-Rodino Antitrust Improvements Act of 1976, § 201, 15 U.S.C. § 18a(f) (1982).

COMMENT

TOWARD AN ALL-COMPETITIVE SYSTEM FOR FEDERAL ONSHORE OIL AND GAS LEASING

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The current system of federal leasing of onshore oil and gas lands has been the subject of mounting criticism in recent years. Critics have focused on the fact that the vast majority of such leasing is done without the submission of competitive bids. Defenders of the present system, on the other hand, have attempted to avert major reforms by instituting minor changes in the leasing of onshore lands. This Comment analyzes the flaws of the noncompetitive system of land leasing, presents an alternative leasing plan, and argues that only a wholesale change in the method of awarding onshore leases can adequately address these problems.

I. THE EXISTING LEASING SYSTEM

The federal government owns more than one third of the total area of the United States.[1] The natural resources of this public domain yield 30% of the natural gas and over 13% of the oil produced in this country.[2] The Mineral Leasing Act of 1920,[3] authorizes the Secretary of the Interior to further this production by issuing two basic types of leases on these public lands: competitive leases and noncompetitive leases.[4]

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[1] T. MALEY, HANDBOOK OF MINERAL LAW 557 (3d ed. 1983); N.Y. Times, June 24, 1970, at A1, col. 1.

[2] R. TANK, LEGAL ASPECTS OF GEOLOGY 458 (1983); 128 CONG. REC. S8377, S8395 (daily ed. July 15, 1982) (statement of Sen. Bumpers (D-Ark.)). Five and one half percent of the oil and six percent of the natural gas comes from onshore federal lands; the remainder comes from the Outer Continental Shelf. R. TANK, LEGAL ASPECTS OF GEOLOGY 458 (1983); 128 CONG. REC. S8377, S8395 (daily ed. July 15, 1982) (statement of Sen. Bumpers). This Comment will deal only with the federal onshore oil and gas leasing system.

[3] 30 U.S.C. §§ 181–287 (1976 & Supp. V 1981).

[4] 30 U.S.C. § 226(b),(c) (1976 & Supp. V 1981).

Land must be leased competitively to the highest bidder if it lies within the "known geological structure" (KGS) of a producing oil or gas field.[5] The Department of the Interior has defined KGS as "technically the trap in which an accumulation of oil or gas has been discovered by drilling and determined to be productive, the limits of which include all acreage that is presumptively productive."[6] Less than three percent of the lands offered for lease are leased competitively.[7] Required features of competitive leases include a maximum size of 640 acres; a term of five years, continuing thereafter as long as paying quantities of oil and gas are produced; and a sliding royalty rate of 12.5% to 25%, depending upon the amount of production.[8]

Noncompetitive leases are awarded for lands not within a KGS to "the person first making application for the lease."[9] The maximum lease size is 10,240 acres,[10] and the lease term is ten years.[11] As with competitive leases, the lease can be renewed as long as commercial quantities of oil or gas are produced.[12] The royalty rate on this type of lease is 12.5%.[13] Applications for a noncompetitive lease must be accompanied by an application fee of seventy-five dollars.[14]

Noncompetitive leases can be obtained through either the over-the-counter or the simultaneous oil and gas leasing system, often referred to as the oil and gas lottery. The over-the-counter system awards leases for land never leased before on a first-come, first-served basis.[15] The lottery, under which the vast majority of federal land is currently leased, is used for lands for which the previous lease has expired or has been relinquished, canceled, or terminated.[16] Before 1960, all land not over a KGS

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[5] *Id.* § 226(b) (Supp. V 1981); Oil & Gas Leasing, 43 C.F.R. § 3101.1-1 (1982).

[6] 43 C.F.R. § 3100.0-5(a).

[7] *See* Letter from Garrey E. Carruthers, Ass't Sec'y of the Interior for Land & Water Resources, to Sen. Dale Bumpers (July 22, 1983) at 1 (on file at HARV. J. ON LEGIS.) [hereinafter cited as Carruthers letter].

[8] 30 U.S.C. § 226(b),(e) (Supp. V 1981); 43 C.F.R. §§ 3103.4(a)(4), 3120.1 (1982).

[9] 30 U.S.C. § 226(c) (Supp. V 1981).

[10] 43 C.F.R. § 3110.1-3 (1982).

[11] 30 U.S.C. § 226(b)(1) (Supp. V 1981).

[12] *Id.* § 226(e) (Supp. V 1981); 43 C.F.R. § 3107.1-3 (1982).

[13] 43 C.F.R. § 3103.3-4(a)(1) (1982).

[14] *Id.* § 3103.2-1(a). The Department of the Interior has proposed changes to the regulatory structure that will require that advance payment of first-year rentals be submitted along with the application fee for future filings. Dep't of the Interior News Release (Jan. 31, 1984) (on file at HARV. J. ON LEGIS.).

[15] COMPTROLLER GEN., U.S. GEN. ACCT. OFFICE, PUB. NO. EMD-80-60, IMPACT OF MAKING THE ONSHORE OIL AND GAS SYSTEM MORE COMPETITIVE 3 app. I (1980) (on file at HARV. J. ON LEGIS.).

[16] *Id.*

was leased through the over-the-counter system.[17] When particularly promising tracts were due to be posted as available for re-leasing, however, the long lines that formed at land offices often turned into mob scenes, resulting in injuries and the disruption of business.[18] The lottery system was developed to avoid such problems in the re-leasing of these tracts.[19] Under the lottery, the Department of the Interior posts notices of parcels available and the deadlines for filing applications to lease these parcels. All applications filed before the deadline are deemed to have been filed simultaneously, and a drawing is held to award the leases.[20] This process of deeming all of the applications as filed simultaneously meets the statutory requirement that the lease go to the first qualified applicant[21] and preserves the frontier notion that "what belongs to the Government really belongs to the first citizen to show up and claim it."[22]

The noncompetitive segments of the current leasing structure, especially the lottery system, have met with substantial criticism in recent years.[23] Three major problems with noncompetitive leasing are: (1) the process is riddled with fraudulent practices; (2) it does not sufficiently promote exploration and development of federal lands; and (3) it does not ensure the public a fair return on the sale of its resources.

The fraudulent practices associated with noncompetitive leasing have generally involved the oil and gas lottery[24] and fall, for the most part, into two major categories: consumer fraud and bid rigging. Consumer fraud has been partially responsible for the huge rise in the number of individuals participating in the lottery. Currently, between 2 and 2.5 million people per year

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[17] *Id.*

[18] *Id.*

[19] DEP'T OF THE INTERIOR, BUREAU OF LAND MANAGEMENT (BLM), PUB. NO. 678-609, THE FEDERAL SIMULTANEOUS OIL AND GAS LEASING SYSTEM 3 (1983) (on file at HARV. J. ON LEGIS.).

[20] *Id.* at 5–6.

[21] Thor-Westcliffe Dev., Inc. v. Udall, 314 F.2d 257 (D.C. Cir. 1963), *cert. denied*, 373 U.S. 951 (1963); *see* 30 U.S.C. § 226(c) (Supp. V 1981).

[22] Barry, *The Great Onshore Oil Lottery*, N.Y. Times, Oct. 11, 1981, § 6 (Magazine), 76, at 78; *see also* W. WYANT, WESTWARD IN EDEN: THE PUBLIC LANDS AND THE CONSERVATION MOVEMENT 12, 17–18 (1982); P.W. GATES, LANDLORDS AND TENANTS ON THE PRAIRIE FRONTIER 11–12, 45–47 (1973).

[23] *See, e.g.*, Quinn, *Congress Should Do Away with Oil Lottery Schemes*, Washington Post, May 23, 1983, at WB-50, col. 1; Barry, *supra* note 22.

[24] The over-the-counter system, however, may not be so free of fraud and deception as might initially appear. Just as oil companies sometimes fail to report major finds in order to try to get adjacent tracts when they come up in the lottery, *see* Washington Post, Oct. 13, 1983, at A11, col. 1, they may easily do the same thing to achieve the same end under the over-the-counter system.

participate in the oil and gas lottery.[25] The large number of participants can be attributed to the efforts of filing service companies, which advise investors as to which tracts appear most promising and file applications on these parcels for their clients.[26] Michael McCrarey, Associate Director of the Federal Trade Commission (FTC) Consumer Protection Bureau, estimates that as many as 250 such companies now exist,[27] and sources in the Department of the Interior's Bureau of Land Management (BLM) believe that filing services now account for up to 80% of all lottery applications.[28] Many of these companies provide a legitimate service to their clients, but BLM investigators say that approximately 20% of them operate fraudulently,[29] running telephone "boiler-rooms" and sponsoring slick newspaper advertisements promising sure payoffs of thousands of dollars if their advice is followed.[30] An FTC staff attorney estimates that these deceptive firms generally charge clients approximately $300 for each application filed; only $75 of this amount goes to the government as the application fee, and because these companies have neither serious research staffs nor other expensive overhead, the other $225 is straight profit for the salesman and the company.[31] If the investor should, by chance, win the rights to a lease, some filing services try to buy the lease from the customer for far less than its market value.[32]

Despite the best efforts of government officials to warn consumers about such schemes and prosecute deceptive companies,[33] securities officials in several states estimate that Americans lost more than $200 million in 1982 by using fraudulent filing services.[34] These losses must be counted as social costs of the lottery, and therefore, any revenues that the government

[25] N.Y. Times, Oct. 27, 1983, at D1, col. 5; Washington Post, Oct. 13, 1983, at A11, col. 1.

[26] *See* Barry, *supra* note 22, at 80–84.

[27] Los Angeles Times, June 3, 1983, § II, 1, at 2, col. 1.

[28] Barry, *supra* note 22, at 86.

[29] *Id.*

[30] Alexander, *Reach Out and Bilk Someone*, TIME, Oct. 24, 1983, at 75; N.Y. Times, May 14, 1983, at A12, col. 2.

[31] Telephone interview with Joseph Phillips, Staff Att'y, Fed. Trade Comm'n (Feb. 10, 1984).

[32] Barry, *supra* note 22, at 86.

[33] Government officials have set up toll-free information numbers, distributed information brochures, and instituted numerous prosecutions of filing service frauds. In addition, the government has tried to obtain maximum media coverage of both the information and the prosecutions in order to inform the public further. *See* Alexander, *supra* note 30, at 75; N.Y. Times, Oct. 27, 1983, at D1, col. 3; Los Angeles Times, June 3, 1983, § II, at 1, col. 1; N.Y. Times, May 14, 1983, at A12, col. 5.

[34] Washington Post, Oct. 13, 1983, at A11, col. 5.

gains from the lottery must be discounted by the amount of these costs.

The second level of fraud in the lottery preys upon the system as a whole. Former Interior Secretary Cecil Andrus recognized that "so long as leases worth tens of thousands of dollars in the private assignment market can be obtained from the Federal Government for only a [$75] filing fee and $1-an-acre advance rental, there will continue to be an incentive to defraud the system, no matter how well it is policed."[35] Several current and former BLM officials have noted that fraud and bid rigging have been part of the lottery for many years.[36]

Although federal law provides that any person or company may file only one application for each tract of land in the lottery,[37] many independent oil companies and sophisticated individuals "'stuff[]' the lottery basket with applications of relatives and associates to improve their chances."[38] In some cases, 80% of all lottery cards filed are tainted in this manner.[39] Often the applicant receives a fee for his services, in return for agreeing that, if he wins, he will turn the lease over to the company or individual behind the scheme.[40] Many within the industry know that such schemes exist,[41] and one oil man convicted of running such a conspiracy called the resulting $1,000 fine "the best investment of my life. It was the price of doing business."[42]

The second general argument against the noncompetitive system is that it fails to provide sufficient incentives for speedy exploration once the land is leased. The system produces a situation in which over 90% of the participants are speculators incapable of exploration or production.[43] These people simply want to sell any lease they might win to an oil or gas developer at an enormous profit.[44] Consequently, authentic drillers must find lottery winners and piece together their tracts for repur-

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[35] Barry, *supra* note 22, at 88, 90.

[36] *Id.* at 76, 88; Wall St. J., March 3, 1980, at 10, col. 3; N.Y. Times, March 1, 1980, at 31, col. 5.

[37] 43 C.F.R. § 3112.2-1(f) (1982).

[38] Barry, *supra* note 22, at 82; *see* Wall St. J., March 3, 1980, at 10, col. 3; N.Y. Times, March 1, 1980, at 31, col. 5.

[39] Barry, *supra* note 22, at 86.

[40] *Id.* at 86, 88.

[41] Wall St. J., March 3, 1980, at 10, col. 3. Gordon Smale, the president of Atlantic Oil Company in Denver, observed: "It seems the same people keep winning the attractive leases over and over again." *Id.*

[42] Barry, *supra* note 22, at 88.

[43] Mayer, *James Watt, Croupier: The Federal Oil and Gas Lottery*, 5 AMICUS J. 38, 40 (1983).

[44] S. REP. No. 293, 96th Cong., 2d Sess. 7 (1980) [hereinafter cited as S. REP.].

chase. Frequently, filing services expedite this process by persuading their clients to transfer the reassignment rights to the filing service before the lottery. The service then contacts the oil producers directly.[45] In the absence of such self-serving coordination by the filing services, the speculator may be prone to hold the land if the oil or gas market seems to be rising. Alternatively, the speculator's poor information might lead to inflated expectations about the land's worth. When the Wyoming Commissioner of Public Lands recommended a competitive leasing system for his state, he noted: "These persons [speculators] have an unrealistic and exaggerated opinion of the value of their leases and refuse to sell or assign them upon terms and conditions which leave sufficient opportunity for profit so that a prudent operator will undertake the drilling of a well . . . ."[46] These problems with speculators, combined with the ten year primary term for noncompetitive leases,[47] the automatic two year extension for continuing drilling, and the further automatic extension as long as oil or gas is produced in paying quantities,[48] often yield long delays before any exploratory drilling takes place.

The following example typifies these problems.[49] In 1969, Doris Soronson, a speculator with no capacity for or desire to drill for oil, won a 1,460 acre lease in New Mexico. She quickly sold the lease to an independent oil man who then sold it to Humble Oil Company, a wholly-owned subsidiary of the Exxon Corporation. Humble scouted the land, decided that it was no longer interested, and relinquished the lease to the independent oil man. He then turned it over to his wife, who in turn sold it to the Yates Petroleum Company. On the last day of the ten year lease, Yates started drilling the first hole in the ground, which came up dry. Because the company had drilled and was drilling on expiration day, it fulfilled the diligence requirement for a two year extension.

The argument that noncompetitive leasing is depriving the government, and thus the public, of a fair return for its resources is largely based upon a number of recent incidents in which land

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[45] *Id.*

[46] Letter & Recommendation from Oscar E. Swan, Wyo. Comm'r of Public Lands & Farm Loans (March 3, 1983) at 2 (on file at HARV. J. ON LEGIS.) [hereinafter cited as Swan].

[47] 30 U.S.C. § 226(b)(1) (Supp. V 1981).

[48] 30 U.S.C. § 226(e) (Supp. V 1981) (extension automatic for continued drilling).

[49] Barry, *supra* note 22, at 90, 92. Barry's article details this entire incident.

that had been leased noncompetitively was adjacent to tracts containing producing wells and/or tracts that had brought high bonus bids in competitive leasing schemes. For example, federal noncompetitive leases in Idaho lie next to state lands where competitive bidding has brought up to $230 per acre in bonus bids.[50] In Oregon, private lands next to noncompetitive federal leases brought a premium of up to $250 per acre.[51] The federal government leased land in the Ouachita National Forest noncompetitively, but the State of Arkansas put its eighty acres in the national forest up for bidding and received $103 per acre.[52]

On October 12, 1983, the Interior Department temporarily suspended operation of the oil and gas lottery because of an incident in Wyoming.[53] Davis Oil Company, one of the largest independent oil producers in the Rocky Mountains, had discovered a major oil and gas field on land it was leasing from the government and had failed to report its find to the BLM. Unaware of the Davis find, the government granted eighteen leases on adjacent tracks through the lottery. The lottery winners then resold the leases to Davis and other oil companies aware of the find for profits ranging from $2.5 million to $100 million.[54]

An incident at Fort Chaffee, Arkansas best illustrates the problems of government misclassification and loss of potential revenue.[55] In May 1977, Texas Oil and Gas Corporation filed applications for thirty-eight noncompetitive over-the-counter leases covering 78,000 acres in the Fort Chaffee Military Reservation, which had just been opened for leasing. Twenty leases covering approximately 33,000 acres were issued to Texas Oil and Gas on July 1, 1979, in return for first year lease payments

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[50] 129 CONG. REC. S1597 (daily ed. Feb. 24, 1983) (statement of Sen. Bumpers); Telephone interview with Susan Rieff, Legislative Aide to Sen. Bumpers (Mar. 14, 1984).

[51] 129 CONG. REC. S1597 (daily ed. Feb. 24, 1983) (statement of Sen. Bumpers); 128 CONG. REC. S8379 (daily ed. July 15, 1982) (statement of Sen. Bumpers); Telephone interview with Susan Rieff, Legislative Aide to Sen. Bumpers (Mar. 14, 1984).

[52] 128 CONG. REC. S8379 (daily ed. July 15, 1982) (statement of Sen. Bumpers); Telephone interview with Susan Rieff, Legislative Aide to Sen. Bumpers (Mar. 14, 1984).

[53] *See* Dep't of the Interior News Release (Oct. 12, 1983) (on file at HARV. J. ON LEGIS.).

[54] Washington Post, Oct. 13, 1983, at A11, col. 1; Dep't of the Interior News Release (Oct. 12, 1983) (on file at HARV. J. ON LEGIS.).

[55] *See* Arkla Exploration Co. v. Watt, 562 F. Supp. 1214, 1216 (W.D. Ark. 1983). This opinion provides the best summary of the incident. The incident's history and further aspects of the continuing litigation are also discussed in Texas Oil & Gas Corp. v. Watt, 683 F.2d 427 (D.C. Cir. 1982); Arkla Exploration Co. v. Watt, 548 F. Supp. 466 (W.D. Ark. 1982); and Texas Oil & Gas Corp. v. Andrus, 498 F. Supp. 668 (D.D.C. 1980).

of $33,000.[56] Subsequently, on January 2, 1981, additional lands within Fort Chaffee immediately adjacent to these 33,000 acres were leased competitively for prices up to $4,007 per acre. The high bids for the competitively leased acreage were not the result of an oil or gas find on the Texas Oil and Gas leases. Those 33,000 acres had been tied up in litigation in the interim and had never been drilled. Rather, the size of the bids reflected the fact that Fort Chaffee lies in the midst of a region characterized by extensive natural gas production.[57] The lands in question were surrounded by producing gas wells long before Texas Oil and Gas filed its applications.[58] When the land was determined not to lie over a KGS and the leases were granted, three-fourths of the drilled sections north and south of the 33,000 acres and two thirds of those to the east and west were actually in commercial production.[59] In light of such evidence, a federal district court held that the procedure followed in making this non-KGS determination was arbitrary and therefore invalidated the leases issued as a result of the determination.[60] Nevertheless, the government's basic procedure for making KGS determinations remains unchanged.[61]

These incidents all demonstrate that the noncompetitive leasing system may result in the government selling valuable mineral rights for a small fraction of their market value. The argument can be made that such incidents could be avoided if the government redesigned its procedure for determining the location and extent of KGS's and kept careful track of developments such as the Davis Oil find. In the final analysis, however, such technical changes are unworkable. As some of the staunchest proponents of the noncompetitive system have noted in a different

[56] Arkla Exploration Co. v. Watt, 562 F. Supp. 1214, 1216 (W.D. Ark. 1983). Eighteen of Texas Oil and Gas Corp.'s applications were either rejected or withdrawn because (1) the Army would not permit the leasing, (2) the United States did not own the mineral rights to the area, or (3) the areas were determined to be within a KGS. *Id.*

[57] *Id.*

[58] *Id.* at 1218.

[59] *Id.* at 1219.

[60] *Id.* at 1221–27.

[61] The procedures for making these determinations are described in *id.* (non-KGS determination made arbitrarily) and 128 CONG. REC. S8394 (daily ed. July 15, 1982) (dialogue between Mr. Edward L. Johnson, Area Geologist, Tulsa, Okla., U.S. Geological Survey, and Sen. Bumpers). After the Fort Chaffee incident, these procedures remain unchanged, as evidenced by Memorandum from Richard Mulberry, Inspector Gen. to Director, BLM, (Oct. 5, 1983) and Memorandum from District Manager, Caspar, Wyo., to U.S. Dep't of the Interior, Office of the Inspector Gen. (Oct. 5, 1983) at 3 (both describing the determination procedure followed at district offices throughout the country) (both on file at HARV. J. ON LEGIS.).

context: "Approximately 4,000 test wells are drilled annually on federal lands. Geologic information from those wells significantly affects surrounding drilling prospects and influences drilling deals. *Government cannot anticipate the results of those wells or react fast enough to information from them.*"[62]

II. A Movement for Change

Rather than attempting to refine the procedure for evaluating a KGS, the simpler, cheaper, and more reliable solution is to allow the marketplace to work through the institution of a system of competitive bidding for all oil and gas leases. Private companies routinely keep up with every shred of geological information that might affect their interests. They obviously did so in the Davis Oil and Texas Oil and Gas cases, and in a situation of competitive bidding, companies will police each other to the benefit of the public. A switch to an all-competitive leasing system would also squarely address the problems of fraud and lack of effective incentives that mar the current approach.

The problems with the current approach prompted interest in all-competitive leasing of federal oil and gas lands beginning in the early 1970's. In 1970, the Public Land Law Review Commission completed the first thorough assessment of public land law and usage in the nation's history.[63] One of its major recommendations in the area of mineral law was to increase the scope of competitive leasing so that competitive sale of exploration permits or leases would be held whenever competitive interest can reasonably be expected.[64] In 1973, President Nixon asked Congress to pass legislation establishing an all-competi-

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[62] 128 Cong. Rec. S8388 (daily ed. July 15, 1982) (excerpt of fact sheet attached to letter by Senators Wallop (R-Wyo.), Warner (R-Va.), Melcher (D-Mont.), Ford (D-Ky.), & McClure (R-Idaho) to the members of the Senate) (emphasis added). This statement was made in the context of a criticism of a proposed all-competitive system as being a damper on exploration because oil companies would be required to wait one extra month before receiving federal land near new oil finds.

[63] Public Land Law Review Commission, One Third of the Nation's Land: The 1970 Report of the Public Land Law Review Commission (1970). *See generally* N.Y. Times, June 24, 1970, at A1, col. 1.

[64] Public Land Law Review Commission, One Third of the Nation's Land: The 1970 Report of the Public Land Law Review Commission (1970); *see also* N.Y. Times, June 24, 1970, at A22, col. 3; 128 Cong. Rec. S8380 (daily ed. July 15, 1982) (statement of Sen. Jackson (D-Wash.)); Arkla Exploration Co. v. Watt, 562 F. Supp. 1214, 1220 (W.D. Ark. 1983) (referring to this recommendation of the Public Land Law Review Commission).

tive oil and gas leasing system with a primary lease term of five years.[65] The avowed purpose of this proposal was "to promot[e] the exploration and production of the minerals on which our society depends" and to "provid[e] a fair return to the public."[66]

Harsh criticism following the Fort Chaffee sale inspired then Secretary of the Interior Cecil Andrus to push for reform of the oil and gas leasing system in 1979. Citing a variety of the abuses mentioned above, the BLM proposed rule changes that would make it more difficult for filing services to submit fraudulent applications or to obtain complete control over the reassignment of their clients' leases.[67] Moreover, the Interior Department quickly put together a legislative proposal that expanded the KGS category, thereby increasing the Secretary's authority to lease land competitively.[68] This bill, S. 1637, sponsored by the Carter Administration, would have amended section 17(a)(1) of the Oil and Gas Act of 1920[69] to read: "The Secretary may lease lands which are favorable for the discovery of oil or gas within a producing geologic province only by competitive bidding."[70] Everything outside this prescription would have continued to have been leased noncompetitively.[71] Members of President Carter's Interior Department contended that under the new statute, the proportion of federal lands leased noncompetitively would have declined from 97% to roughly 50%.[72] They argued that this revision would strike an optimal balance between totally competitive and totally noncompetitive formats.[73]

Predictably, such a moderate solution pleased few and angered many. A majority of the Senate Energy and Natural Resources committee voted to abolish the lottery and over-the-counter leasing entirely.[74] Those most disturbed with the abuses and problems of the noncompetitive leasing system could see

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[65] *See* 119 CONG. REC. 5751 (1973) (introduction of bill by request and letter from John C. Whitaker, Acting Sec'y of the Interior, to Spiro Agnew, Pres. of the Senate); *see also* 128 CONG. REC. S8380 (daily ed. July 15, 1982) (statement of Sen. Jackson).

[66] 119 CONG. REC. 5751 (1973) (letter from John C. Whitaker to Spiro Agnew).

[67] Notice of Proposed Rulemaking on Oil & Gas Leasing, 44 Fed. Reg. 56,176 (1979) (now codified at 43 C.F.R. pt. 3100).

[68] S. 1637, 96th Cong., 1st Sess. (1979).

[69] 30 U.S.C. § 226(a) (1976).

[70] S. 1637, *supra* note 68, § 2.

[71] *Id.*

[72] *The Federal Oil and Gas Leasing Act of 1979: Hearings on S. 1637 Before the Subcomm. on Energy Resources and Materials Production of the Sen. Comm. on Energy and Natural Resources*, 96th Cong., 1st Sess. 42 (1979) (testimony of Guy R. Martin, Ass't Sec'y of the Interior) [hereinafter cited as *Hearings*].

[73] *Id.*

[74] S. REP., *supra* note 44, at 1–12.

little merit in replacing the arbitrariness of "known geologic structure" with S. 1637's equally ambiguous language of "producing geologic province."[75]

Among the members of the Senate Energy and Natural Resources Committee who believed that S. 1637 was merely a step in the right direction were Senators Howard Metzenbaum (D-Ohio), Dale Bumpers (D-Ark.), and Henry Jackson (D-Wash.), the late Chairman of the committee. These three senators led the movement in the committee mark-up session to amend S. 1637.[76] In its final version, the bill called for the total elimination of the noncompetitive leasing of federal lands.[77] The government would be involved only in the determination of whether environmental considerations allowed any leasing at all on the particular tract. The oil industry would make all other relevant determinations.[78] By a margin of one vote, the Committee recommended the passage of the amended S. 1637.[79] The full Senate, however, never considered the bill before the ninety-sixth Congress adjourned.

When a new Congress convened after the 1980 elections, Senator Bumpers introduced a bill that was essentially identical to the amended S. 1637.[80] His fervent opposition to the noncompetitive leasing system came in part from his indignation over the Fort Chaffee sale, which he believed had cost his home state millions of dollars.[81] Under new leadership,[82] the Energy Committee refused to act on Bumpers's bill. The Senate's only opportunity to debate this proposal came when Bumpers offered it unsuccessfully as an amendment to an appropriations bill in 1982.[83]

III. S. 581: AN ARGUMENT FOR FUNDAMENTAL REFORM

In 1983, Senator Bumpers reintroduced legislation requiring conversion to an all-competitive leasing system.[84] This bill, S.

[75] *Hearings*, *supra* note 72, at 11, 12 (statement of Sen. Bumpers).
[76] S. REP., *supra* note 44, at 12.
[77] *Id.* at 1.
[78] S. 1637, *supra* note 68, § 2.
[79] S. REP., *supra* note 44, at 12.
[80] S. 60, 97th Cong., 1st Sess., 127 CONG. REC. S109 (daily ed. Jan. 6, 1981).
[81] 128 CONG. REC. 8397, 98 (1982) (statement of Sen. Bumpers); Newsletter from Sen. Bumpers to his constituents (Dec. 1983) at 1 (discussing whether government leasing policy affects Ark.) (on file at HARV. J. ON LEGIS.).
[82] Sen. McClure succeeded Sen. Jackson as chairman of the committee.
[83] 128 CONG. REC. S8377 (daily ed. July 15, 1982) (statement of Sen. Bumpers).
[84] S. 581, 98th Cong., 1st Sess. (1983).

581, is still in committee at the time of this writing.[85] Because the Energy Committee's Chairman, Senator James McClure (R-Idaho), is adamantly opposed to the idea of fully competitive leasing,[86] the bill is likely to remain dormant in committee. Bumpers has stated, however, that he intends to force a floor vote on this issue by seeking to affix his bill to some other matter before the full Senate.[87]

The Reagan Administration is vehemently opposed to S. 581's competitive leasing scheme.[88] Faced with increasing revelations of the current system's flaws, the Administration has been forced to acknowledge the problems addressed by S. 581. The few remedial steps actually taken by the Administration, however, are only minor measures. For example, the BLM suspended the lottery in October, 1983, ostensibly to gain time to update its data on recognized petroleum-rich federal lands and to prevent their continued sale through the lottery.[89] The BLM has now resumed the lottery.[90] Earlier, the Administration attempted to mitigate lottery abuses by raising the filing fee for lease applicants, first from $10 to $25 and finally to the current $75.[91] More recently, the BLM also instituted a policy requiring advance payment of first year rentals with the lease applications.[92] While such changes politically undermine the claims that the Administration is unwilling to confront the issue and inhibit some speculators, the magnitude of the problems with the noncompetitive leasing system suggest that a more drastic overhaul is required.

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[85] Telephone interview with Susan Rieff, Legislative Aide to Sen. Bumpers (Feb. 21, 1984).

[86] 128 CONG. REC. S8394 (daily ed. July 15, 1982) (statement of Sen. McClure).

[87] Letter from Sen. Bumpers to his Colleagues in the Senate (Nov. 7, 1983), at 1 (on file at HARV. J. ON LEGIS.) [hereinafter cited as Bumpers Letter].

[88] 128 CONG. REC. S8384 (daily ed. July 15, 1982) (reprinting letters from James B. Edwards, Sec'y of Energy and James G. Watt, Sec'y of the Interior to Sen. McClure); *see also* Dep't of the Interior News Release (Jan. 31, 1984) (statement by William Clark, Sec'y of the Interior, that major changes in the leasing system are undesirable) (on file at HARV. J. ON LEGIS.).

[89] Dep't of the Interior News release (Oct. 12, 1983) (on file at HARV. J. ON LEGIS.).

[90] Dep't of the Interior News Release (Jan. 31, 1984) (on file at HARV. J. ON LEGIS.); Boston Globe, Feb. 1, 1984, at 8, col. 3.

[91] Notice of Final Rulemaking on Increase in Filing Fees Accompanying Noncompetitive Oil & Gas Lease Applications and Rental Increases for Simultaneous Oil & Gas Leases, 47 Fed. Reg. 2864 (1982) (now codified at 43 C.F.R. pt. 3100) (raise from $25 to $75); Notice of Interim Final Rulemaking on Increase in Filing Fees Accompanying Noncompetitive Oil & Gas Leasing Applications, 46 Fed. Reg. 45,887 (1981) (then codified at 43 C.F.R. pt. 3100) (raise from $10 to $25).

[92] Dep't of the Interior News Release, *supra* note 90.

S. 581 proposes substantial reforms. The bill's operative language states that the Secretary of the Interior "may lease onshore Federal lands for oil and gas development by competitive bidding only."[93] Under the bill, competitive lease sales would automatically occur whenever the Interior Department received nominations on available tracts from any two parties in one three-month quarter or from a single party in two consecutive quarters.[94] The bill would increase the maximum tract size for any one lease from the 640 acre limit on competitive leases[95] to 5120 acres[96] and would reduce by half the current ten year initial lease period.[97] The lessee could apply to extend the initial term for an additional period not to exceed five years.[98]

Passage of S. 581 would eliminate the fraud and delay that the lottery invites by severely limiting the number of speculators involved. Because a competitive regime requires bidders to have significantly more capital and information and to expend greater effort than a noncompetitive regime does, those filing firms with an exclusive expertise in marketing the lottery to unsuspecting citizens would vanish. Experiences in Wyoming, a state that switched to a competitive leasing system for state lands last year, demonstrate the limited involvement of speculators in competitive leasing. Of the gross receipts generated by the Wyoming lottery from January through June, 1983, 97% of the total, or $5,207,875, represented the $25 filing fee collected from each application.[99] After the lottery was shelved, a mere $8475 was collected from filing fees in the lease sales.[100] Such a significant change can only be explained by a tremendous decrease in the number of speculators. The percentage of speculators partici-

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[93] S. 581, *supra* note 84, § 2.
[94] *Id.*
[95] 30 U.S.C. § 226(b)(1) (Supp. V 1981).
[96] S. 581, *supra* note 84, § 2.
[97] *Id.*
[98] *Id.*
[99] Wyo. Dep't of Public Lands, Summary of 1983 Simultaneous, and August 1983–January 1984 Competitive Bids (on file at HARV. J. ON LEGIS.) [hereinafter cited as Wyoming DPL].
[100] *Id.* Wyoming maintains a filing fee although the system is competitive. This is a common practice among the states. *See* K. NELSON, CONG. RESEARCH SERV. REP. NO. 82-182S, Leasing of Oil and Gas Lands in Selected States, 97th Cong., 2d. Sess. CRS-9 (1982) (on file at HARV. J. ON LEGIS.) [hereinafter cited as K. NELSON]. If the federal government exercised this option, the $600 million subtracted from the projected gross receipts under a competitive system because of lost filing fees, Letter from Alice Rivlin, Director of the Congressional Budget Office (CBO) to Sen. Henry Jackson (July 14, 1982) at 1, would be reduced, yielding an even greater increase in federal revenues.

pating in the federal lottery is probably as great as it was in Wyoming,[101] and conversion to an all-competitive system at the federal level would have the same effect in reducing the number of speculators.

In addition to limiting the fraud and inefficiencies caused by speculators, S. 581 would alleviate other hindrances to production. The new proposal would increase the maximum size for any competitive lease to 5120 acres, "unless the Secretary finds that a larger area is necessary to comprise a reasonable economic unit."[102] It also authorizes the Secretary to disallow any assignment of less than 640 acres.[103] An oil developer has more incentive to purchase a tract if he believes that it encompasses an entire petroleum reservoir.[104] Thus, leasing larger tracts directly to the oil or gas developer would eliminate delays required to piece together smaller tracts held by numerous speculators.[105]

The current lack of incentives for prompt drilling on leased lands is even more detrimental to timely production. Once someone with the means to extract oil or gas acquires a lease on the land, nothing in that lease encourages diligence in drilling.[106] While S. 581 retains provisions granting the lessee the right to a lease extension when a well is producing at the end of the lease, more prompt development is encouraged by reducing the length of the original lease to five years. In addition, an all-competitive system increases the front-end costs of exploration rights by (1) producing higher rental charges that more truly approximate the value of the right to explore and (2) ensuring that the actual oil and gas developer incurs this cost at the beginning of the lease term. As a result, merely holding the lands until the lease is about to expire will be more costly, creating incentives to make the lands produce revenues sooner.[107]

Opponents of competitive leasing express concern that increasing the front-end costs will actually reduce development.

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[101] *Hearings*, *supra* note 72, at 71 (exchange between Sen. Bumpers and Guy R. Martin).

[102] S. 581, *supra* note 84, § 2.

[103] *Id.* §§ 2, 4.

[104] *Hearings*, *supra* note 72, at 152 (statement of Prof. Robert J. Kalfer, Cornell Univ.); *Id.* at 156–57 (statement of Dr. Audrey Buyrn, Material Programs Manager, Office of Technology Assessment); *Id.* at 161 (statement of Sen. Wallop).

[105] S. REP., *supra* note 44, at 9.

[106] *See id.* at 6–7; *Hearings*, *supra* note 72, at 47 (statement of Guy R. Martin, Ass't Sec'y of the Interior).

[107] S. REP., *supra* note 44, at 11.

They argue that making the oil producer pay more for the rights to explore means that less money can be invested in the actual exploration of the lands.[108] This outcome is unlikely, however, because the costs of buying the rights to explore are relatively small when compared to the total costs of oil production.[109] According to a 1981 estimate, the oil industry was prepared to spend in excess of $30 billion on exploration that year.[110] This figure is over twenty-five times the amount that the Congressional Budget Office (CBO) estimates would be generated from bonus bids under a competitive system over a five year period.[111] Furthermore, some portion of the difference between the current $1 per acre charge and the price established by competitive bids is already being spent by the oil interests when they repurchase leases from lottery winners. Even if the price necessary to purchase the leases through a bidding system is greater than what the oil producer ultimately pays the speculator under the current regime, this amount will (1) not be so onerous as to deter development, given the total relative costs of exploration and production; (2) be properly paid to the rightful owners of the land, the American people; and (3) further the incentive to develop oil or gas because the producer must pay for the right to hold the lease from the outset.

Another production-related criticism of S. 581 concerns the market structure of the oil industry. Those favoring retention of an essentially noncompetitive system of leasing federal lands suggest that abolishing the lottery will harm the smaller independent oil producers because their more limited capital would exclude them from the lease market.[112] Protection of these independents should be a primary objective, since they are responsible for much of the development on federal lands.[113] In reality, however, small producers do quite well in the competitive leasing market which currently exists: eighty-five percent

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[108] 128 CONG. REC. S8396 (daily ed. July 15, 1982) (reprinting letter from Lloyd N. Unsell, Vice Pres. of the Industrial Petroleum Ass'n, to Sen. Ford); *id.* at S8397 (statement of Sen. Simpson (R.-Wyo.)).

[109] *See* Lohr, *The Great Oil Rush of the Eighties*, N.Y. Times, Aug. 30, 1981, § 6 (Magazine), at 20 (explaining the costs of exploration).

[110] *Id.* at 22.

[111] Rivlin Letter, *supra* note 100, at 2 (outlining the CBO study on S. 60, the competitive leasing bill introduced by Sen. Bumpers in the 97th Congress, which was identical to S. 581) (on file at HARV. J. ON LEGIS.) [hereinafter cited as Rivlin letter].

[112] 128 CONG. REC. S8383–86 (daily ed. July 15, 1982) (statement of Sen. Wallop).

[113] *Id.* at S8386; *Hearings*, *supra* note 72, at 88 (statement of Scott Matheson, Governor of Utah).

of the three percent of federal lands currently leased competitively are won by independents.[114] S. 581, therefore, poses no danger to these smaller companies. Experiences in states where public lands are leased by bids also demonstrate that the major oil companies have not displaced smaller independents.[115] Furthermore, independents have dominated the secondary market in which lottery winners sell their leases.[116] The fact that independents account for over ninety percent of all wildcat wells also indicates their ability to compete with the major companies.[117] Even if a change to competitive leasing might threaten independents, under S. 581 the Secretary of the Interior would retain the authority to tailor some leases especially for independents with relatively less capital strength.[118]

By requiring that all federal lands be leased at whatever price the oil industry deems them to be worth, S. 581 also addresses the criticism that the noncompetitive system wastes public assets by leasing valuable lands at $1 per acre. The most recent analysis of the budgetary consequences of eliminating the lottery estimates that gross receipts would rise by roughly $1.3 billion over five years if a system of solely competitive bids were established.[119] The loss of some $600 million in projected filing fees over that period would decrease this gross figure to a net amount of approximately $700 million, that would be shared by the states and the federal government.[120]

Opponents of competitive leasing question the soundness of these CBO estimates.[121] However, the CBO study relies on basic

[114] *Hearings*, *supra* note 72, at 43 (statement of Guy R. Martin).

[115] Bumpers letter, *supra* note 87, at 3.

[116] *Id.*; Telephone interview with Susan Rieff, Legislative Aide to Sen. Bumpers (Feb. 21, 1984).

[117] 128 CONG. REC. S8386 (daily ed. July 15, 1982) (letter from James Watt, Sec'y of the Interior, to Sen. McClure).

[118] *See* S. 581, *supra* note 84, §§ 2, 5. One possible design for such a special system might involve making the royalty rate the bidding variable for some lands. Such an adjustment would reduce the front-end burden on the company, since the royalty payments would begin only with the production of oil.

[119] Rivlin letter, *supra* note 100, at 1.

[120] *Id.* The existing federal law requires that 50% of the receipts from federal oil and gas leases go to the states that encompass the leased land. 30 U.S.C. § 191 (1976). Forty percent of the revenue is placed in an environmental reclamation fund, and 10% goes into the general treasury. *Id.* This split, and the fact that the entire amount of the lost filing fees would have gone into the general treasury, indicate that the major net revenue gains from competitive leasing would accrue to the states. Specifically, the net revenue gain would approximate $40 million to the federal government and $660 million to state governments. Rivlin letter, *supra* note 100, at 3.

[121] 128 CONG. REC. S8392 (daily ed. July 15, 1982) (letter from James Watt).

BLM data and conservative assumptions.[122] For example, in predicting potential revenue from competitive bids, the CBO assumed that only 30% of the total number of acres historically leased noncompetitively would attract a bonus bid under a competitive system. It also assumed that 60% of the usual acreage leased would continue to bring the current $1 per acre, even if competitively leased. The remaining 10% was considered too marginal to draw any bids and was therefore removed from the calculation.[123]

Several details of the study suggest that the net revenue gain from S. 581 could be greater than the estimated $700 million. For the most attractive land, the expected bonus bids were conservatively valued at $60 per acre.[124] Actually, the average bonus bid on the federal lands that were competitively leased in 1982 was $281 per acre.[125] Furthermore, according to one estimate, the typical price paid by an oil developer to a lottery winner for reassignment of a lease ranges from $75 to $100 per acre.[126] Consequently, the amount bid for the best 30% of the existing noncompetitive acreage could easily exceed $60. The CBO noted that a $5 change in the bonus bid figure would affect the gross federal receipts by $270 million over the five year period.[127] Additionally, the actual number of acres attracting bonus bids could exceed the CBO's estimated 30%, thereby furthering the budgetary gains of adopting a totally competitive system.

A final argument supporting a competitive system is that thirteen of the fourteen states with the highest levels of oil and gas leasing activity have competitive systems.[128] Wyoming, for ex-

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[122] Letter from Dep't of the Interior, BLM, to Alice Rivlin, Director of the CBO (July 8, 1982) at 1 (on file at HARV. J. ON LEGIS.).

[123] Rivlin letter, *supra* note 100, at 2.

[124] *Id.*

[125] Carruthers letter, *supra* note 7, at 1. The $281 per acre average represents bids on lands above known geologic structures. *Id.* Therefore, the average bonus bid on the 30% of the existing noncompetitive acreage would probably be less than $281. However, there is no reason to assume that the bonus bid would be closer to $60 per acre than $281 per acre.

[126] Dep't of the Interior Study, Final Regulatory Impact Analysis of Options to Change the Application Fees and Rental Structures of the Noncompetitive Portion of the Federal Onshore Oil and Gas Leasing Program (Jan. 1982) at 7 (on file at HARV. J. ON LEGIS.).

[127] Rivlin letter, *supra* note 100, at 2.

[128] K. NELSON, *supra* note 100, at CRS-v. Most of the thirteen states with competitive bidding have statutes mandating that practice. *See* ALASKA STAT. § 38.05.180 (Supp. 1983); CALIF. PUB. RES. CODE § 6827 (West 1977); FLA. STAT. § 253.54 (1975); LA. REV. STAT. ANN. § 30:127 (West Supp. 1984); MONT. CODE ANN. § 77-3-407 (1981);

ample, converted from a predominantly noncompetitive system to a competitive one in 1983, largely because the existing lottery caused a proliferation of speculating middlemen that obstructed production.[129] Impetus for the switch might also have come from a 1982 Congressional Research Service study revealing that Wyoming was the only state where state oil and gas leases were earning less per acre than the federal government's leases within the state.[130] Recent revenue figures from Wyoming lease sales confirm the notion that revenue increases accompany a switch to competitive leasing.[131] For the first six months of 1983, the state's noncompetitive lottery produced $5,388,333.[132] After switching to a competitive system at midyear, the state collected $6,797,077 on its lease sales during the subsequent six months.[133] Wyoming's 26% increase in revenues from oil and gas leasing and the decisions by other states to opt for competitive sales provide concrete support for the claim that passage of S. 581 will achieve a higher return on federal lands as well.

The current leasing system is costing the states and the nation millions in lost rent, is depressing oil production, and is creating a fertile opportunity for fraud. Those who wish to perpetuate the current leasing scheme must come forward with convincing evidence of the social benefits that justify this system and its concomitant social costs. Since such evidence has not been forthcoming, an all-competitive system, like that embodied in S. 581, which does adequately address and resolve these problems, should be adopted.

N.M. STAT. ANN. §§ 19-10-16 to -17 (1978 & Supp. 1983); N.D. CENT. CODE § 38-09-17 (1980); OKLA. STAT. tit. 74, § 360.1 (1976). The remaining states allow the state land commission to lease the land by whatever method it deems best. *See* COLO. REV. STAT. § 36-1-113(2) (Supp. 1983); MICH. COMP. LAWS § 322.427 (1984); MISS. CODE ANN. § 29-7-3 (Supp. 1983); TEX. NAT. RES. CODE ANN. § 52.011, 52.013 (Vernon 1978); WYO. STAT. § 36-6-101 (1977 & Supp. 1983). Utah is the only one of the fourteen states that retains a noncompetitive system. UTAH CODE ANN. § 65-1-45 (Supp. 1983).

[129] Swan, *supra* note 46, at 2.

[130] K. NELSON, *supra* note 100, at CRS-22.

[131] Wyoming DPL, *supra* note 99.

[132] *Id.*

[133] *Id.*

COMMENT

THE CONCEPT OF NATIONAL PRESERVES IN SENATE BILL 49: A DANGEROUS PRECEDENT?

DAVID M. ROSENBERG*

Alaska's National Park System includes 54.7 million acres of land.[1] It contains diverse natural resources such as rain forests,[2] active volcanoes,[3] North America's largest assemblage of glaciers,[4] the continent's highest mountain,[5] and some of the most significant archeological sites known in the arctic.[6] This huge tract of land represents approximately 13.3 percent of the total area of Alaska[7] and approximately 69.2 percent of all National

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[1] The Alaskan National Park System includes the following: Alagnak Wild River (69 miles); Aniakchak National Monument (136,955 acres, all federal); Aniakchak National Preserve (federal: 466,238 acres, nonfederal: 86,193 acres); Bering Land Bridge National Preserve (federal: 2,457,000 acres, nonfederal: 317,182 acres); Cape Krusenstern National Monument (federal: 560,000 acres, nonfederal: 96,685 acres); Denali National Park (4,698,583 acres, all federal); Denali National Preserve (federal: 996,910 acres, nonfederal: 338,470 acres); Gates of the Arctic National Park (federal: 7,008,673 acres, nonfederal: 489,393 acres); Gates of the Arctic National Preserve (943,327 acres, all federal); Glacier Bay National Park (federal: 3,220,198 acres, nonfederal: 198 acres); Glacier Bay National Preserve (54,948 acres, all federal); Katmai National Park (federal: 3,544,900 acres, nonfederal: 134,029 acres); Katmai National Preserve (410,473 acres, all federal); Kenai Fjords National Park (federal: 567,000 acres, nonfederal: 109,667 acres); Klondike Gold Rush National Historical Park (federal: 11,745 acres, nonfederal: 1,526 acres); Kobuk Valley National Park (federal: 1,710,000 acres, nonfederal: 39,037 acres); Lake Clark National Park (federal: 2,617,513 acres, nonfederal: 16,420 acres); Lake Clark National Preserve (1,405,487 acres, all federal); Noatak National Preserve (federal: 6,460,000 acres, nonfederal: 97,204 acres); Sitka National Historical Park (federal: 107.05 acres, nonfederal: 0.66 acres); Wrangell-St. Elias National Park (federal: 7,445,047 acres, nonfederal: 886,359 acres); Wrangell-St. Elias National Preserve (4,872,953 acres, all federal); and Yukon-Charley Rivers National Preserve (federal: 1,713,000 acres, nonfederal: 803,821 acres). NATIONAL PARK SERVICE, NATIONAL PARK SYSTEM INDEX 12–15 (1982) [hereinafter cited as NATIONAL PARK SYSTEM INDEX].

[2] Glacier Bay National Park and Preserve and Kenai Fjords National Park contain rain forests. *Id.* at 13–14.

[3] Aniakchak National Monument and Preserve include the site of the Aniakchack Volcano, which last erupted in 1933. *Id.* at 12. The Katmai National Park and Preserve contain the Novarupta Volcano, which last erupted in 1917. *Id.* at 13.

[4] The Wrangell-St. Elias National Park and Preserve, located east of Anchorage, contain the largest group of glaciers in North America. *Id.* at 15.

[5] Mount McKinley, which is 20,320 feet high, is in the Denali National Park and Preserve. *Id.* at 15.

[6] Kobuk Valley National Park, located entirely north of the Arctic Circle, contains archeological sites which reveal more than 10,000 years of human occupation. *Id.* at 14.

[7] The land area of Alaska is 591,004 square miles. U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1982–83, 199 (103d ed. 1982).

Park System land in the United States.[8] The current scheme of protecting Alaskan federal land was made final on December 2, 1980, when President Carter signed the Alaskan National Interest Lands Conservation Act (ANILCA).[9] The enactment of ANILCA marked the end of a nine year struggle[10] during which oil, gas, mineral, and timber concerns sought increased access to Alaska's vast resources.[11] The introduction of Senate Bill 49 (S. 49), however, has reopened the Alaskan land debate and has endangered the compromised reached in ANILCA.

S. 49 was introduced on January 26, 1983, by Senator Ted Stevens (R-Alaska).[12] In its original form, it called for the reclassification of 12,778,000 acres of national park land as national preserves in order to legalize sport hunting.[13] Essentially, all other rules governing use of the land would remain the same.[14] The Senate Committee on Energy and Natural Resources amended the bill to reclassify only 4,961,000 acres from parks to preserves and reported it to the full Senate without recommendation on October 26, 1983.[15] S. 49 is currently pending on the Senate legislative calendar.[16]

Senator Stevens argues that his bill should be passed because sport hunting traditionally has been allowed on the land in ques-

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[8] As of January 1, 1982, the total land area contained within the National Park System was 79,017,972.54 acres. NATIONAL PARK SYSTEM INDEX, *supra* note 1, at 10.

[9] Pub. L. No. 96-487, 94 Stat. 2371 (1980) (codified at 16 U.S.C. §§ 3101–3233 (1982)).

[10] The Alaska Native Claims Settlement Act (ANCSA), Pub. L. No. 92-203, 85 Stat. 688 (1971) (codified as amended at 43 U.S.C. §§ 1601–1624 (1976 & Supp. 1981)), in addition to settling Alaskan aboriginal claims, directed the Secretary of the Interior to make recommendations to Congress on the completion of the public land allocation process in Alaska. S. REP. No. 413, 96th Cong., 1st Sess. 129 (1979), *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 5073. Studies and hearings conducted by federal agencies formed the foundation for the ANILCA bill. *Id.*, at 131–33, *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 5075–78.

[11] CONGRESSIONAL QUARTERLY, INC., 1980 ALMANAC 575 (1981).

[12] 129 CONG. REC. S90 (daily ed. Jan. 26, 1983); *see* S. 49, 98th Cong., 1st Sess. (1983) [hereinafter cited as S. 49], *reprinted in Redesignatng Public Land in Alaska to Allow Hunting: Hearing on S.49 Before the Subcomm. on Reserved Water of the Senate Comm. on Energy and Natural Resources*, 98th Cong., 1st Sess. 6–11 (1983) [hereinafter cited as *Hearing: Redesignating Public Land in Alaska to Allow Hunting*].

[13] *See* S. 49, *supra* note 12.

[14] S. 49 simply changes the boundaries of the national preserves established by ANILCA. *Id.* ANILCA provides that:

> [a] National Preserve in Alaska shall be administered and managed as a unit of the National Park System in the same manner as a national park except as otherwise provided in this Act and except that the taking of fish and wildlife for sport purposes and subsistence uses, and trapping shall be allowed in a national preserve under applicable State and Federal law and regulation.

16 U.S.C. § 3201 (1982). S. 49 provides for no other significant differences.

[15] S. REP. No. 281, 98th Cong., 1st Sess. 1 (1983).

[16] SENATE CALENDAR OF BUSINESS, 98th Cong., 2d Sess. 25 (Mar. 22, 1984).

tion.[17] He also maintains that the ANILCA national park classification is inequitable because it permits subsistence hunting but prohibits sport hunting.[18] Neither of these two arguments, however, takes into account the long-range consequences that passage of S. 49 might have as a precedent for reclassification of federal land.

This Comment examines the impact that passage of S. 49 would have upon future federal land classification. The first part describes two land classification policies to which the federal government has adhered in the past. The second part discusses the departure of S. 49 from each of these policies and evaluates the likelihood that enactment of S. 49 would set a precedent for future departures. The Comment concludes that passage of S. 49 would set a counterproductive precedent for the current system of federal land classification.

I. CURRENT FEDERAL LAND CLASSIFICATION POLICIES

Since the creation of the first national park, no land classified as a national park has ever been returned to its pre-classification status or given any new, less protective classification. The federal government has strictly adhered in the past to a policy that once land is afforded the protection of designation as a national park, that degree of protection is at least maintained.[19] Yellowstone National Park, the United States' first national park, was established in 1872 "as a public park or pleasuring ground for the benefit and enjoyment of the people."[20] The national park designation presently denotes a large area that "contains a variety of resources and encompasses sufficient land or water to ensure adequate protection of the resources."[21] Since the creation of this classification, lands deemed national parks have remained inviolable.

The federal government has also followed a principle of using the designation "national preserve" solely as a means of upgrading the environmental protection afforded a piece of land.

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[17] *See Hearing: Redesignating Public Land in Alaska to Allow Hunting, supra* note 12, at 23–24 (statement of Sen. Stevens).

[18] *Id.* at 24.

[19] *Id.* at 226 (statement of Cecil D. Andrus, former Governor of Idaho and former Sec'y of the Interior).

[20] Yellowstone National Park Act, ch. 24, 17 Stat. 32 (1872) (codified as amended at 16 U.S.C. §§ 21, 22 (1982)).

[21] NATIONAL PARK SYSTEM INDEX, *supra* note 1, at 6.

The first two national preserves, Texas's Big Thicket National Preserve and Florida's Big Cypress National Preserve were established in 1974.[22] In each instance, an interest that the government recognized as being worthy of protection was threatened by encroaching development.[23] The act establishing Big Thicket, the first of the national preserves, protected unique biological resources—chiefly a wide variety of plant life—that were threatened by oil, timber, agricultural, and construction development.[24] The act establishing Big Cypress National Preserve protected from development the area's natural resources and in particular the water supply "critical to the survival of considerably more than half of the Nation's most famous subtropical environment—the Everglades National Park."[25] In both cases, the direct effect of the national preserve designation was an increase in environmental protection of the land involved.

The national preserve was conceived as a classification that would provide appropriate protection to the resources at stake while accomodating, to the greatest extent possible, private or public interests in the land that did not affect the endangered resource. In both the Big Thicket and Big Cypress cases, for example, it was thought that prohibiting exercise of pre-existing mining and drilling rights would be unnecessary for the protection of the threatened resources.[26] Prohibition of sport hunting was also thought to be unnecessary to preserve the scientific

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[22] Big Thicket National Preserve—Establishment, Pub. L. No. 93-439, 88 Stat. 1254 (1974) (codified at 16 U.S.C §§ 698–698e (1982)); Big Cypress National Preserve—Establishment, Pub. L. No. 93-440, 88 Stat. 1258 (1974) (codified at 16 U.S.C §§ 698f–698m (1982)).

[23] *Proposed Big Thicket National Reserve, Tex.: Hearings on H.R. 4270, et al. Before the Subcomm. on National Parks and Recreation of the House Comm. on Interior and Insular Affairs*, 93d Cong., 1st Sess. 85 (1973) (statement of Rep. Eckhardt (D-Tex.)) [hereinafter cited as *Hearings: Proposed Big Thicket National Reserve, Tex.*]; *Proposed Big Cypress Reserve, Florida: Hearings on H.R.46 and H.R.4866 Before the Subcomm. on National Parks and Recreation of the House Comm. on Interior and Insular Affairs*, 93d Cong., 1st Sess. 36–37 (1973) (statement of Rubin Askew, Governor of Florida).

[24] *See* S. REP. No. 875, 93d Cong., 2d Sess. 1, *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS 5554.

[25] *See* S. REP. No. 1128, 93d Cong., 2d Sess. 1, *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS 5568.

[26] *See Hearings: Proposed Big Thicket National Reserve, Tex., supra* note 23, at 55–56 (statement of Nathaniel P. Reed, Ass't Sec'y of Interior for Fish & Wildlife & Parks); *Big Cypress National Preserve: Hearings on S.334, S.783, S.920, and H.R.10088 Before the Subcomm. on Parks and Recreation of the Senate Comm. on Interior and Insular Affairs*, 93d Cong., 1st Sess. 74 (1974) (statement of Nathaniel P. Reed) [hereinafter cited as *Hearings: Big Cypress National Preserve*].

value of the Big Thicket[27] or the hydrologic value of the Big Cypress Watershed.[28]

In both preserves, protection against significant threats was provided by acquiring land and restricting its use to certain relatively harmless activities. The Secretary of the Interior was entitled to acquire land or water within the boundaries by donation, purchase, exchange, or transfer from another federal agency. Such lands could be acquired from the state only by donation.[29] The Secretary could not acquire mineral rights or improved property without the consent of the owner unless use of such rights by the owner could be or was in fact "detrimental" to the purpose of the preserve.[30] Improved property could be acquired at the fair market rate.[31] In addition, the statutes set forth a range of rules and restrictions that the Secretary could establish within the preserve. While the lists differed somewhat between the two preserves, they were substantially the same. Limitations could be placed upon the use of motorized vehicles, mineral development, construction, grazing, and agriculture.[32] Hunting was allowed within the restrictions of applicable state and federal law.[33]

The first two national preserves were established in order to provide some protection to land that the federal government had not previously owned. The national preserves were instruments designed to extend protection to land that previously had been inadequately protected.

National preserves were included in the ANILCA package as a means of providing as much protection to the land as possible while making enough of a concession to sport hunting interests to enable a compromise. Early versions of the Act placed virtually all the land presently in ANILCA's parks and preserves in parks alone.[34] As a means of reaching an agreement, nineteen

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[27] *See Hearings: Proposed Big Thicket National Reserve, Tex., supra* note 23, at 47 (statement of Rep. Steelman (R-Tex.)).

[28] *See generally Hearings: Big Cypress National Preserve, supra* note 26, at 81, 83 (statement of Nathaniel P. Reed).

[29] *See* 16 U.S.C. § 698(c) (1982) (Big Thicket); *id.* § 698f(c) (Big Cypress).

[30] *See id.* § 698a(a) (Big Thicket); *id.* § 698f(c) (Big Cypress).

[31] *See id.* § 698b (Big Thicket); *id.* § 698h (Big Cypress).

[32] *See id.* § 698c(b) (Big Thicket); *id.* § 698i(b) (Big Cypress).

[33] *See id.* § 698c(c) (Big Thicket); *id.* § 698j (This provision in the statute that established Big Cypress is identical to § 698c(c) except for additional allowance for subsistence hunting).

[34] *See* H.R. REP. No. 1045, 95th Cong., 2d Sess. 83 (1978).

million acres of preserves were created instead.[35] As a result, this land was left open to sport hunting but kept subject to the same restrictions as park land in every other significant respect.[36]

II. S. 49 AND ITS CONSEQUENCES

Enactment of S. 49 would depart from previous federal policy in two important ways. First, the passage of S. 49 would mark the only time that national park protection previously afforded federal land would be lessened by changing its status to that of a national preserve.[37] S. 49 would downgrade nearly five million acres of national park land to national preserve status in an unprecedented declassification. This new classification would allow sport hunting where it is currently prohibited.[38] Second, the use of the national preserve in S. 49 is a departure from the established notion that a national preserve is an instrument to upgrade, not downgrade, environmental protection.[39] In this case, S. 49 would lift the existing restriction against sport hunting in a direct concession to private interests, uncompensated by any offsetting evnironmental accommodations.

Moreover, the passage of S. 49 could easily pave the way for further encroachment upon other ANILCA protections. Former Secretary of the Interior Cecil D. Andrus has expressed his concern that "creating such a crack in the ANILCA compromise could cause the whole structure to be weakened or to fall altogether."[40] If one interest group that was a party to the ANILCA compromise could get more than it had originally bargained for, other groups (for example, industry) might feel justified in demanding and working for concessions to their own interests. The compromise reached through ANILCA, however, was a nine year struggle to accomodate all competing interests. Tampering now with the balance previously struck would only in-

[35] *See Hearing: Redesignating Public Land in Alaska to Allow Hunting*, *supra* note 12, at 226.

[36] *See* 16 U.S.C. § 3201 (1982). *See also supra* note 14.

[37] *See Hearing: Redesignating Public Land in Alaska to Allow Hunting*, *supra* note 12, at 226 (statement of Cecil D. Andrus).

[38] *See* S. 49, *supra* note 12.

[39] *See supra* notes 22–33 and accompanying text.

[40] *See Hearing: Redesignating Public Land in Alaska to Allow Hunting*, *supra* note 12, at 226 (statement of Cecil D. Andrus).

crease the probability that the compromise would fall apart in the future.

Furthermore, if the protection of land sheltered by the time-honored national park classification can be downgraded, there is no reason to think that any ANILCA provision is impervious to assault. Indeed, Senator Stevens has expressed a definite interest in attacking ANILCA provisions that are unrelated to hunting. Introducing S. 49 to the Senate Subcommittee on Public Lands and Reserved Water, he stated:

> I urge you all who [s]tate that you're going to oppose it to reconsider. Because if this festers, if this festers, gentlemen, God willing—and I will make a political statement—I'm going to be here for a long time. The next bill I introduce will cover mining, and oil and gas, areas that were closed to timber, the areas that were closed to access, and we will use this, we will use this as a springboard to get to the other issues that bother us.[41]

It is also conceivable that passage of S. 49 could lead to downgrading the protection of federal land in states other than Alaska. The proponents of the so called "Sagebrush Rebellion" have been seeking transfer of federal land to the states for some time.[42] Downgrading protection while allowing the federal government to retain title might be seen as a way of accomplishing some of the goals of the Rebellion. The enactment of S. 49 could be a precedent-setting employment of this strategy. Indeed, Senator Stevens sees his efforts for Alaskan land reform as being consistent with the Sagebrush goals. Speaking to Sagebrush supporters in Nevada, Stevens said that he would be pushing for changes in ANILCA that would reflect "the western philosophy of multiple use of public lands."[43]

Arguably there are three reasons why S. 49 would not have an important precedential impact on land classification in states other than Alaska. First, the Sagebrush Rebels have focused their attacks upon Bureau of Land Management land, not upon

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[41] *Id.* at 30 (statement of Sen. Stevens).

[42] In 1979, the Nevada state legislature passed a bill claiming all Bureau of Land Management (the major federal land holding agency) land within its state. Webb, *How the West Hungers for Federal Land*, Bus. & Soc'y Rev., SPRING 1981, AT 13. THE SAGEBRUSH REBELLION THEN SPREAD THROUGHOUT THE WEST. GREGG, *S V* *S R*, NAT'L J., Mar. 21, 1981, at 480. It was endorsed by four state legislatures and by then candidate Ronald Reagan. It has since lost its momentum, having been defeated in five states. Reese, Lubenow & Cook, *Watt Defuses a Rebellion*, NEWSWEEK, Sept. 21, 1981, at 47.

[43] C. Callison, *The Great Sagebrush Rebellion*, AUDUBON, Jan. 1981, at 113, 115.

National Park Service land.[44] This preference, however, may have been motivated by an evaluation of the chances of downgrading national park land. Such an evaluation would be changed by the enactment of S. 49. Second, the land classification schemes of other states are better established than those of the three-year-old ANILCA. Enactment of S. 49, however, would downgrade a national park designation, thus setting a new standard for attack on seemingly well-entrenched classifications. Third, an amendment added to S. 49 by the Senate Committee on Energy and Natural Resources attempts to preclude citation of S. 49 as a precedent for land reform in other states: "That it is hereby declared to be the policy of Congress that the further designation of preserves in this act is done in recognition of a unique situation applicable to national parks in Alaska and does not have applicability in other national parks elsewhere in the United States."[45] This provision, however, would not preclude Congress from taking similar actions in the future. Proponents of land reform outside Alaska could argue that unique and compelling circumstances justify changing the classification of the land in which they are interested. Thus, while it is by no means certain that enactment of S. 49 would have any impact on federal land outside Alaska, the possibility that it could is real and should not be discounted.

III. Conclusion

S. 49 would change federal policy by using the national preserve designation as a means of downgrading national park land. It would convert the national preserve from a shield that is used to accomplish increased protection to a sword that decreases protection and destroys the stability of current land classifications. The most likely precedential impact of the enactment of S. 49 would be to encourage further attacks upon ANILCA. Replaying the struggle that produced ANILCA would only be counterproductive. The interests that were weighed and balanced against each other in 1980 have not changed significantly. The process that resolved the conflicts was an equitable one in which all major interests were represented[46] in a nine year bat-

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[44] *See* Andrus, *The Attack on Federal Lands*, Wall St. J., Dec. 5, 1979, at 22, col. 1.
[45] S. Rep. No. 281, 98th Cong., 1st Sess. 1 (1983).
[46] *See Hearing: Redesignating Public Land in Alaska to Allow Hunting*, *supra* note 12, at 225 (statement of Cecil D. Andrus).

tle.[47] Without better justification than has been presented to date, Congress should not enact a bill that would at best reopen this debate and could conceivably lead to an even more bitter fight before it is resolved.

[47] *See* S. REP. No. 413, *supra* note 10, at 129, 131–33.

COMMENT

THE STRUCTURE OF COLLAPSIBILITY: A POLICY COMPARISON OF SECTION 341 AND SECTION 751 OF THE INTERNAL REVENUE CODE

JOHN M. BAKER*

This Comment begins with the story of Mr. Collapser. Mr. Collapser owns and operates a successful widget business. The business, which is not incorporated, consists of a building, grounds, and a large inventory of widgets. Because widgets are not capital assets under the Internal Revenue Code,[1] Mr. Collapser has ordinary income each time he sells a widget. After some time, Mr. Collapser decides to sell the entire business, all components of which have appreciated substantially in his hands. Although he sells the business as a whole, the government "fragments" the gain into its component parts and requires Mr. Collapser to pay ordinary income tax on the sale of the inventory widgets.[2]

Mr. Collapser is unhappy with the Internal Revenue Service's treatment of the sale of his business. He knows that the IRS treats the capital stock[3] and partnership interests[4] of other businesses as capital assets, even though part of these other businesses also consists of inventory like his. He concludes that he could have received capital gains treatment if he had incorporated or taken in a partner.

Fresh from this heady thought, Mr. Collapser approaches his neighbor, Ms. Quickgain, and suggests that they jointly form a business, the Ordinary Income Avoidance Company, to produce and sell inventory. He describes to her how they can enjoy capital gains treatment simply by incorporating or by forming a partnership. Ms. Quickgain agrees to join the enterprise.

The two entrepreneurs have their new company buy a suburban tract of land, which they intend to subdivide into individ-

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[1] *See* I.R.C. § 1221(1) (1982).

[2] Williams v. McGowan, 152 F.2d 570, 572 (2d Cir. 1945).

[3] United States v. Mississippi Chem. Corp., 405 U.S. 298, 310 (1972).

[4] I.R.C. § 741 (1982).

ual lots for single-family residences. By selling the enterprise as a whole when the subdivision is complete, they plan to realize a capital gain rather than ordinary income.

Unfortunately for the Ordinary Income Avoidance Company, the conversion to capital gain is not quite as easy as expected. If the company is a corporation, Mr. Collapser's and Ms. Quickgain's proposed transaction is governed by section 341, the collapsible corporation statute;[5] if the company is a partnership, the transaction falls under section 751, the collapsible partnership statute.[6]

These provisions, which take radically different approaches to preventing the conversion of ordinary income into capital gains, are among the most complex[7] and most criticized sections in the entire Code.[8] Part I of this Comment examines section 341 and considers the problems it presents, while Part II does the same for section 751. Part III considers some of the revisions that have been proposed for each section. The Comment concludes that similar problems call for similar solutions and that a comparison of the two provisions and of the proposed revisions to them will produce a single, workable approach to this complex area.

I. PROBLEMS: SECTION 341

Suppose that Mr. Collapser and Ms. Quickgain incorporate the Ordinary Income Avoidance Company, and the company begins selling its inventory—the houses and lots in the subdivision—in the ordinary course of its business. Under these circumstances, the corporation would pay ordinary income tax on these sales and distribute the remaining income to its two share-

[5] *Id.* § 341.

[6] *Id.* § 751. Section 751, unlike § 341, does not contain the word "collapsible" in its title, but the conference report and the Senate report do refer to it as the "collapsible partnership" provision. H.R. REP. No. 2543, 83d Cong., 2d Sess. 60, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 5280, 5320; S. REP. No. 1622, 83d Cong., 2d Sess. 98, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4731.

[7] *Compare* Halpern, *Collapsible Corporations: Recent Ruling May Add New Limitation to Application of Section 341*, 8 J. REAL EST. TAX'N 86, 88–89 (1980) ("Section 341(e) is perhaps the most complex provision in the whole Code."), *with* Drucker & Segal, *Problems and Opportunities In Working with Collapsible Partnerships*, 61 TAXES 110, 113 (1983) ("[T]he greater complexity of Section 751 becomes obvious when one begins to apply the rules of both sections.").

[8] Commentators have criticized both sections with such unanimity that citation to individual authorities would perhaps be less accurate than a general reference to the authorities cited in this Comment.

holders, Mr. Collapser and Ms. Quickgain. Because this distribution is a dividend,[9] Mr. Collapser and Ms. Quickgain would also be taxed at ordinary income rates.[10]

Instead, suppose that Mr. Collapser and Ms. Quickgain plan to liquidate the Ordinary Income Avoidance Company before any sale of inventory takes place. If section 341 did not exist or did not apply, the corporation, upon liquidation, would not realize any gain on its distribution of appreciated property to its two shareholders.[11] Mr. Collapser and Ms. Quickgain would receive a capital gain in the amount of the fair market value of the appreciated property.[12] Because the shareholders' basis in the property would be its fair market value,[13] they presumably would not realize additional gain if they were to sell it.[14]

Since 1950, such tax savings to shareholders like Collapser and Quickgain have been restricted by the collapsible corporation[15] statute, section 341. Section 341, an onion-like

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[9] I.R.C. § 316(a) (1982).

[10] *Id.* § 301(c)(1).

[11] *Id.* § 336(a).

[12] *Id.* §§ 331, 1001(b).

[13] *Id.* § 334(a).

[14] A simple computation demonstrates that Collapser's and Quickgain's plan would provide them with a substantial tax savings. Suppose the cost of the houses and lots was $500,000 and their ultimate sale price, more than one year later, is $1,000,000. If Collapser and Quickgain are already in the maximum tax bracket, and they had sold this inventory as individuals, they would have paid $250,000 in tax. *See id.* § 1. If the Ordinary Income Avoidance Company had sold all the houses and lots and only then liquidated, it would have paid $209,750 in tax, *see id.* § 11, and its shareholders would have paid $58,050 in tax on the remaining income, *see id.* §§ 1, 331, 1202(a), for a total of $267,800. If, however, the Company completed the houses and liquidated before it had any income, it would have faced no tax and its shareholders would have paid only $100,000 at the capital gains rate. *See id.*

[15]

> The collapsible corporation is a device which has been used in an attempt to convert ordinary income into long-term capital gain by use of a temporary corporation. The device has been used principally in the motion-picture industry. A legitimate corporation engaged in the business of producing motion pictures would pay ordinarily the corporate income tax on its net income and its shareholders would pay ordinary income tax on their dividends from the corporation. Producers have tried to avoid these results by organizing separate corporations for each motion picture. Upon completion of the film but prior to the realization by the corporation of any income therefrom, the corporation is liquidated and the assets are distributed. In such a case, the corporation pays no tax, claiming that it has realized no income. The producer pays tax upon the difference between his cost and the fair market value of the assets so distributed; but such gain is reported as long-term capital gain with a maximum effective rate of 25 percent. After liquidation, the fair market value of the released production is ordinarily amortized against the income from the film as it is received. If the income from the film does not exceed such fair market value, there is no further tax.
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> In addition to the motion-picture industry, it is understood that the collapsible-corporation device has also been used in the building-construction trade

statute passed over a series of years,[16] transforms a shareholder's long-term capital gain into ordinary income if the gain is from: (a) the sale or exchange of stock of a collapsible corporation; (b) a distribution in complete or partial liquidation of a collapsible corporation; or (c) a distribution by a collapsible corporation that is treated as gain from the sale or exchange of property.[17] The statute defines a collapsible corporation as a corporation

> formed or availed of principally for the manufacture, construction, or production of property, for the purchase of [section 341 assets; essentially, noncapital assets held less than three years], or for the holding of stock in a corporation so formed or availed of, *with a view to*—
>
> (A) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, before the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a *substantial part* of the taxable income to be derived from such property, and
>
> (B) the realization by such shareholders of gain attributable to such property.[18]

The provision is replete with problems. First, the statute converts a shareholder's long-term capital gain[19] to ordinary in-

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by contractors who have corporations construct buildings for sale and then liquidate the corporations and sell the buildings as individuals.

S. REP. No. 2375, 81st Cong., 2d Sess. 45, *reprinted in* 1950 U.S. CODE CONG. & AD. NEWS 3053, 3099, *and in* 1950-2 C.B. 483, 516; H.R. REP. No. 2319, 81st Cong., 2d Sess. 56–57, *reprinted in* 1950-2 C.B. 380, 422–23.

[16] The predecessor statute of § 341, § 117(m) of the Internal Revenue Code of 1939, was passed in 1950, Revenue Act of 1950, ch. 994, § 212, 64 Stat. 906, 934–36, and amended in 1951, Revenue Act of 1951, ch. 521, § 326, 65 Stat. 452, 502–03. Section 341 was passed in 1954. Internal Revenue Code of 1954, ch. 736, § 341, 68A Stat. 3, 107–10 (codified as amended at I.R.C. § 341(a)–(d) (1982)). Subsection (e) was added in 1958, Technical Amendments Act of 1958, Pub. L. No. 85-866, § 20, 72 Stat. 1606, 1615–20 (codified as amended at I.R.C. § 341(e) (1982)), and subsection (f) was added in 1964, Act of Aug. 22, 1964, Pub. L. No. 88-484, § 1, 78 Stat. 596, 596–97 (codified as amended at I.R.C. § 341(f) (1982)).

Two additional provisions of the Internal Revenue Code bolster section 341. A collapsible corporation "to which section 341(a) applies" cannot elect the nonrecognition of shareholder gain under the provisions of I.R.C. § 333(a) (1982), and a collapsible corporation "as defined in section 341(b)" cannot get the benefits of nonrecognition of corporate gain or loss on certain sales in conjunction with a complete liquidation under I.R.C. § 337(c)(1) (1982).

This Comment does not attempt to be a detailed guide to § 341. The reader is referred to B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 12.01–.09 (4th ed. 1979 & Supp. 3, 1983), and to Ginsburg, *Collapsible Corporations--Revisiting an Old Misfortune*, 33 TAX L. REV. 307 (1978) for a more comprehensive treatment of § 341.

[17] I.R.C. § 341(a) (1982).

[18] *Id.* § 341(b)(1) (emphasis added).

[19] The omission of short-term capital gain is a flaw (although a minor one by comparison), because it permits advantageous use of collapsible corporations by shareholders

come, when it is the corporation's income on appreciated property that is really being avoided. Second, the taxpayer pays extra tax on the entire amount of gain on sale or distribution, even though only part of the corporation's income may have been "collapsed." This all-or-nothing approach is an imprecise way of dealing with the varying amounts of tax that a corporation may try to avoid.[20] Furthermore, this all-or-nothing aspect of section 341 is penal.[21] There is no economic or social policy reason to impose an additional tax on a corporation that is liquidated or is sold before it realizes substantially all its income. Because there may be sound economic reasons for the liquidation or sale of a corporation before it realizes income,[22] the penal aspect is both unfair and bad economic policy. In fact, the statute is so arbitrary that it may even be advantageous for a corporation to be collapsible.[23]

The arbitrariness of the provision is further manifested in the "substantial part" requirement of the definition. Although there has been significant controversy over the meaning of that phrase, it is now settled that a corporation that has realized at least one third of the taxable income derivable from its property is not collapsible.[24] It seems implausible that so harsh a statute would have such a generous loophole, but that is nevertheless the case.[25]

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who have capital losses that can be offset against short-term capital gain. B. BITTKER & J. EUSTICE, *supra* note 16, ¶ 12.03, at 12-6; Ginsburg, *supra* note 16, at 313–14.

[20] "[T]here is no doctrine of 'partial collapsibility,' permitting the shareholder's gain under § 341 to be fragmented between capital gain and ordinary income depending on the 'mix' of collapsible and noncollapsible assets involved; this all-or-nothing aspect of §341 makes it difficult to settle close cases with the Service." B. BITTKER & J. EUSTICE, *supra* note 16, ¶ 12.03, at 12-7.

[21] Axelrad, *Collapsible Corporations and Collapsible Partnerships*, 12 MAJOR TAX PLAN. 269, 276 (1960).

[22] The Treasury takes the position that sound economic reasons are irrelevant in determining collapsibility. *See infra* note 26 and accompanying text.

[23] The ordinary income rates for individuals provided by § 341(a) cannot exceed 50%. I.R.C. § 1 (1982). If the corporation had instead realized ordinary income, at a maximum rate of 46%, *id.* § 11, and liquidated, causing a capital gain at a maximum rate of 20%, *id.* §§ 1, 1202(a), the effective marginal rate would be 56.8%. *See* B. BITTKER & J. EUSTICE, *supra* note 16, ¶ 12.03, at S12-2 n.14. In addition, the individual whose corporation avoided collapsibility might well face an alternative minimum tax under I.R.C. § 55 (1982).

[24] Rev. Rul. 72-48, 1972-1 C.B. 102. Whether less than one-third is a "substantial part" remains unsettled. One-sixth has been held not to be a substantial part. Heft v. Commissioner, 294 F.2d 795, 798 (5th Cir. 1961) (Wisdom, J.).

[25] The loophole dates from Judge Wisdom's decision in Kelley v. Commissioner, 293 F.2d 904 (5th Cir. 1961), *aff'g* 32 T.C. 135 (1959), *acq.*, Rev. Rul. 72-48, 1972-1 C.B. 102, which allowed one-third as a substantial part.

> The effect of our holding is to leave the loophole two-thirds open to these taxpayers. Section 117(m) [now § 341], as we feel we should construe it, seems

The most important problem with section 341 is its essential subjectivity. Only shareholders "with a view to" collapse are taxed by the statute. The regulations interpret this requirement as broadly as possible: the requisite view is present whenever sale or distribution before realization of a substantial part of the taxable gain is contemplated,

> unconditionally, conditionally, or as a recognized possibility. . . . The existence of a bona fide business reason for doing business in the corporate form does not, by itself, negate the fact that the corporation may also have been formed or availed of with a view to the action described in section 341(b).[26]

The regulations thus adopt the position that the damning view is not a specific intent to bypass the revenue laws, as one might expect from reading the legislative history,[27] but rather is a general willingness to sell if the right circumstances arise.[28] This interpretation of the requisite view represents a government attempt to make section 341 as pervasive and nonsubjective as possible, for businessmen are always willing to sell if the price is right.[29] The regulations are particularly unfair to a minority

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> therefore a poor sort of tool for plugging loopholes. But the best workman can work only with the tools he has. If Congress wants a better job done, Congress should provide a tool that will not just plug the loophole "a substantial part of the way."

Id. at 913 (footnote omitted). The passage is distinctly uncharitable to Congress, considering the variety of contemporary interpretations open to the court. *See* Axelrad, *supra* note 21, at 316–23. A stricter judicial interpretation might have minimized this problem. On the other hand, it is at least arguable that Congress was concerned only with the extreme case of tax avoidance, so that a one-third realization requirement is, if anything, rather high. *Id.* at 323; *see also supra* note 15.

[26] Treas. Reg. § 1.341-2(a)(2) (1955).

[27] *See supra* note 15.

[28] While the regulations do provide an exception when the sale or distribution is clearly a result of extraordinary circumstances that arise after the manufacture, production, construction, or purchase of the property, such as illness of an active shareholder, Treas. Reg. § 1.341-2(a)(3) (1955); Treas. Reg. § 1.341-5(d) example (3) (1955), difficulties of proof make this exception less useful than might be expected, B. BITTKER & J. EUSTICE, *supra* note 16, ¶ 12.04, at 12-6.

[29]

> It must be concluded, therefore, that the regulations bring within § 341 any corporation that is formed or availed of for the production or purchase of property if the persons in control recognize (before production is completed) the possibility of selling or liquidating the corporation at a profit before it has realized a substantial part of the income from its property. Moreover, the natural tendency of courts and administrators to assume that what actually did happen was intended is evident in this area, so that self-serving declarations about the shareholders' state of mind are likely to be less persuasive than the actual results.

B. BITTKER & J. EUSTICE, *supra* note 16, ¶ 12.04, at 12-15.

shareholder, for the proscribed view is imputed to him regardless of his own ignorance of or opposition to collapsibility.[30]

As an aid to determining whether a corporation is collapsible, section 341(c) provides a percentage test. There is a rebuttable presumption of collapsibility if, at the time of sale or distribution, the fair market value of the corporation's section 341 assets is more than 120% of their adjusted basis and more than 50% of the fair market value of its total assets.[31] It does not matter that this test is subject to manipulation,[32] for avoidance of the prescribed percentages does not give rise to a presumption of noncollapsibility.[33] Because there is a presumption of correctness in any assessment of deficiency by the Internal Revenue Commissioner,[34] section 341(c) is of little value to the taxpayer; it has been called "a handkerchief thrown over something covered by a blanket."[35]

Because the legislative history makes it clear that section 341 was passed to combat wholesale tax avoidance,[36] one obvious question is whether the statute applies when there clearly is no tax avoidance present, notwithstanding that the taxpayer is within the literal terms of the statute. The Supreme Court in its only decision on section 341, has held that the taxpayer can look only to the statute itself for relief.[37]

Some relief has been present in the statute from the outset.[38] Section 341(d) provides three limitations on its application.[39]

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> [I]t is immaterial that a particular shareholder was not a shareholder at the time of the manufacture, construction, production, or purchase of the property, or if a shareholder at such time, did not share in such view. Any gain of such a shareholder on his stock in the corporation shall be treated in the same manner as gain of a shareholder who did share in such view.

Treas. Reg. § 1.341-2(a)(2) (1955).

31 I.R.C. § 341(c) (1982).

32 B. BITTKER & J. EUSTICE, *supra* note 16, ¶ 12.05, at 12-20.

33 I.R.C. § 341(c)(1) (1982).

34 *E.g.*, Helvering v. Taylor, 293 U.S. 507, 515 (1935); Mallette Bros. Constr. Co. v. United States, 695 F.2d 145, 148 (5th Cir.), *cert. denied*, 104 S. Ct. 341 (1983); King v. United States, 641 F.2d 253, 259 (5th Cir. 1981).

35 B. BITTKER & J. EUSTICE, *supra* note 16, ¶ 12.05, at 12-20 n.43.

36 *See supra* note 15.

37 Braunstein v. Commissioner, 374 U.S. 65, 71 (1963).

38 Comparable relief was in § 117(m)(3) of the Internal Revenue Code of 1939. Revenue Act of 1950, ch. 994, § 212, 64 Stat. 906, 935.

39 The limitations only apply to shareholders' gain on their stock. A collapsible corporation still is not entitled to the corporate nonrecognition benefits of § 337, *see supra* note 16, even if its shareholders are all protected by § 341(d). Leisure Time Enterprises v. Commissioner, 56 T.C. 1180, 1185 (1971); Rev. Rul. 63-125, 1963-2 C.B. 146. The shareholder nonrecognition election of § 333, however, can be used if all the shareholders are within § 341(d). Rev. Rul. 63-114, 1963-1 C.B. 74; Rev. Rul. 57-491, 1957-2 C.B.

First, the shareholder is not subject to section 341 unless he owns or is considered to own more than five percent of the outstanding stock of the corporation.[40] Congress may have inserted this limitation on the theory that small shareholders will play no significant part in forming the proscribed view; however, the regulations make it irrelevant whether minority shareholders share the view.[41] It has not been shown that this limitation is a major source of tax avoidance; nevertheless, it is easy to imagine it becoming one.[42]

Second, section 341 does not apply to shareholders unless more than seventy percent of the shareholder's gain is attributable to the property collapsed before realization of a substantial part of its income.[43] Again, while this provision may provide some relief, it is a treacherous limitation, because appreciation on noncollapsible property may be attributed to collapsible property.[44] Furthermore, its effect is to encourage corporations to retain earned income: if the corporation can accumulate thirty percent of its value in noncollapsible property, it can collapse

232; *see supra* note 16. *But see* Ginsburg, *supra* note 16, at 310 n.7 (single shareholder not within § 341(d) precludes § 333 election by any shareholder).

[40] I.R.C. § 341(d)(1)(A) (1982). The section also applies if the shareholder owns stock that is considered to be owned by another shareholder who owns or is considered to own more than five percent in value of the outstanding stock of the corporation. *Id.* § 341(d)(1)(B). Because one-way attribution of stock ownership is unusual, this provision will rarely apply. For example, if the attribution applies because the two shareholders are members of the same family, ownership will be attributed one-way only if one shareholder is the spouse of a lineal descendant of the other shareholder. *See id.* §§ 341(d), 544(a)(2).

[41] *See supra* note 30.

[42] One example is 21 equal shareholders who purposefully form a collapsible corporation. Alternatively, suppose a builder has excess deductions, not an unusual situation for builders. He takes eight 5% shareholders into a corporation organized to subdivide a tract of land. Because of the expected tax advantages, however, the small shareholders put up more than 40% of the capital. When the corporation has completed the subdivision, 40% of the tract houses are distributed to the small shareholders and 60% to the developer. The small shareholders realize capital gains on the distribution and no additional gain on sale, because of the basis step-up, I.R.C. § 334(a) (1982). The developer realizes ordinary income on the distribution and no additional gain on sale.

[43] *Id.* § 341(d)(2).

> For the purpose of this limitation, the gain attributable to the property referred to in section 341(b)(1) is the excess of the recognized gain of the shareholder during the taxable year upon his stock in the collapsible corporation over the recognized gain which the shareholder would have if the property had not been manufactured, constructed, produced, or purchased.

Treas. Reg. § 1.341-4(c)(2), T.D. 6152, 1955-2 C.B. 61, 159, 20 Fed. Reg. 8875, 8907.

[44] Treas. Reg. § 1.341-4(c)(3), T.D. 6152, 1955-2 C.B. 61, 159, 20 Fed. Reg. 8875, 8907. In the *King* case, appreciation was attributed not only to entirely different property, but to property owned by a different corporation controlled by the same taxpayer. King v. United States, 641 F.2d 253, 266 (5th Cir. 1981).

without harm to its shareholders.[45] And, like section 341 itself, the limitation is all or nothing, so that a single percentage point can determine capital gains or ordinary income treatment for a shareholder's entire holdings.[46]

Finally, section 341 does not apply to shareholders' gain "realized after the expiration of 3 years following the completion of such manufacture, construction, production, or purchase."[47] It is odd to apply this provision to purchases of inventory, because the inventory provisions were first enacted to prevent the collapse of inventories that appreciate while being held for long periods of time, such as whiskey.[48] The statute aims to free long-established businesses of collapsibility worries. Otherwise, a service or utilities corporation might find itself perpetually collapsible. However, "manufacture, construction, production, or purchase" has been interpreted so broadly that the limitation is in many cases meaningless.[49] The effect is that an ongoing business that is forced continually to alter or upgrade its property will always be collapsible, while an intentionally collapsible corporation can escape the rigors of section 341 simply by waiting three years.

The limitations just discussed existed in section 341 as it was passed in 1954. But the statute, as it existed then, sometimes called for ordinary income treatment when the shareholders would have received capital gains income had they not used the

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[45] B. BITTKER & J. EUSTICE, *supra* note 16, ¶ 12.06, at 12-23 & n.48. Bittker and Eustice also suggest that shareholders might come within § 341(d)(2) by contributing appreciated securities to the corporation before collapse. *Id.*

[46] Treas. Reg. § 1.341-4(c)(1), T.D. 6152, 1955-1 C.B. 61, 159, 20 Fed. Reg. 8875, 8907.

[47] I.R.C. § 341(d)(3) (1982).

[48] S. REP. No. 781, 82d Cong., 1st Sess. 33, *reprinted in* 1951 U.S. CODE CONG. & AD. NEWS 1969, 2002, *and in* 1951-2 C.B. 458, 481; H.R. REP. No. 586, 82d Cong., 1st Sess. 25, *reprinted in* 1951 U.S. CODE CONG. & AD. NEWS 1781, 1806, *and in* 1951-2 C.B. 357, 375.

[49] *See* King v. United States, 641 F.2d 253, 265 (5th Cir. 1981) (laying of water lines and connecting new customers held to be continuing construction of utility); Glickman v. Commissioner, 256 F.2d 108, 111 (2d Cir. 1958) (landscaping grounds and getting F.H.A. approval held construction); Estate of Diecks v. Commissioner, 65 T.C. 117, 123 (1975) (continuous laying of cables and connecting new customers held construction of cable television system); Rev. Rul. 56-137, 1956-1 C.B. 178 (rezoning of land from residential to commercial use held construction); *see also* Mirsky & Willens, *New Developments Augur a Changed View in Applying the Collapsible Corporation Rules*, 57 J. TAX'N 2, 2 (1982). The timing-of-completion issue also arises in determining whether the view to collapse existed during the manufacture, production, construction, or purchase of the property. *See* Treas. Reg. § 1.341-2(a)(3) (1955).

corporate form,[50] and this was felt to be unfair.[51] The somewhat bizarre congressional response was section 341(e).[52]

The general effect of section 341(e)—and it should be noted that any description of the subsection is necessarily a gross oversimplification—is that section 341 will not apply with respect to the individual shareholder in the case of sales of stock and complete liquidations, or with respect to the corporation for purposes of sections 333 and 337, if the net unrealized appreciation in subsection (e) assets of the corporation does not exceed an amount equal to fifteen percent of the net worth of the corporation.[53] Subsection (e) assets are essentially ordinary income assets and property used in the trade or business.[54] Shareholders who are dealers, so that otherwise capital assets are inventory assets in their hands, taint the corporation with dealer status if they own more than twenty percent of its stock, and taint it with respect to themselves regardless of the amount of their holdings.[55]

The problem with section 341(e) is not that it is somehow fatally flawed in concept, but that it is simply too complicated.[56] The opening sentence alone is said to be the longest sentence in the Internal Revenue Code.[57] It is incomprehensible to lawyers, revenue agents, and judges alike.[58]

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[50] *See* Braunstein v. Commissioner, 374 U.S. 65 (1963).

[51]

> The collapsible-corporation provisions of [pre-1958] law, however, both by their terms and as interpreted, are so broad that in a number of situations they may have exactly the opposite effect from that intended—instead of preventing the conversion of ordinary income into capital gain, they may instead convert what would otherwise be capital gain into ordinary income .... [T]he collapsible-corporation provisions of present law frequently impede or prevent legitimate business transactions and in some cases even result in the imposition of ordinary income taxes which would not be imposed if the shareholders of such corporations had not employed the corporate method of doing business.

S. REP. No. 1983, 85th Cong., 2d Sess. 31–32, *reprinted in* 1958 U.S. CODE CONG. & AD. NEWS 4791, 4820, *and in* 1958-3 C.B. 922, 952–53.

[52] Technical Amendments Act of 1958, Pub. L. No. 85-866, § 20, 72 Stat. 1606, 1615–20 (codified as amended at I.R.C. § 341(e) (1982)).

[53] I.R.C. § 341(e)(1)–(4) (1982).

[54] *Id.* § 341(e)(5).

[55] *Id.* § 341(e)(1)(B), (e)(2)(B), (e)(5). Although only five-percent shareholders taint their own gain on distribution or sale, shareholders with less than a five-percent holding are usually exempt from § 341 in any case. *Id.* § 341(d)(1)(A); *see also supra* note 40.

[56] Axelrad, *supra* note 21, at 377–78.

[57] 2 A. WILLIS, J. PENNELL & P. POSTLEWAITE, PARTNERSHIP TAXATION § 121.02, at 121-2 n.3 (3d ed. 1983) [hereinafter cited as A. WILLIS].

[58] Ginsburg, *supra* note 16, at 313, 321.

These varied relief provisions were still felt to be inadequate,[59] and in 1964 Congress added a final way out—section 341(f).[60] The subsection strikes at the root of the problem by excepting sales of stock of a corporation from the provisions of section 341 if the corporation has filed a section 341(f) consent.[61] The effect of the consent is to compel the corporation to recognize gain on any disposition of appreciated noncapital or real property[62] to its shareholders.[63] The filing of a consent does not affect the determination of whether a corporation is collapsible.[64]

One problem with section 341(f) is that it discriminates against small shareholders,[65] for it is the corporation as a whole, rather than the selling shareholders, that recognizes gain under the consent. Because probably only a controlling shareholder can

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> *Reasons for bill.*—The problem with which the first section of this bill deals centers around the sale of stock of a corporation that is rapidly growing and expects to continue in business but which holds constructed or produced properties which are worth substantially more than their cost and upon which there has not been substantial realization of the profits to be derived from the properties. The shareholders, through a sale of stock (whether or not through a "public offering"), would like to capitalize on the future prospects of this growing company. The buyers of the stock clearly intend to have the corporation continue in business. However, on such a stock sale, the corporation might be regarded as fitting precisely into the literal definition of a collapsible corporation (under sec. 341(b)) if the shareholders intended to sell the stock of the corporation prior to the realization by the corporation of a substantial part of the income to be derived from the constructed or produced property. Moreover, the corporation usually cannot qualify under any of the several existing exceptions, principally because it has not had a substantial prior business history and is growing rapidly.
>
> *Explanation of bill.*—This section meets the problem described above by providing that the collapsible provisions will not apply to the sale of stock in a corporation which consents to a special type of tax treatment described below. The treatment provided has the effect of assuring that ultimately there will be the same tax consequences as if the assets had been sold before the stock.

S. REP. No. 1241, 88th Cong., 2d Sess. 2, *reprinted in* 1964 U.S. CODE CONG. & AD. NEWS 3081, 3082, *and in* 1964-2 C.B. 684, 685; *see also* H.R. REP. No. 1308, 88th Cong., 2d Sess. 2 (1964) (substantially identical language).

60 Act of Aug. 22, 1964, Pub. L. No. 88-484, § 1, 78 Stat. 596, 596–97 (codified as amended at I.R.C. § 341(f) (1982)).

61 I.R.C. § 341(f)(1) (1982). A corporation, however, that is in fact not collapsible and mistakenly files a § 341(f) consent cannot later repudiate the consent. H.R. REP. No. 1308, *supra* note 59, at 4; Treas. Reg. § 1.341-7(e)(5)(i), T.D. 7655, 1980-1 C.B. 72, 75, 44 Fed. Reg. 68,458, 68,461 (1979).

62 I.R.C. § 341(f)(2), (4) (1982).

63 Treas. Reg. § 1.341-7(e)(2), (4) examples (1)–(3), T.D. 7655, 1980-1 C.B. 72, 74–75, 44 Fed. Reg. 68,458, 68,460–61 (1979).

64 *Id.* § 1.341-7(a)(3), 1980-1 C.B. at 72–73, 44 Fed. Reg. at 68,460.

65 *See* Ginsburg, *supra* note 16, at 323–25.

cause a corporation to file a section 341(f) consent, the statute discriminates against any minority shareholders who do not want to sell their stock. In addition, because buyers are willing to pay less for stock in a consenting corporation, the statute discriminates against shareholders holding less than five percent of the outstanding stock, who already could sell at capital gains rates.[66] Furthermore, while Congress anticipated that future buyers of stock in consenting corporations would adjust the price to reflect the future tax disadvantage,[67] there is no provision for warning buyers that a section 341(f) consent has been filed.[68]

II. PROBLEMS: SECTION 751

Suppose Mr. Collapser and Ms. Quickgain now form a partnership that buys a tract of land and develops it into a subdivision. When the subdivision is complete, Mr. Collapser and Ms. Quickgain sell their partnership interests to an unrelated third party. They then claim capital gains treatment on the sale of their partnership interests.

Capital gains treatment on such a transaction is now precluded by section 751.[69] Although the Internal Revenue Code of 1954 treats partnership interests as capital assets,[70] that rule is limited by section 751(a), which provides that the portion of a payment for a partnership interest that is allocable to unrealized receivables and substantially appreciated inventory items ("hot

[66] I.R.C. § 341(d)(1); *see also supra* note 40.

[67] S. REP. No. 1241, 88th Cong., 2d Sess 3, *reprinted in* 1964 U.S. CODE CONG. & AD. NEWS 3081, 3083, *and in* 1964-2 C.B. 684, 686; H.R. REP. No. 1308, 88th Cong., 2d Sess. 3 (1964).

[68] As a result, every buyer of stock should demand a warranty or other proof that the corporation has never filed a section 341(f) consent. Ginsburg, *supra* note 16, at 395–96. As time goes on and more corporations file consents, all of which live as long as the corporation does, the need for such a warranty will become increasingly great. Of course, such warranties are impractical for transactions on public markets—and Congress specifically anticipated that consents would be filed in connection with public offerings, *see supra* note 59—so some shareholders simply will be unaware that their stock may be worth less than they paid for it.

[69] Internal Revenue Code of 1954, ch. 736, § 751, 68A Stat. 3, 250–51 (codified as amended at I.R.C. § 751 (1982)).

For detailed guides to § 751, the reader is referred to 2 W. MCKEE, W. NELSON & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶¶ 16.01–.04, 21.01–.04 (1977 & Supp. 3, 1983) [hereinafter cited as W. MCKEE], and to 2 A. WILLIS, *supra* note 57, §§ 102.01 - .17, 121.01–123.06.

[70] I.R.C. § 741 (1982).

assets"[71]) will receive ordinary income treatment.[72] An arm's length allocation of the purchase price to hot and cold assets by the buyer and seller has a presumption of correctness.[73]

Problems arise under section 751 in the definitions of unrealized receivables and substantially appreciated inventory items. "Unrealized receivables" are defined to include,

> to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for—
>
> (1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or
>
> (2) services rendered, or to be rendered.[74]

"Inventory items" are property other than capital assets and other than property used in the trade or business, as defined in section 1231(b), plus any other partnership property which in the hands of the selling or distributee partner would be inventory items.[75] Inventory items have appreciated substantially if their

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[71] The Internal Revenue Service has dubbed unrealized receivables and substantially appreciated inventory "section 751 property," Treas. Reg. § 1.751-1(e), T.D. 6175, 1956-1 C.B. 211, 288, 21 Fed. Reg. 3500, 3526, and other property "other property," *id.*, but this Comment will use the more descriptive terms "hot assets" and "cold assets."

[72]

> *(a) Sale or exchange of interest in partnership.*—The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to—
>
> (1) unrealized receivables of the partnership, or
>
> (2) inventory items of the partnership which have appreciated substantially in value,
>
> shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

I.R.C. § 751(a) (1982).

[73] Treas. Reg. § 1.751-1(e), T.D. 6175, 1956-1 C.B. 211, 288, 21 Fed. Reg. 3500, 3525.

[74] I.R.C. § 751(c) (1982). Such was the original definition of unrealized receivables in the Internal Revenue Code of 1954, but subsequent amendments have added a long list of items deemed unrealized receivables. *See id.*

[75]

> *Inventory items.*—For purposes of this subchapter the term "inventory items" means—
>
> (A) property of the partnership of the kind described in section 1221(1),
>
> (B) any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231,
>
> (C) any other property of the partnership which, if sold or exchanged by the partnership, would result in a gain taxable under subsection (a) of section 1246 (relating to gain on foreign investment company stock), and
>
> (D) any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described in subparagraph (A), (B), or (C).

Id. § 751(d)(2).

fair market value exceeds 120% of their adjusted basis and 10% of the fair market value of all partnership property other than money.[76]

A problem arises because the regulations interpret inventory items to include unrealized receivables.[77] Although this does not affect the unrealized receivables, which are hot assets in any case, it does increase the chance that the inventory items will be substantially appreciated.[78] This interpretation has been criticized as both bad policy[79] and contrary to congressional intention.[80] The dangers of overlap are reduced somewhat by the fact that true inventory items ordinarily are held only by accrual-method taxpayers,[81] whereas unrealized receivables—except for those additional items designated by the Code[82]—ordinarily are held only by cash-method taxpayers.[83]

A second problem is the degree to which the substantial appreciation percentages are subject to manipulation.[84] For example, suppose Collapser and Quickgain put one million dollars into their partnership. They borrow four million dollars and spend the entire five million dollars developing a subdivision. They sell their partnership interests in the completed subdivision for six million dollars, an increase over basis of 20% but a return on their investment of 100%. Because the sale price was not more than 120% of basis, section 751 does not apply.[85] They also might have sold some of the inventory, contributed capital assets to the partnership, or borrowed money to buy govern-

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[76] *Id.* § 751(d)(1).

[77] Treas. Reg. § 1.751-1(d)(2)(ii), T.D. 6175, 1956-1 C.B. 211, 287, 21 Fed. Reg. 3500, 3526.

[78] Including more property in inventory items will increase the chance of meeting the 10%-of-all-partnership-property de minimis standard. As for the 120%-of-basis requirement, the basis of an unrealized receivable is its costs or expenses paid or accrued but not yet taken into account under the partnership method of accounting. *Id.* § 1.751-1(c)(2), T.D. 6175, 1956-1 C.B. 211, 287, 21 Fed. Reg. 3500, 3526. This means that unrealized receivables will in the ordinary situation have a zero basis, and the rest of the time may be expected to have a value greater than 120% of basis. *See, e.g.*, Alexander, *Collapsible Partnerships*, 19 INST. ON FED. TAX'N 257, 264 (1961).

[79] Alexander, *supra* note 78, at 262.

[80] *See* S. REP. NO. 1622, *supra* note 6, at 404, 1954 U.S. CODE CONG. & AD. NEWS at 5046; *see also* Anderson & Coffee, *Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K* (pt. 2), 15 TAX L. REV. 497, 501 n.226 (1960).

[81] Treas. Reg. § 1.446-1(c)(2), T.D. 6282, 1958-1 C.B. 215, 219, 22 Fed. Reg. 10,686, 10,687 (1957).

[82] *See* I.R.C. § 751(c) (1982).

[83] *See* Alexander, *supra* note 78, at 262.

[84] The examples in this paragraph are drawn from 2 A. WILLIS, *supra* note 57, § 102.08.

[85] I.R.C. § 751(d)(1)(A) (1982).

ment bonds, any of which, under the right circumstances, would prevent the application of section 751.

Section 751 applies not only to sales of partnership interests, but also to certain distributions. In other words, whenever a partner receives a share of hot assets that is not prorated in a distribution, it is deemed a sale of the hot assets by the partner or the partnership, as the case may be.[86] Thus, section 751(b) applies only to the extent that the distribution is not prorated,[87] and therefore does not apply at all to prorated distributions.[88] The regulations also take the position that section 751(b) applies to current as well as liquidating distributions,[89] except that it does not apply to "current drawings or to advances against the partner's distributive share, or to a distribution which is, in fact, a gift or payment for services or for the use of capital."[90] Exceptions are made for property the distributee contributed to the partnership and for section 736(a) retirement payments.[91]

In spite of its straightforward appearance, section 751(b) has problems that make it difficult to understand why it is still in force. The problems posed by the unrealized receivables and substantially appreciated inventory requirements of section 751(a) remain with subsection (b) of the provision. In addition, section 751(b) is even more complicated to apply than section 341(e). It takes no more than a look at the examples in the

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> *(b) Certain distributions treated as sales or exchanges.*--
> *(1) General rule.*—To the extent a partner receives in a distribution—
> (A) [unrealized receivables or substantially appreciated inventory items] in exchange for all or a part of his interest in other partnership property (including money), or
> (B) partnership property (including money) other than [unrealized receivables or substantially appreciated inventory items] in exchange for all or a part of his interest in [unrealized receivables or substantially appreciated inventory items],
>
> such transaction shall, under regulations prescribed by the Secretary, be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution).

Id. § 751(b)(1).

87 S. REP. No. 1622, *supra* note 6, at 401–02, 1954 U.S. CODE CONG. & AD. NEWS at 5044; Treas. Reg. § 1.751-1(b)(1)(i), T.D. 6175, 1956-1 C.B. 211, 283–84, 21 Fed. Reg. 3500, 3525.

88 H.R. REP. No. 2543, *supra* note 6, at 65, 1954 U.S. CODE CONG. & AD. NEWS at 5325–26; Treas. Reg. § 1.751-1(b)(1)(ii), T.D. 6175, 1956-1 C.B. 211, 284–85, 21 Fed. Reg. 3500, 3525.

89 Treas. Reg. § 1.751-1(b)(1)(i), T.D. 6175, 1956-1 C.B. 211, 284–85, 21 Fed. Reg. 3500, 3525. *Contra* Anderson & Coffee, *supra* note 80, at 528–29.

90 Treas. Reg. § 1.751-1(b)(1)(ii) T.D. 6175, 1956-1 C.B. 211, 284, 21 Fed. Reg. 3500, 3525.

91 I.R.C. § 751(b)(2) (1982).

regulations[92] to see why section 751(b) has been called "a trap for the wary."[93] The corollary is that section 751(b), being unenforceable, is in fact unenforced.[94]

Even if the complexity issue is put aside, the purpose of section 751(b) remains a question. Partners are taxed as individuals,[95] so that the tax characteristics of assets will not change on distribution. A recognition statute, therefore, seems unneeded. The commentators speculate that Congress enacted the statute because it was concerned that partners would distribute ordinary income property to partners in a low tax bracket or with a tax loss, leaving the capital assets to high-bracket partners.[96] Such a statute is inconsistent with the general intent of the partnership tax provisions to allow partners to allocate the tax burden among themselves,[97] provided only that the allocations have "substantial economic effect."[98]

Even if the statute were needed and otherwise enforceable, it is easily evaded. Because the partners are taxed on the amount of hot assets deemed to be sold rather than on the amount of ordinary income avoided by the distribution,[99] the partners can

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[92] Treas. Reg. § 1.751-1(g) examples (2)-(6), T.D. 6175, 1956-1 C.B. 211, 289-98, 21 Fed. Reg. 3500, 3527-29, T.D. 6832, 30 Fed. Reg. 8573, 8575 (1965).

[93] THE AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: TENTATIVE DRAFT No. 3, 54 n.* (1979) [hereinafter cited as TENTATIVE DRAFT No. 3].

[94] *Id.* at 54.

[95] I.R.C. § 701 (1982).

[96] *See* TENTATIVE DRAFT No. 3, *supra* note 93, at 51; 2 W. MCKEE, *supra* note 69, ¶ 21.01[2], at 21-5 & n.8 (1977); 2 A. WILLIS, *supra* note 57, § 121.02, at 121-2; Anderson & Coffee, *supra* note 80, at 527-28. The purpose of § 751(b) is unclear from the committee reports, which seem to consider it as directed at the same problem as § 751(a).

> The provisions relating to unrealized receivables and appreciated inventory items are necessary to prevent the use of the partnership as a device for obtaining capital-gain treatment on fees or other rights to income and on appreciated inventory. Amounts attributable to such rights would be treated as ordinary income if realized in normal course by the partnership. The sale of a partnership interest or distributions to partners should not be permitted to change the character of this income. The statutory treatment proposed, in general, regards the income rights as severable from the partnership interest and as subject to the same tax consequences which would be accorded an individual entrepreneur.

S. REP. No. 1622, *supra* note 6, at 99, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4732; *see also* H.R. REP. No. 1337, 83d Cong., 2d Sess. 71, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4017, 4097-98 (substantially identical language). Since the Senate added § 751(b), but did not change the only general description of the purpose of § 751, it seems that little thought was given to any special purpose of this far-reaching provision.

[97] *See* Foxman v. Commissioner, 41 T.C. 535, 551-52 (1964), *aff'd*, 352 F.2d 466 (3d Cir. 1965), *acq.* 1966-2 C.B. 4.

[98] I.R.C. § 704(b)(2) (1982).

[99] Treas. Reg. § 1.751-1(b)(1)(ii), T.D. 6175, 1956-1 C.B. 211, 283-84, 21 Fed. Reg. 3500, 3526.

simply make a nontaxable, prorated distribution of the hot assets, but ensure that most of the potential ordinary income goes to the low-bracket partners.[100]

III. SOLUTIONS

Both section 341 and section 751 attempt to reduce tax avoidance at ordinary income rates by investors who sell their ownership interests before the enterprise has realized any gain on ordinary income assets. The problems dealt with by the two sections, however, are not exactly parallel. First, the purpose of section 751 is to prevent partners from achieving capital gains treatment on any actual or deemed sale of ordinary income assets. The purpose of section 341, on the other hand, is to prevent shareholder avoidance of corporate-level taxation, whether at ordinary income or capital gains rates, by distributing appreciated property to shareholders "before the realization . . . of a substantial part"[101] of the appreciation.

Second, section 751 is designed to avoid any unintended tax benefits arising out of the partnership form. Section 751 is thus an integral part of the flow-through taxation concept of the partnership tax provisions.[102] In contrast, section 341 is a prophylactic provision, designed to increase sharply the taxes of taxpayers seeking to manipulate the corporate form for tax advantages. Section 341 operates as a limit on the *General Utilities*[103] principle that the corporation does not recognize gain on the distribution of appreciated property with respect to its stock.[104]

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[100] 2 W. McKEE, *supra* note 69, ¶ 21.01[2], at 21-5 to -7 (1977). For additional problems with § 751(b), see TENTATIVE DRAFT No. 3, *supra* note 93, at 53–55.

[101] I.R.C. § 341(b)(1)(A) (1982).

[102] *Id.* § 701.

[103] General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).

[104] I.R.C. §§ 311, 336 (1982). Viewed another way, § 341 is the limitation not on *General Utilities*, but on I.R.C. § 331(a) (1982), which states: "Amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock." Although this is consistent with the capital gains treatment given sales of stock, *see supra* note 3 and accompanying text, it is a sharp departure from the treatment of nonliquidating distributions. Distributions of appreciated inventory assets cause an increase in earnings and profits by the amount of the appreciation, I.R.C. § 312(b) (1982), ensuring that the distribution will be taxed as a dividend at ordinary income rates, at least to the extent of the appreciation. *Id.* §§ 301(c), 312(a). *But see* B. BITTKER & J. EUSTICE, *supra* note 16, ¶ 7.24, at 7-69 n.169 (exceptions). Section 341 thus may be considered to be a legislative determination that *General Utilities* is sacred, but shareholders who abuse the doctrine are not entitled to the additional advantage of capital gains treatment for their dispositions of stock.

There have been frequent proposals to restructure both provisions. The proposals for restructuring section 751 have been uniform in most of the salient aspects, though differing in details. For instance, every major proposal—the 1957 Advisory Group on Subchapter K report,[105] the 1959–1960 Ways and Means Committee bill,[106] and the 1979 American Law Institute proposal[107]—has advocated fragmentation of gain into ordinary income and capital gains, just as is done on the sale of a sole proprietorship,[108] rather than continue the present definitions of unrealized receivables[109] and substantially appreciated inventory.[110] Because fragmentation is used on sales of sole proprietorships, and because the general intent of the partnership provisions is not to alter the taxation scheme on account of the choice of the partnership form, the fragmentation approach seems clearly preferable.

In addition, both the American Law Institute and the Advisory Group proposals would have abolished section 751(b).[111] The Ways and Means Committee did not follow its Advisory Group's recommendation.[112] The Committee apparently felt that it could not risk the possibility of income shifting that the repeal of subsection (b) would allow. Without the provision, a partnership could distribute ordinary income assets to partners in low tax brackets or with tax losses and retain capital assets for distribution to those in higher tax brackets. Although the other two proposals do concede that some opportunity for income shifting would exist,[113] the problem seems too small and the

[105] Advisory Group on Subchapter K of the Internal Revenue Code of 1954, *Revised Report on Partners and Partnerships*, in *Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code: Hearings Before the House Comm. on Ways and Means*, 86th Cong., 1st Sess. 115 (1959) [hereinafter cited as Advisory Group on Subchapter K]; *see also* Anderson & Coffee, *supra* note 80.

[106] H.R. 9662, 86th Cong., 2d Sess. §§ 749–751, *reprinted in* H.R. REP. No. 1231, 86th Cong., 2d Sess. 101, 148–50 (1960).

[107] TENTATIVE DRAFT No. 3, *supra* note 93. Of course, these three proposals are not the only important proposals to rewrite § 751 that have been made, but these three are both representative and currently the most important of existing proposals for change.

[108] *See supra* note 2 and accompanying text. The earlier proposals would achieve fragmentation by definitions, H.R. 9662, *supra* note 106, secs. 749, 751; Advisory Group on Subchapter C, *supra* note 105, at 163, but the ALI proposal would simply and without elaboration apply the fragmentation rule of Williams v. McGowan, 152 F.2d 570, 572 (2d Cir. 1945). TENTATIVE DRAFT No. 3, *supra* note 93, at 22, 31.

[109] I.R.C. § 751(c) (1982).

[110] *Id.* § 751(d).

[111] TENTATIVE DRAFT No. 3, *supra* note 93, at 57; Advisory Group on Subchapter K, *supra* note 105, at 160.

[112] H.R. 9662, *supra* note 106, § 750, H.R. REP. No. 1231, *supra* note 106, at 150.

[113] TENTATIVE DRAFT No. 3, *supra* note 93, at 56; Advisory Group on Subchapter K, *supra* note 105, at 160.

solution too complex for a workable tax scheme. Perhaps the best that can be done is to impose a requirement of "substantial economic effect" like that in section 704.[114]

Other issues open to reform of section 751 are whether there should be a de minimis exception for small amounts of appreciation and whether capital assets should become ordinary income assets with respect to partners who are dealers in the property and thus would have to include the assets in inventory if they did not use the partnership form. Both provisions are included in the older proposals,[115] but are omitted from the American Law Institute suggestion. Currently the character of the gain is determined at the partnership level.[116] It seems fairest to continue this for nondealer partners and to make capital assets ordinary income assets with respect to the dealer. Furthermore, considering how small and unsophisticated most partnerships are, and how complex these calculations can become, it also seems best to have some kind of de minimis exception for very small appreciations in ordinary income assets. This exception, however, should be drafted to discourage its manipulation for tax avoidance purposes.[117]

Many reforms of section 341 have also been proposed. Generally, two approaches have been taken: (a) the repeal of the *General Utilities* doctrine so as to obviate the need for a collapsible corporation statute; or (b) the fragmentation of gain into ordinary income or capital gains—the same approach taken in attempts at reform of section 751.

Since section 341 is designed to recapture income at the shareholder level that was evaded at the corporate level, one solution is to require the recognition of gain at the corporate level on every distribution or other disposition of appreciated property. This solution, which would amount to the repeal of the *General Utilities* doctrine, was recently proposed by the American Law Institute[118] and is currently being considered by the Senate

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[114] I.R.C. § 704(b)(2) (1982).

[115] H.R. 9662, *supra* note 106, § 751(c)(1), (d); Advisory Committee on Subchapter K, *supra* note 105, at 163.

[116] Podell v. Commissioner, 55 T.C. 429 (1970). *But see* 1 A. WILLIS, *supra* note 57, § 1.05, at 1-11 (dealer's taint can carry over to partnership).

[117] *See, e.g.*, 2 A. WILLIS, *supra* note 57, § 102.08. A de minimis exception is most likely to be effective, judging by the loopholes Professor Willis suggests, if it is phrased in terms of net ordinary income appreciation as a percentage of overall asset value less cash, securities, and liabilities.

[118] THE AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: SUBCHAPTER C (1982) [hereinafter cited as ALI, SUBCHAPTER C].

Finance Committee.[119] It has been suggested that adoption of this solution would mean the end of section 341.[120] The proposed Tax Reform Act of 1984, recently reported out of the House Committee on Ways and Means as of this writing, would repeal *General Utilities* with respect to current distributions of appreciated assets.[121] Such a partial repeal would not affect the need for section 341.

The problem with the repeal of *General Utilities* is that, alone, it is too harsh a reform. Although leaving the corporate form has no more economic substance than entering the corporate form, which is usually tax-free,[122] repeal of *General Utilities* would cause a large tax on corporate liquidations. It is generally agreed that some sort of relief provision should accompany repeal.[123] Any such relief provision, however, gives rise to a renewed possibility of abuse, which might well call for a continued collapsible corporation statute.[124]

An alternative series of proposals suggests a fragmentation approach similar to that recommended for reform of section 751.[125] The proposals define a collapsible corporation as one

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[119] *See* STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 1ST SESS., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS (1983).

[120] *Id.* at 89; ALI, SUBCHAPTER C, *supra* note 118, at 10. The Senate Finance Committee print takes the position that the collapsible corporation provisions would be entirely repealed for domestic corporations, but would be retained for foreign corporations. STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 1ST SESS., *supra* note 119, at 89. The abolition of the *General Utilities* doctrine would make § 341 unnecessary since the recognition of gain sought by the provision would take place automatically upon the distribution of appreciated property to the shareholders.

[121] H.R. 4170, 98th Cong., 2d Sess. § 54(a)(1), *reprinted in* FED. TAXES (P-H) Bulletin 13 Extra (Mar. 9, 1984).

[122] I.R.C. § 351 (1982).

[123] *See, e.g., Reform of Corporate Taxation: Hearing Before the Senate Comm. on Finance*, 98th Cong., 1st Sess. 10 (1983) (statement of Ronald A. Pearlman, Deputy Ass't Sec'y for Tax Policy, Dep't of the Treasury).

[124] Block, *Liquidations Before and After Repeal of* General Utilities, 21 HARV. J. ON LEGIS. 307, 369 (1984); Telephone interview with Mark Yecies, Office of Tax Legislative Counsel, Department of the Treasury (Mar. 8, 1984).

This Comment does not attempt to consider the various proposals for relief and their implications. For such consideration, the reader is referred to Block, *supra*, at 361–68.

[125] Indeed, the earliest of these proposals, a 1958 American Law Institute report, explicitly tried for a consistent approach. THE AMERICAN LAW INSTITUTE, FEDERAL INCOME, ESTATE AND GIFT TAX PROJECT: INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS 19–20, 160–61 (1958) [hereinafter cited as ALI, INCOME TAX PROBLEMS]. Because a 1959 Advisory Group report, Advisory Group on Subchapter C of the Internal Revenue Code of 1954, *Revised Report on Corporate Distributions and Adjustments*, in *Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code: Hearings Before the House Comm. on Ways and Means*, 86th Cong., 1st Sess. 473 (1959) [hereinafter cited as Advisory Group on Subchapter C], and a 1979 American Bar Association proposal, Committee on Closely Held Corps., Section of Tax'n, American Bar Ass'n, *Tax Section Recommendation No. 1979-4*, 32 TAX LAW. 1452 (1979) [hereinafter cited as *Tax Section Recommendation No. 1979-4*], were largely

whose unrealized appreciation in ordinary income assets[126] exceeds fifteen percent of the net worth of the corporation.[127] They recommend that the shareholder's gain on the sale of stock in a collapsible corporation be recognized at ordinary income rates to the extent of unrealized appreciation in collapsible assets.[128]

Because any version of section 341 would differ from section 751 in that application of the provision would result in the taxation of any gain at both the corporate and shareholder levels, the proposals for reform of section 341 contain a number of relief provisions. For instance, all three proposals would apply only to those shareholders who actually or constructively own more than five percent of the stock of the corporation.[129] This seems unjust because even de minimis sales of stock by five-percent shareholders in corporations with substantial appreciation in ordinary income assets would require all of the complex

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modeled on the American Law Institute proposal, it is not surprising that all three are similar.

[126] The ALI proposal did not formulate a more precise definition of collapsible assets than "ordinary income assets." ALI, INCOME TAX PROBLEMS, *supra* note 125, at 165. The ABA proposal defined collapsible assets as property other than

> (A) money,
>
> (B) property (except property used in the trade or business, as defined in section 1231(b) without regard to any holding period therein provided), to the extent that the gain from its sale would be treated under this title as gain from the sale of a capital asset held for more than one year or would be so treated if such property had been held for more than one year,
>
> (C) property described in section 1231(b) (without regard to any holding period therein provided), but only if there exists unrealized appreciation on all such property considered in the aggregate,
>
> (D) property (other than inventory and stock of a collapsible corporation) 90 percent or more of whose basis (without reduction for any adjustment provided in section 1016) consists of costs incurred more than 3 years previously, and
>
> (E) inventory of a kind customarily sold by the corporation for a period of 3 years or more, other than—
>
> (i) inventory the quality and value of which customarily increases by reason of aging, and
>
> (ii) inventory in excess of the reasonable needs of the trade or business.

Tax Section Recommendation No. 1979-4, *supra* note 125, at 1458–59; *accord* Advisory Group on Subchapter C, *supra* note 125, at 522.

[127] ALI, INCOME TAX PROBLEMS, *supra* note 125, at 165. The Advisory Group and ABA proposals add a second requirement that unrealized appreciation on collapsible assets be no more than 15% of the aggregate appreciation. Advisory Group on Subchapter C, *supra* note 125, at 520; *Tax Section Recommendation No. 1979-4*, *supra* note 125, at 1459.

[128] Advisory Group on Subchapter C, *supra* note 125, at 513; ALI, INCOME TAX PROBLEMS, *supra* note 125, at 167–68; *Tax Section Recommendation No. 1979-4*, *supra* note 125, at 1457.

[129] Advisory Group on Subchapter C, *supra* note 125, at 518; *Tax Section Recommendation No. 1979-4*, *supra* note 125, at 1458. The ALI proposal would also have required that the corporation be closely held. ALI, INCOME TAX PROBLEMS, *supra* note 125, at 165, 167–68.

calculations under the statute. The proposals give more favorable treatment to a four-percent shareholder who sells out than to a five-percent shareholder who sells a single share. It seems fairer to make the minimum the amount of stock sold within a certain period of time, such as a year, rather than the total amount held by the seller.

In addition, property held for more than three years and customary inventory are excluded from collapsible assets by the Advisory Group and American Bar Association proposals.[130] While this might have been a sensible provision in the old, subjective section 341, for such assets show no evil "view," the provision would act only as an affirmative tax preference for established businesses. The reason given for the provision—that it is a "matter[ ] of practicality"[131]—is unconvincing, given that it only complicates the statute and cannot be justified on economic grounds.

The American Law Institute proposal also would allow the ordinary gain to be allocated over a three-year period.[132] If relief is felt to be needed, this proposal should be considered.

Finally, the American Bar Association proposal would allow an exemption for shareholders and corporations who could prove that the corporation was not formed or availed of for the avoidance of tax.[133] The commentary indicates that the provision is intended to apply to forced sales and possibly to shareholders of publicly held corporations.[134] Again, the problems of subjectivity involved in section 341 determinations have already been shown, so it seems unwise to reintroduce them. If, however, the legislative history clearly indicates that it is intended only for the most compelling circumstances, the provision may succeed in doing good without doing too much harm.

The proposals also suggest generally similar fragmentation tax treatment for distributions of stock, especially in complete liquidations.[135] If the statute is to work, it must apply to complete liquidations. It need not, however, apply to other uniform distributions, for they are fully taxable as dividends,[136] nor need it

[130] *See supra* note 126.

[131] Advisory Group on Subchapter C, *supra* note 125, at 523.

[132] ALI, INCOME TAX PROBLEMS, *supra* note 125, at 171.

[133] *Tax Section Recommendation No. 1979-4*, *supra* note 125, at 1460.

[134] *Id.* at 1457.

[135] Advisory Committee on Subchapter C, *supra* note 125, at 514–17; INCOME TAX PROBLEMS, *supra* note 125, at 166–75; *Tax Section Recommendation No. 1979-4*, *supra* note 125, at 1455, 1458.

[136] *See supra* note 104.

apply to redemptions, for they usually occasion the realization of gain at the corporate level.[137] Furthermore, the proposals deal at length with the problem of nonaliquot distributions—distributing high-tax assets to low-bracket taxpayers.[138] This is the same problem faced by section 751(b). This Comment suggests that, regardless of any efforts to find a less complex solution in the corporate area, a corporate tax analogue of section 751(b) would be as complex and useless as the original.

The fundamental difference between the two approaches at reform of section 341—repeal of *General Utilities* or fragmentation of gain—is that one seeks to tax unrealized appreciation to the corporation, while the other uses unrealized appreciation as a measure of the amount of capital gains income to be converted to ordinary income. If the problem with a collapsible enterprise is that it tries to prevent ordinary income assets from ever being taxed at ordinary income rates, then the two approaches are equally effective, although they will differ somewhat as individual and corporate tax rates differ. The choice between the two approaches, however, will depend not on this difference in tax rates, but rather on whether a policy judgment is made to tax a corporation to the extent of the unrealized appreciation on distributed property.

No matter what policy decision is made, both approaches are quite similar to the collapsible partnership, fragmentation approach discussed above. In all three cases there is fragmentation of gain in order to prevent a would-be collapsible enterprise from realizing only capital gain from an ordinary income asset.

IV. Conclusion

It is by no means self-evident that collapsible partnerships and collapsible corporations require the same or similar treatment. Partnerships and corporations are inherently different for tax purposes. In the partnership context, Congress has decreed that there should be as few tax consequences resulting from form as possible. In contrast, the decision to incorporate results in an additional level of taxation. There is thus no reason for

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[137] I.R.C. § 311(d) (1982).

[138] Advisory Committee on Subchapter C, *supra* note 125, at 514–17; ALI, Income Tax Problems, *supra* note 125, at 166–75; *Tax Section Recommendation No. 1979-4*, *supra* note 125, at 1455, 1458.

the treatment of collapsible partnerships to be the same as the treatment of collapsible corporations. Nevertheless, similar problems do demand similar solutions. The best solutions to the problem of collapsible corporations, though occasionally very different in form, are substantively quite similar to the best solutions to the problem of collapsible partnerships.**

**As this issue was going to press, it appeared likely that both § 341 and § 751 were about to be amended. The most important change would be to substitute "2/3" for the "substantial part" language in the definition of a collapsible corporation. H.R. 2163, 98th Cong., 2d Sess. § 51(a) (Senate amendment in the nature of a substitute), *reprinted in* FED. TAXES (P-H) Bulletin 17 Extra (Apr. 6, 1984); H.R. 4170, 98th Cong., 2d Sess. § 164(a), *reprinted in* FED. TAXES (P-H) Bulletin 13 Extra (Mar. 9, 1984); *see supra* text accompanying note 18. The changes would not affect the basic thrust of this Comment.

BOOK REVIEW

LEGISLATION. By David R. Miers and Alan C. Page. London, England: Sweet & Maxwell, 1982. Pp. xviii, 266, index. £9.00 cloth.

THE SEMIOLOGY OF STATUTES

A Review by Allan C. Hutchinson and Derek Morgan***

I. REASSESSING LEGISLATION: THE HISTORICIAL CONTEXT

For the past four centuries, a major feature of English jurisprudence has been the contrast between the stability and continuity of the common law and the volatility and incongruity of legislation.[1] The common law is portrayed as a vast and intricate landscape, carved out with enduring patience over time. Statutes are treated as unsightly man-made structures that disturb the natural beauty and harmony of the common law. The need for legislative intervention is begrudgingly acknowledged, but never fully accepted. Whereas legislation is identified as a temporary structure for accomodating transient economic and political interest groups, the common law is presented as the embodiment of impartial rationality. Its life force is not cold logic, but a living experience that has been forged at the anvil of constitutional history. That history has consisted of a continual, shifting conflict between King and Commons, Parliament and Privy Council, statute and perogative order, and legislature and executive. In short, law is older and more venerable than legislation.[2]

The judicial struggle to enforce or enfeeble statutes is at the heart of the legal process. Throughout English history, differing interpretations have been placed upon the doctrine of the separation of powers. In consequence, the force and nature of the obligations and responsibilities imposed upon the different arms of government have varied considerably. Yet, ever since the days of Sir Edward Coke, the friction between statute and com-

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[1] *See generally* S. THORNE, A DISCOURSE UPON THE EXPOSICION AND UNDERSTANDING OF STATUTES, WITH SIR THOMAS EGERTON'S ADDITIONS (1942).

[2] 1 F. HAYEK, LAW, LEGISLATION AND LIBERTY 72 (1973).

mon law has been constant and pivotal. Unfortunately, the sedative rhetoric of the dictates of constitutional liberty has exercised such a powerful hold over the collective legal consciousness that this crucial relationship, and the shifts in legal terrain that it has portended, have been obscured.[3] Time is well past to chart these topographical realignments. Indeed, a thorough inquiry is urgently required. Miers and Page's *Legislation* might have contributed to the necessary reassessment of the relationship between statute and common law. A valuable opportunity seems to have slipped by.

II. UNDERSTANDING LEGISLATION: THE CRISIS IN CONTEMPORARY THEORY

Until very recently, the judiciary perceived legislation as an evil. As late as 1974, Sir Leslie Scarman could suggest that "the modern English judge still sees enacted law as an exception to, a graft upon, or a correction of, the customary [i.e., common] law."[4] His view was not aberrant. In 1979, Patrick Devlin declared that, while they have a responsibility to keep the common law alive, the judges' duty to statute "is *simply* to interpret and apply it and not to obstruct it."[5] This attitude represents the inherited wisdom of contemporary practice. Its modern jurisprudential roots can be traced to the writings of Roscoe Pound.[6] For Pound, the common law was a taught tradition of ideals, methods, doctrines and principles into which legislation and new institutions and adaptations *from without* could be added. It was a tradition in which judging and not administering held the chief place. Sir Frederick Pollock's characterization of this attitude remains pertinent; the rules of statutory interpretation give expression to a judicial belief that "Parliament generally changes the law for the worse and that the business of the judges is to keep the mischief of its interference within the narrowest possible bounds."[7]

The patent difficulty with this attitude is that it begs the foundational question of the appropriate source of adjudicative

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[3] *See* R. PORTER, ENGLISH SOCIETY IN THE EIGHTEENTH CENTURY 130–31 (1978).

[4] L. SCARMAN, ENGLISH LAW—THE NEW DIMENSION 3 (1974).

[5] P. DEVLIN, THE JUDGE 14 (1979)(emphasis added).

[6] *See, e.g.*, Pound, *Common Law and Legislation*, 21 HARV. L. REV. 385 (1908); Pound, *The Future of the Common Law*, 7 U. CIN. L. REV. 483 (1933).

[7] F. POLLOCK, ESSAYS IN JURISPRUDENCE AND ETHICS 85 (1882).

resources. It assumes that statutory enactments appear as temporary blights on the legal landscape, but never become part of that landscape. It insists that legislative intrusions can be filtered out to leave a full and life-like picture of the common law. Beneath the concrete pathways of legislation, there still thrives the natural countryside of the common law. Yet this picture resides only in the nostalgic mind of the English lawyer. In truth, that picture has not existed for a least a century. In the early twentieth century gathering legislative clouds began to obscure the "brooding omnipresence in the sky"[8] that was the common law.

Although Dicey spotted this increasing legislative trend in the latter decades of the nineteenth century, labelling that time "the period of collectivism,"[9] Maitland recognized the significance of this change. He saw the pervasive impact of regulatory law on our daily life. In response, he demanded that his students lift their gaze from law reports and familiarize themselves with statute books. His demand was as propitious as it was profound: "I have been trying to turn your thoughts away from what I think to be an obsolete and inadequate idea of the province of constitutional history. I have been asking you to set your faces towards the rising sun. And the sun will rise, not a doubt of it."[10] Maitland's radical approach was not the only reaction against the Dicey-inspired apathy to legislation in the legal community. In a popular but highly sophisticated essay, Edmund Robertson argued that the explosion of nineteenth century legislation was a function of deep-seated institutional changes in English society:

> the legislature at the present day undertakes the deliberate alteration of the law to a much greater extent than it has ever done before . . . . Nor is this activity to be accounted for by the theory that the domain of law is more intrusive than in earlier times . . . . The true explanation is that Parliament has effectively secured for itself exclusive authority as the source of legal changes.[11]

There are now some signs of recognition that the legal landscape has undergone a quiet but fundamental revolution. Only eight years after his optimistic eulogies on behalf of the common

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[8] Southern Pacific Co. v. Jensen, 244 U.S. 205, 222 (1917) (Holmes, J., dissenting).

[9] A. DICEY, LAW AND OPINION IN ENGLAND IN THE NINETEENTH CENTURY 64 (1905).

[10] F. MAITLAND, CONSTITUTIONAL HISTORY OF ENGLAND 536–37 (1908).

[11] Robertson, *Law* in 14 ENCYCLOPEDIA BRITTANICA 354, 365–66 (9th ed. 1882).

law,[12] legislator Scarman conceded that statutes represent the bulk of English law and that "the common law is delightful, but it is now of marginal importance only."[13] Lord Hailsham has made a similar concession.[14] However, there are still echoes to be heard within the English legal community of Coke's belligerent championing of the medieval legal order.[15] Not surprisingly, the acknowledgement of change has not resulted in a corresponding reorientation of action. Reluctance to change has meant that the judicial struggle with late twentieth century legislation continues to be fought with sixteenth century weapons. This failure to appreciate fully or act upon this statutorification of the law has, regrettably, obscured more pressing and fundamental problems.

Through the mists of institutional myth, a more accurate representation of English constitutional history is emerging.[16] The "matchless constitution" has been pilloried as a "museum of constitutional archaelogy where the relics of past ages accumulate."[17] The common law is becoming a leading candidate for inclusion within such a cultural archive. As Parliament becomes almost exclusively subject to executive control,[18] as law becomes *the* major mode of communicating political ideals,[19] and as senior judges become leading movers in the British legislative process,[20] a deep sense of change and challenge is manifest. The vaunted integrity of the judiciary and its independence from government is in severe jeopardy. The traditional pretence of judges and politicians as distinct creatures is wearing extremely

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[12] *See* L SCARMAN, *supra* note 4.

[13] 437 PARL. DEB. H.L. (5th ser.) 437 (1982).

[14] "[S]tatute law," the Lord Chancellor said, "whether you like it or not, is the fabric upon which the modern state is founded." 437 PARL. DEB. H.L. (5th ser.) 638 (1982). *See also* LORD HAILSHAM, HAMLYN REVISITED—THE BRITISH LEGAL SYSTEM TODAY 66 (1983).

[15] This attitude toward tradition is reflected in the writings of many of the adherents of the new law and economics school. *See, e.g.*, Posner, *Economics, Politics and the Reading of Statutes and the Constitution*, 49 U. CHI. L. REV. 263 (1982).

[16] *See, e.g.*, C. HILL, THE INTELLECTUAL ORIGINS OF THE ENGLISH REVOLUTION 225–65 (1965).

[17] E. HALEVEY, AN HISTORY OF THE ENGLISH PEOPLE IN THE NINETEENTH CENTURY 73 (1961).

[18] This now almost axiomatic point was made early on by, *inter alia*, S.A. Walkland. *See* S. WALKLAND, THE LEGISLATIVE PROCESS IN GREAT BRITAIN 20 (1968); *see also* J. GRIFFITH, PARLIAMENTARY SCRUTINY OF GOVERNMENT BILLS 206–07 (1974); Lord Hailsham, *Obstacles to Law Reform*, 34 CURRENT LEGAL PROBLEMS 279, 286–87 (1981).

[19] Griffiths, *Is Law Important?*, 54 N.Y.U.L. REV. 339, 354 (1979).

[20] R. STEVENS, LAW AND POLITICS 614 (1979); *see also* L. JAFFE, ENGLISH AND AMERICAN JUDGES AS LAWMAKERS 5 (1969).

thin. A crisis is imminent within the modern English constitutional arrangement. Whether this represents a critical Kuhnian revolution from which a novel and more plausible approach will emerge[21] is a matter of speculation. But it is clear that, as the contemporary relationship between executive and judiciary, between enacted law and common law is exposed to keener examination, a legitimation crisis is approaching.[22]

Of course, these problematic relations are an ineradicable feature of political and social discourse. They strike at the heart of the constitutional compact and demand continual reappraisal. The rate and depth of recent change, however, make debate particularly pressing and desirable. In his inaugural Maccabaean lecture almost thirty years ago, Lord Evershed suggested that the volume and character of statutes threatened the very supremacy of the law. Insofar as the principal judicial task had already become statutory interpretation, he pondered over whether the relevant rules and principles accumulated throughout the centuries were adequate and satisfactory in modern society. For him, statute law had so radically changed the structure and dynamics of the judicial process that he felt compelled to pose a critical question: "can there be—ought there to be—some change in the method or character of the judicial function so far as it is concerned with the interpretation of enacted law?"[23]

With Hobbesian echoes, Evershed grasped that the central constitutional question is not simply *how*, but *who* is to interpret the wishes of the senior law-making body in a democracy. Although reluctantly, Evershed confessed that he doubted "whether the practising lawyer, particularly the judiciary, provides the most effective forum."[24] Sadly, this controversial thesis has received scant attention. Yet it lies at the core of the legitimation crisis. There is an urgent need to take a fresh, clear and considered perspective on legislation. Such an assessment would have to embrace a critical stance. Moreover, it would not only have to address Evershed's central question, but also tackle the vexing issue of the new social relations spawned by modern legislation.

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[21] T. KUHN, THE STRUCTURE OF SCIENTIFIC REVOLUTIONS 77 (2d ed. 1970).
[22] *See generally*, J. HABERMAS, LEGITIMATION CRISIS (1975).
[23] Lord Evershed, *The Impact of Statute on the Law of England*, 42 PROCEEDINGS OF THE BRITISH ACADEMY 247, 261–62 (1956).
[24] *Id.* at 261–62.

III. DESCRIBING LEGISLATION: THE ANALYSIS OF PAGE AND MIERS

Alan Page and especially David Miers[25] seem well placed to meet this challenge. In their recent book, *Legislation*, they set out to redress any previous imbalance and "provide a systematic and comprehensive account of legislation . . . from its inception to its implementation" (p. viii). Sadly, they have completed this task with only mixed success. While they have consolidated and made accessible a vast amount of information, they have been content to accumulate rather than analyse. Despite their contrary ambitions, they rely largely on the same old tired set of legal materials. The reader can be assured of *knowing* more about legislation, but is unlikely to *understand* more. To understand only the rules of the game gives the spectator merely a partial appreciation of the game itself. The legislative process is not simply a static and formal framework; it is a dynamic and vital activity. Unfortunately, Miers and Page concentrate on the former at the expense of the latter, thereby presenting a distortedly simple image of legislation. In short, they have failed to depart from the powerful, traditional vision of legislation. They have painted a legislative still-life when what is demanded is a video of legislation-in-motion.

The first seven chapters of the book focus on the preparation, drafting, enactment and interpretation of legislation. The presentation is informative and incisive. Insofar as they present a full and sequential treatment of the legislative process, the authors eclipse earlier fragmented and unsystematic treatments. In this respect, Miers and Page deserve warm praise. Yet, as they concede at the beginning of the eighth and final chapter, "we have so far adopted a formal approach to the concept of legislation" (p. 211). Indeed, in its stark contrast, their sophisticated and dynamic analysis of the impact and efficacy of legislation merely serves to underline the weakness of the bulk of the book. The strength of this final chapter leaves the reader with a sad glimpse of what might have been. For example, in their very brief review of the pressures that operate to stimulate legislative initiatives (p. 56–59), they gloss over the life-force of the legislative process: the politics and techniques of lobbying.

The battle for legislative control is fought and won in the

[25] *See* W. TWINING AND D. MIERS, HOW TO DO THINGS WITH RULES (2d ed. 1982).

backrooms and corridors, not in the public chambers and committee rooms. Legislation is a political process and must be studied as such. Miers and Page's treatment is too clean and tidy; they seem reluctant to dirty their hands in the muddy world of political life. Nonetheless, these criticisms do not bring out the main problems with the book. Like so much English scholarship, it is atheoretical and exhibits disciplinal parochialism. Its focus obscures rather than illuminates the background drama.

Miers and Page remain securely within the traditional community of jurisprudential learning, largely ignoring[26] the revealing insights of other relevant disciplines. They do not explicitly relate their account of legal practice to any background theory of law and society.[27] For instance, whereas they emphasise that Hoadly's "true law-givers"[28] comprise many different non-judicial personnel, they do not offer any general account of adjudication. They prefer to describe the practice of statutory interpretation rather than locate it within any broader conception of the judicial role (pp. 178–96). At a time when the jurisprudential scene is marked by a heated and wide-ranging debate over the performance and legitimacy of the judicial function in a liberal democracy, this omission seems difficult to excuse.[29] To write of statutory interpretation without any reference to the work of Dworkin and his detractors is puzzling. Whatever the judges may claim or Miers and Page suggest by their silence, statutory interpretation is a voyage with considerable ideological freight.

IV. Describing and Understanding Legislation: The Contribution of Modern Language Theory

As Miers and Page neglect the theoretical work of the legal community, it is not surprising that they do not draw on the powerful insights of other relevant disciplines. Within the con-

[26] Again, chapter 8 stands out as the exception.

[27] Of course, this is not to suggest that they do not subscribe to certain jurisprudential assumptions. As F.S.C. Northrop noted, "the only difference between a person without a philosophy and someone with a philosophy is that the latter knows what his philosophy is." F. NORTHRUP, THE COMPLEXITY OF LEGAL AND ETHICAL EXPERIENCE 6 (1959). This is not the place to tease out Miers and Page's assumptions.

[28] *Quoted in* J.C. GRAY, THE NATURE AND SOURCES OF LAW 172 (1948).

[29] For a critical survey of this debate, see Hutchinson & Monahan, *Law, Politics and The Critical Legal Scholars: The Unfolding Drama of American Legal Thought*, 36 STAN. L. REV. 801 (1984).

fines of a review, we can only refer sketchily and selectively to the potential benefits of such scholarship. A fruitful source of assistance would be the recent developments and controversies in "language theory." Insofar as legislation represents a major form of cultural communication, contemporary research on the significance and complexity of the relationship between language, power and culture seems particularly pertinent. Miers and Page take an elementary and uncritical view of language and interpretation. For them, meaning is an unproblematic concept; "[c]ertainty is a question of degree and can be increased or reduced as a matter of policy" (p. 90). In contrast, those scholars who specialize in the subject recognize the inherently sophisticated and dynamic nature of the meaning-giving enterprise. The difficulty centers on the interaction between the author's intention, the nature of the text, and the reader's knowledge.[30]

Traditionally, the focus was upon the author's intention, but this was rejected by the New Criticism school which maintained that a text possessed a definite meaning within its own four corners. More recently, a deconstructionist movement has sought to demonstrate the self-referential nature of language. They refuse to identify any given set of words with any concept of embodied meaning; "the word carries with it . . . [an] indeterminacy of meaning."[31] Others, while accepting the thrust of this thesis, claim that this does not entail a tailspin into a hopeless nihilism. Although meaning is made and not found, it is not totally subjective. It has a social and conventional existence. Stanley Fish has argued that "meanings are the property neither of fixed and stable texts nor of free and independent readers but of interpretive communities that are responsible both for the shape of a reader's activities and for the texts those activities produce."[32] The central message of contemporary thought is that interpretation is a meta-linguistic exercise. The search for a transcendental truth hidden in the text has been abandoned. Meaning is the product of interpretation and not its determinant. All interpretations are culture-specific. Any theory of meaning

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[30] For a survey of the contemporary exchanges, see F. LENTRICCHIA, AFTER THE NEW CRITICISM (1980) and C. BELSEY, CRITICAL PRACTICE (1980).

[31] H. BLOOM, J. DERRIDA, G. HARTMAN, P. DE MAN & J. MILLER, DECONSTRUCTION AND CRITICISM at vii–viii (1979).

[32] S. FISH, IS THERE A TEXT IN THIS CLASS? 322 (1980).

must go beyond words and seek to understand the semiological and ideological dimensions of communication.[33] As Levi-Strauss pithily observes, "the nature of truth is . . . indicated by the care it takes to remain elusive."[34]

Although law is a special category of cultural communication, it shares many of the general characteristics of the more generic form. For instance, while the intention of legislators can claim especial relevance in the democratic context of legal interpretation, the difficulty of isolating that intention in any meaningful way, as Miers and Page point out (pp. 184–90, 204–10), is notorious. Further, after an interval of several years, the relevance of legislative intention becomes suspect. Any attempt to provide a full account of the practice and reform of statutory interpretation must use and integrate legal theory and language theory. The task is formidable, but initial work is already being done.[35] The study of statutory interpretation must become a more sophisticated and embracing enterprise. Words are prisms through which meanings are refracted in many colors and hues. Yet the prism is not natural or static; it is inserted and held in place by a group of cultural actors. The challenge is to analyse the structure and quality of that prism. As Fish might say, the terms and substance of "the interpretive community" must be isolated and evaluated.[36] Accordingly, legal scholars must identify the linguistic and semiological constraints that give meaning and content to the act of statutory interpretation. They must crack the code of legislation. In more familiar terms, a self-conscious ideological element must be incorporated into legal scholarship—the search for the cluster of ideas, beliefs and assumptions that represent a certain way of thinking about legislation and interpretation at any given time.[37] Miers and Page's lack of any ideological reference point troubles their analysis.

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[33] *See generally* J. CULLER, THE PURSUIT OF SIGNS (1981); G. KRESS & R. HODGE, LANGUAGE AS IDEOLOGY (1980).

[34] C. LEVI-STRAUSS, TRISTES TROPIQUES 44 (J. & D. Weightman trans. 1974).

[35] *See, e.g.*, Fiss, *Objectivity and Interpretation*, 34 STAN. L. REV. 739 (1982). For a more skeptical approach, see Hutchinson & Monahan, *The "Rights" Stuff: Roberto Unger and Beyond*, 62 TEX. L. REV. (forthcoming).

[36] *See* S. FISH, *supra* note 32, at 303–371.

[37] This should not be confused with the Marxist conception of ideology as "false consciousness." It is intended to be used in a more Althusserian sense as a necessary intellectual construct for living. However, that ideology must still be assessed in terms of its potentially distortive effect and political function.

V. Politicizing Legislation: The Ideology of Statutory Interpretation

In probing the hinterlands of contemporary scholarship, legal scholars will rediscover many familiar common law actors, clothed in different garb. In particular, they will be comforted to find courts as one focal point for the analysis of statutes and semiology. The courts play an important institutional role within the drama of social conflict. This is not to suggest or accept an *instrumental* role for court action. Indeed, quite the opposite is argued. It is sufficient that courts are seen as important by both lawyers and society generally. In one special sense, courts are obviously of significance. It is not the words of the statutes that are law, but the courts' particular exposition of those words. Of course, as Miers and Page reflect (p. 178–80), although courts are not the only code breakers at work, they do help write the code of the statute book.

Law and lawyers are caught in an increasingly self-conscious engagement on the battleground of social and political theory. Insofar as a statute represents the major institutional form of lawgiving in modern society, the courts are engaged in the continual struggle to work out society's positive political commitment. However, if it is conceded that the law's *practical* effect is minimal,[38] any debate over the role of courts must become ideological in nature. As such, the challenge is to identify and bring forward the multi-dimensional ideological backdrop against which the courts must perform. As Edward Thompson has so accurately stated:

> The rhetoric rules of a society are something a great deal more than sham. In the same moment they modify, in profound ways, the behaviour of the powerful and mystify the powerless. They may disguise the true realities of power, but, at the same time, they may curb that power and check its intrusion . . . . The notion of the regulation and reconciliation of conflicts through the rule of law . . . seem to me a cultural achievement of universal significance . . . . The imposing and effective inhibitions upon power and the defence of the citizen from powers or intrusive claims, seems to me to be an unqualified human good. To deny or belittle

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[38] And the scant evidence demands this concession. *See, e.g.*, L. Friedman and S. Macaulay, Law and the Behavioural Sciences chs. 2–3 (2d ed. 1977) (the discussions at 141–192 and at 501–575 are particularly significant).

> this good is, in this dangerous century when the resources and tensions of power continue to enlarge, a desperate error of intellectual abstraction.[39]

The orthodox constitutional view that Parliament makes the laws and the judiciary interprets them was recently reiterated by Lord Diplock in *Duport Steels Ltd. v. Sirs*.[40] In performing that task, the role of the courts is to give effect to "the intention of Parliament *as expressed in the words of the statute*."[41] The law-job is to find the meaning of the words that Parliament has used.[42] As most exhaustively elaborated in the recent speeches in *Bromley L.B.C. v. Greater London Council*, the senior judiciary set out on the quest for the "true," "proper," or "correct" meaning of the statutory words under observation.[43] As has been said of Coke's equation of reason with discretion, "rarely can so many questions have been begged in so few words."[44] Indeed, the psychological attitude displayed in the *Bromley* case, which is chosen for its representativeness and not its singularity, is an almost direct descendant of Coke's thinking on the common law.

While there has been a judicial capitulation to the supremacy of Parliament, that surrender is to a command to be obeyed begrudgingly according to its letter. Otherwise, it is of little consequence. For the courts, the triumph of statute over common law is a pyrrhic victory. But this betrays the ideological superstructure of adjudication. Words do not interpret themselves. A sentence will never mean exactly the same thing to any two different people or even the same thing to one person on different occasions. Meaning is shaped by the apperceptive mass of understanding and background that an individual brings to bear on the external fact of a sound or series of marks. As words lack "self-evident reference," purpose and context are ultimately major determinants of meaning.[45] However, as the expression of legislative intent is always more or less incom-

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[39] E. THOMPSON, WHIGS AND HUNTERS: THE ORIGINS OF THE BLACK ACT 265–66 (1975).

[40] [1980] 1 W.L.R. 142 (Q.B.).

[41] *Id.* at 157.

[42] *Black-Clawson International Ltd. v. Papierwerke Waldhof-Aschaffenburg*, 1975 A.C. 591, 613 (H.L.) (Lord Reid).

[43] 1983 A.C. 801, 829, 836, 839, 842, 850–51 (H.L.).

[44] C.HILL, *supra* note 16, at 252, commenting on E. COKE, A LITTLE TREATISE ON BAILE AND MAINPRIZE 31 (2d. ed. 1635).

[45] Cohen, *Field Theory and Judicial Logic* 59 YALE L.J. 238, 240–41 (1950).

plete, it is doubtful whether any impartial method of adjudication can be fashioned in a liberal society.[46] Indeed, even Ronald Dworkin concedes that legislative intent can never be legitimately characterized as "some complex psychological fact locked in history waiting to be winkled out from old pamphlets and letters and proceedings . . . . There is no such thing as the intention of [the Legislature] waiting to be discovered, even in principle. There is only some such thing waiting to be invented."[47]

The necessity of engaging in such invention requires the courts to make substantive political decisions, the very decisions that semantic, historical or counter-factual approaches *claim* to avoid. No one single "construction" is inevitable or natural. Construction means choice. And choice confers power. Of course, this is not to suggest that judicial creativity breeds constitutional anarchy. Communities of interpretation have their own bonding mechanisms, a mixture of moral values and social customs. Interpretation is inextricably bound up with values and it is nowhere seriously suggested the values do not carry ideological underpinnings. The lesson to be gathered from this realization is quite simple. Courts that shield themselves behind descriptions of law as clear, predetermined and objective norms against which they pitch their neutral decisions are worthy of suspicion. In addition to incorporating, or at least introducing, the insights of contemporary jurisprudential scholarship, a full and proper understanding of legislation must begin by recognizing and addressing the substantive democratic issues that lie behind a formal examination of the legislative process. As it operates today, Parliament is a conduit through which the outcomes of struggles for power between elite interest groups are formally communicated. It is doubtful that it has ever been anything more. The judicial approach to legislation merely confirms and legitimates this veiled relationship.

While courts cast themselves as the dumb-show on the political stage, the inevitably ideological nature of the meaning-giving enterprise ensures that they will be as unrepresentative as the Parliament whose will they purport slavishly to follow. In such

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[46] R. UNGER, LAW IN MODERN SOCIETY 180 (1976).

[47] Dworkin, *The Forum of Principle*, 56 N.Y.U. L. REV. 467, 475 (1981). *See also* Dworkin, *Political Judges and the Rule of Law*, 64 PROCEEDINGS OF THE BRITISH ACADEMY 259 (1978); Dickerson, *Statutory Interpretation: A Peek into the Mind of a Legislator*, 50 IND. L.J. 206 (1975).

circumstances, those who must abide by their interpretations are entitled to ask the judiciary to recognize and declare that fact. The crisis for the judiciary in our pseudo-pluralistic state is whether, as Evershed suggested,[48] it can still maintain its cloak of neutrality in light of the realities of the struggle for political power. The British legal community has yet to grasp the full force of Ely's pithy remark that "we may grant until we're blue in the face that legislatures aren't wholly democratic, but that isn't going to make courts more democratic than legislatures."[49] In an instrumental sense, courts are an overated past-time. Yet this does not prevent us from remaining alert to Thompson's suggestion about the exhilarating ideological possibilities of the rule of law.[50] In the modern statutory state, law and lawyers have a constitutional obligation to face and to accept this challenge.

Although little mention has been made of it, delegated legislation is perhaps the extreme form of the problem addressed. The statutory instrument has been nicely parodied as the modern form of power fighting against which Hampden died on the battlefield and Sidney on the scaffold.[51] The modern legislative technique of passing acts that confer general powers, leaving the details to the discretion of the executive department, can be seen as both necessary and desirable. But its development needs further and better safeguards. The growth of tribunals is one response to this, but they represent a double-edged sword. Unless and until the courts move from their common law approach to statutes to a fresh and dynamic perspective, the development of any procedural or substantive safeguards is seriously threatened. If the courts are unable so to change, it may be that the citizenry will be left to conclude that the courts are no longer an appropriate or necessary forum for modern dispute-resolution. Then there may well be real ideological crisis, and more.[52]

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[48] *See generally* LORD EVERSHED, *supra* note 23.

[49] J. ELY, DEMOCRACY AND DISTRUST 67 (1980).

[50] Thompson's evaluation of the Rule of Law as an "*unqualified* human good" is suspect; *see* E. THOMPSON, *supra* note 39 at 235–36. Nonetheless, its potential for good must not be overlooked; *See* Horwitz, Book Review, 86 YALE L.J. 561 (1977).

[51] C. HUGHES, THE BRITISH STATUTE BOOK 45 (1957).

[52] We shall fully elaborate this sketch in a short monograph on statutes which is in preparation.

RECENT PUBLICATIONS

VALUES AND ASSUMPTIONS IN AMERICAN LABOR LAW. By *James B. Atleson*. Amherst, Mass.: The University of Massachusetts Press, 1983. Pp. 240, notes, index. $25.00 cloth; $11.95 paper.

James Atleson describes this polemical attack on the conventional wisdom of American labor law as "part of the emerging literature of demystification" (p. 181, note 4). The "mystery," as he sees it, is that decisions in labor law are based on the underlying assumptions of judges. These assumptions are not found in the National Labor Relations Act (NLRA), but are rooted in nineteenth-century common law notions of property, contract, and master-servant law. Atleson argues that courts assume owners have exclusive and inherent managerial rights that grant them autocratic control over the workplace and that undermine industrial democracy.

Atleson derives this assumption from analyses of decisions in a wide variety of doctrinal areas. He argues, for example, that the statutory right to strike was undermined by the Supreme Court's 1938 decision in *NLRB v. MacKay*, 304 U.S. 333 (1938) (allowed employers to replace strikers permanently) because the Court gave great weight to the employer's nonstatutory interests in maintaining productivity (p. 6). Court decisions prohibiting such "concerted activities" as sitdowns, slowdowns, and wildcat strikes are similarly condemned as stemming from the courts' assumption that employers' management functions must be protected against irresponsible employees. Atleson also believes that the courts have interpreted the duty to bargain created by section 8(a)(5) of the NLRA to exclude a variety of "managerial" functions because of preconceived and restricted notions of the role of workers in an enterprise (p. 135).

Atleson deems these assumptions unwarranted and harmful. He documents that courts do not fully express, explain, or justify their assumptions, and his examples of courts making conclusory arguments are occasionally persuasive. More controversial is Atleson's assertion that these assumptions are rarely based on empirical evidence, contain false historical premises, and only take account of the views of one segment of the population. In his view, our system of labor law legitimizes and strengthens the control of society by employers.

There is force to some of Atleson's criticisms, particularly a number of his attacks on individual court decisions. Here and there he effectively argues that specific legal rules unfairly favor management over labor, and that the courts do not always justify their decisions sufficiently.

The book's very serious flaws, however, severely limit any contribution it might make toward a better understanding of labor law. In writing as though all judges have the same assumptions when they use words such as "managerial" or "property," Atleson is guilty of conceptualism. Perhaps all judges accept some notion of capitalism, but beyond that there are a wide variety of different assumptions and beliefs. The sharp divisions on the Supreme Court over the years, the very different approaches taken by Democratic and Republican NLRB's, and the variations among the various Circuit Courts of Appeals demonstrate such a multiplicity of views. Atleson's portrayal of judges as adhering to some monolithic and uniform body of assumptions is simplistic and unwarranted. To the author, all capitalists look alike.

His repeated assertions about congressional intent seem both forced and ahistorical. First, Atleson's references to legislative history focus almost exclusively on the original Wagner Act, passed in 1935. In the entire book there are only two brief references to the Taft-Hartley Act (1947), and absolutely none to the Landrum-Griffin Act (1959). Atleson's notion of legislative history excludes any intent to alter the NLRA in a pro-employer direction, and he inexplicably ignores the later two Acts in which such intent is clearly manifested. Furthermore, it is very hard to believe that Congress was ever as radical as Atleson claims it was, even in 1935. He attacks Franklin Roosevelt as having been insufficiently radical, and notes that when the *MacKay* decision came down very few scholars considered the holding "at all startling" (p. 185, note 16). It is not at all clear why Atleson thinks that the Congress was so much more radical than the President, the courts, academe, and even the unions of the time. It is especially hard to believe that the NLRA was meant to supplant completely all of contract and property law, despite Atleson's repeated assertion that courts which consider these notions are completely at odds with congressional intent.

Atleson's interpretations of various terms in the statute are frequently so literal as to defy common sense. His literal interpretation (purportedly backed by congressional intent) of the protection for concerted activities would protect workers who got together to burn down the plant and murder the boss. Such absolutist positions are hardly conducive to reasonable solutions. The real issue is not whether *MacKay* is incorrect because it might affect the incidence of strikes, but whether *MacKay* goes too far in restricting strikes.

From a stylistic perspective, *Values and Assumptions in American Labor Law* leaves much to be desired. Major themes are repeated *ad nauseum*, and Atleson reasserts his conclusions about each example several times. In addition to invoking outworn ideological cliches, he frequently resorts to strident and even shrill language. More than being mere "aberrations" or judicial "insanity," labor law decisions show that the "Court's tortured logic is the result of fitting a pre-ordained conclusion into what on the surface looks like a traditional legal mode of exposition" (p. 142). The book is filled with lengthy, unnecessary digressions. For example, the entire chapter on the New Deal is only barely integrated into the book and does not advance the frequent invocations of legislative history.

Often Atleson's barbs are not directed so much at labor law as at American capitalism itself. He attacks the entire body of property law as unfairly pro-employer, and decries contract law as a tool of "exploitation" based on the "myth" of voluntary exchange (p. 12). He does not seem to accept any separate legitimate role for management, and admits that very few unions have sought the type of restructuring he desires. His conclusions thus require the reader to accept his radical left assumptions. The book preaches to the already converted, and probably fails to convince anyone else.

Atleson's literalism and his opposition to balancing interests are understandable, given the paucity of empirical evidence in his policy arguments. Despite repeated assertions that *MacKay* will prevent strikes and "result in the destruction of the union's representational status" (p. 27), Atleson can generate no empirical studies or quantification. Rather brazenly he asserts that "empirical research, however, would not seem required in order to demonstrate *MacKay*'s destructive effect on [statutory] rights . . ." (p. 32). It may not be required for his own absolutist view of the statute, but once one recognizes the complexity of the issues and the need for balancing competing interests, it is hard to deny the need for evidence on the extent of the asserted harm. This failure of documentation is ironic, given Atleson's repeated attacks on court decisions made without empirical evidence.

Perhaps the author's greatest flaw is the degree to which his argument is one-sided. When a court argues that the employers will need to be able to promise replacements permanent jobs in order to recruit them, which is at least a facially plausible argument, Atleson's response is that "it obviously will not be universally true, and it might not operate in specific contexts at all times" (p. 29). The standard seems to be that pro-employer arguments must be proven absolutely true in every possible case, but pro-employee arguments require no empirical evidence at all. Such a tendentious standard makes it hard to lose an argument.

Atleson's biases commit him to overstatement, and the book is populated with straw men. When the Supreme Court inveighs against "equal partnership," Atleson concludes that the Court has abandoned "industrial democracy and worker participation" (p. 133). In a similar extrapolation he declares that "the underlying notions of American labor law have not significantly been altered by the passage of the Wagner Act," because the NLRB uses an "improper means" test on the question of slowdowns (p. 52). The silliness in drawing such strong conclusions from such limited data raises serious doubts about the author's willingness to make reasonable, balanced judgments.

Atleson seeks to employ a judicial conspiracy theory. We are told that "*Bell Aerospace* represents an attempt to mask or avoid recognition that a clear confrontation exists between owners, on the one hand, and workers on the other" (p. 173). It seems patently absurd to picture the justices huddled in their Doric Temple, hatching schemes to delude the trusting masses into false consciousness. This type of argument does little to advance serious discussion.

Finally, this volume is simply not relevant to the important issues in labor law today. Atleson is so busy revealing the startling disaster that court decisions in the 1930's failed to abolish capitalism, that he completely overlooks any of the dynamic trends evident in the labor movement that belie his simplistic presentation of a corporate dominated, master-servant structure. There is no mention of such progressive union activities as using massive union pension funds for social leverage, arranging employee stock purchase plans, getting union seats on the Board of Directors, or quality-of-worklife and participatory management schemes.

Atleson also ignores the most important real and current threats to unionism. For all his polemic, we hear nothing about such crucial, concrete problems as the susceptibility of the machinery of labor law to delaying tactics that allow discriminatory firings during organizing campaigns to go unpunished; the inadequacy of Board sanctions; the hostility of Reagan's NLRB to labor; the abuse of bankruptcy laws to void union contracts; the effects of deregulation; or the burgeoning corps of anti-union consultants. Given the intellectual ferment and pressing need for reform in labor law, such efforts as Atleson's, which forsake the concrete concerns of workers and make abstract pleas for the elimination of property law, contract law, and any role for management, add little to the debate.

F. Paul Bland

POLITICAL INNOVATION IN AMERICA: THE POLITICS OF POLICY INITIATION. By *Nelson W. Polsby*. New Haven, Conn.: Yale University Press, 1984, Pp. xiv, 174, index. $18.50 cloth.

Political Innovation in America is Nelson Polsby's attempt to place "the study of policy initiation . . . on as firm an empirical footing as the study of policy enactment, or of administrative implementation" (p. 173). Polsby centers his study around one simple question: "Where do new public policies come from?" (p. 1).

Polsby considers that question in the context of eight case studies of policy innovation: (1) the establishment of the Atomic Energy Commission; (2) the creation of the National Science Foundation; (3) the ratification of the nuclear test ban treaty; (4) the formulation of the Truman Doctrine; (5) the formation of the Peace Corps; (6) the creation of the Council of Economic Advisers; (7) the formulation of medicare insurance; and (8) the promotion of local participation in Community Action Programs. The case studies admittedly concentrate on the achievements of the liberal Democrats in the post-New Deal era, but Polsby contends that this concentration should not adversely affect the legitimacy of his analysis (pp. 9–10). He implicitly assumes, therefore, that the process of policy innovation is universal for all political contexts and controversies.

Readers may initially sense that Polsby's presentation of the case studies lacks direction. Although he continuously tries to tie elements of the cases together by reference to seven "descriptive dimensions" through which policy initiation can be analyzed (pp. 14–15), Polsby does not succeed in unifying the study until his conclusion, when he finally applies those dimensions to the eight cases. In that conclusion, Polsby identifies four of the seven dimensions as significant determinants of policy innovation: *timing*, which measures the elapsed time between the policy's first proposal and its ultimate enactment; *political conflict*, which focuses on the existence of public opposition to the innovation; *research*, which considers the level of inquiry into the empirical bases for the policy; and *staging*, which focuses on whether the innovation precedes the perceived need or whether the need produces the innovation.

As a result of his analysis, Polsby divides policy innovation into two types. The first type Polsby entitles "acute" innovation (p. 150). Acute innovation, he explains, is characterized by a short lapse of time between the idea's proposal and its ultimate enactment, the devotion of little time or energy to research on alternative policies, the adoption of the first good policy created after the identification of the perceived need, and a truncation and restraint of political conflict (p. 158, Table 5.2). The second type of innovation Polsby entitles "incubated" innovation (p. 153). An inverse image of acute innovation, incubated innovation is characterized by slow development with the demand for innovation building gradually, extensive research on alternative policies, a search for problems that the developed innovation appropriately addresses, and a high level of ideological, partisan conflict (p. 158, Table 5.2). Polsby then categorizes the case studies as representative of either acute or incubated innovations. He discovers that the case studies on the Atomic Energy Commission, Truman Doctrine, and Community Action Programs represent acute innovation while the studies on medicare, the Peace Corps, and the Council of Economic Advisers represent incubated innovation (p. 158, Table 5.2). Two case studies—the creation of the National Science Foundation and the ratification of the nuclear test ban treaty—do not fit comfortably within either type of innovation (p. 159).

Finally, Polsby examines the causes of policy innovation. He initially discovers two prerequisites to policy innovation: "first, an underlying cultural disposition must be present favoring the application of rational thought to problems; second, the political system must embody incentives to search for innovations" (p. 165). The American political system provides for both of these requirements, for there are expert and interested parties everywhere, and there are politicians who are always searching for ideas to help build their political futures. The combination of these two factors with the presence of interest groups, experts, and past experience produces the foundation for policy innovation in America (p. 166).

Although *Political Innovation in America* provides a refreshingly new perspective to the discipline of policy studies, it is limited in its scope to the study of policy innovation in the context of *pre*-legislative enactment. The study unfortunately fails to consider the formulation of innovative policy at the implementation stage—that is, after policy has been enacted into legislation. One explanation for this may be that Polsby views the implementation of policy only as the shaping and reshaping of policy already adopted (p. 2). This view, however, becomes questionable in light of drastically new policies implemented unilaterally by presidents and administrative agencies based on broad grants of legal authority. The attempts by Presidents Ford, Carter, and Reagan to control the economic impact of federal regulation by virtue of their authority as Chief Executive exemplify the initiation of new public policy removed from the legislative context.[1] Similarly, the efforts of the Federal Communications Commission to deregulate the radio industry[2] pursuant to its authority to regulate radio "as public convenience, interest, or necessity requires . . ."[3] also represent policy innovation after the enactment of legislation. Surely, neither of these actions could be characterized as shaping or reshaping already existing policies, and an application of Polsby's analysis

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[1] *See* Exec. Order No. 12,291, 3 C.F.R. 127 (1982) (creating a presidential task force on regulatory relief), *reprinted in* 5 U.S.C. § 601 app. at 431–34 (1982); Exec. Order No. 12,044, 43 Fed. Reg. 12,661 (1978) (ordering review of existing regulations *and* analysis of all new significant regulations), *reprinted in* 5 U.S.C. § 553 app. at 107–109 (Supp. III 1979), *revoked by* Exec. Order No. 12,291; Exec. Order 11,821, 3 C.F.R. 926 (1971–75) (requiring inflationary impact statements to accompany major regulations), *reprinted in* 12 U.S.C. § 1904 app. at 592–93 (1976) (this regulation expired on Dec. 31, 1976).

[2] *See In re* Deregulation of Radio, Report & Order, 84 F.C.C.2d 968 (1981).

[3] Communications Act of 1934 § 303, 47 U.S.C. § 303 (1976).

to both of them may ultimately test his assumption that the process of policy innovation may be universal for all political contexts and controversies.

Although further inquiry into the discipline of policy analysis is necessary, Polsby has provided a firm foundation for that work. *Political Innovation in America* has renewed the study of policy by giving political science a new perspective from which to approach the subject. In the end, Polsby's study is as innovative in its approach and analysis as the very policies that it examines.

Richard J. Bozzelli

POWER, EMPIRE BUILDING AND MERGERS. By *Stephen A. Rhoades*. Lexington, Mass.: Lexington Books, 1983. Pp. x, 153, index. $20.00 cloth.

In *Power, Empire Building and Mergers*, Stephen Rhoades suggests that the merger wave of the early eighties is unrelated to conventional economic phenomena such as the search for enhanced economies of scale or increased profits. The mergers of our age are motivated by the pursuit of power (p. 2 *passim*). The "power motive" has prompted industry executives to arrange conglomerate mergers, combinations that increase the concentration of economic power in the hands of the few without generating corresponding efficiency gains (p. 97).[1] If this trend is allowed to continue, government will face "monolithic capitalism—a system dominated by relatively few large, diversified companies" (p. ix). The public will demand sweeping government regulation of the economy to correct this imbalance of power (pp. 121–130 *passim*).

Rhoades believes that, in the absence of effective antitrust reform to prevent the rise of monolithic capitalism, such a basic transformation of the economic system is inevitable. He argues that this development would be undesirable because expansion of the command sector of the economy would lead to inefficient

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[1] In addition, conglomerate mergers limit the sources of profit information necessary for investment decisionmaking and increase opportunities for anticompetitive behavior. *See* S. RHOADES, POWER, EMPIRE BUILDING AND MERGERS 97 (1983).

decisionmaking and because centralized planning would be inconsistent with our society's shared belief in the efficacy and normative value of pluralism (pp. 133–141 *passim*).

Rhoades proposes that the rise of monolithic capitalism could be prevented by modifying antitrust law in the following manner:

> A. No company, regardless of size, would be allowed to acquire or merge with more than one other company during a single calendar year.
>
> B. No company, regardless of its size, that is among the top quarter of the number of firms in an industry or accounts for twenty per cent or more of industry sales would be allowed to acquire a firm that is among the top quarter of the number of firms in another industry or accounts for twenty per cent or more of its industry's sales (p. 146).

The author's basic assumptions are somewhat problematic. First, demand for a massive program of government economic regulation is not the only possible public response to the problem of increasing industrial concentration. As the recent attempts to halt petroleum industry mergers[2] indicate, controlling concentration in selected industries may be preferable. Second, the proposed Procrustean anti-merger guidelines inadequately address the possibility that some mergers may in fact have socially desirable justifications unrelated to the will-to-power.

The book has some serious flaws. *Power, Empire Building and Mergers* merely outlines Rhoades's thesis. Documentation has been held to a bare minimum. In addition, Rhoades occasionally finesses potentially significant challenges to his analysis. For example, he reduces the antitrust economics of the "Chicago School" to the following aphorism: if "monopoly profits are not the likely results of a particular business action, then efficiency must be . . . ." (p. 145).

Despite its flaws, Mr. Rhoades's work is a valuable contribution to the contemporary debate over the appropriate governmental response to industrial concentration. At a minimum, *Power, Empire Building and Mergers* may help to shift the rhetoric associated with the proposition "bigness is bad" toward a more thoughtful plane.

Mark R. Haskell

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[2] *See generally* N.Y. Times, March 22, 1984, at D1, col. 5 (discussing the withdrawal of a bill proposed by Sen. Johnston (D-La.) to halt oil mergers for six months).

POLITICS AND MONEY: THE NEW ROAD TO CORRUPTION. By *Elizabeth Drew*. New York: Macmillan Publishing Company, 1983. Pp. viii, 156, index. $11.95 cloth.

Andrew Young once said, "Money is the mother's milk of politics."[1] In *Politics and Money*, Elizabeth Drew demonstrates that it is now the politician's meat and potatoes as well. The fundraising that was once only an early hurdle in the race for political achievement is now, according to Drew, a daily necessity or, in some cases, an obsession. The result of this change is that even the best-intentioned politicians are forced to respond less to their constituents and more to organized interests contributing heavily to their campaigns. Democracy based on citizen and constituent access is being eclipsed by the rise of the special interest state.

Of course, money and politics have long been inextricably linked. As Drew notes, throughout the 1950's people were well aware that cash was available in exchange for legislation (p. 3). The difference today, she reports, is one of approach and extent, amounting to a new, more pervasive, and thus more dangerous form of political corruption.

The amount of money expended on political campaigns today is enormous by any standard and has increased rapidly in recent years. Part of this increase can be accounted for by the rising costs associated with the ever more sophisticated campaign techniques that are constantly being introduced. Yet more of the truth lies in the explanation that more is being spent on sophisticated campaigns because politicians are raising more money. Generally, candidates seek ever more money because of fear. As Drew puts it, "A candidate feels compelled to spend so much money because his opponent is spending so much, or might spend so much, or groups intent on his defeat might spend so much" (p. 94).

The source of this new money is predominantly nationally organized interest groups with great financial resources. The existence of such groups is not a new development, but the vast number of them spread across the landscape is. Not long ago, there were only a few such groups, for example, big business and big labor. Now they are so numerous that a recently compiled directory weighed nine pounds (p. 75). Associations exist

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[1] Atlanta J., May 23, 1979, at 17, col. 3.

for almost any type or subgroup of business that can be imagined. In addition, there are groups organized around specific causes—such as women's rights or the environment—and a plethora of ideological groups covering both broad philosophical outlooks and single issues.

The growth in importance of such groups is due in part to this increase in their number as well as to the concomitant increase in the resources at their disposal. But perhaps most important of all is their recent shift in strategy. Rather than just trying to influence policy by giving money to incumbents, special interest groups have begun to target specific candidates to get the maximum return on their investment. This new era began with the 1980 election, when unprecedented amounts were given by political action committees (PACs) to candidates who were challenging incumbents. This money "helped defeat some incumbents," Drew reports, "and it scared the daylights out of incumbents who survived" (p. 20). Officeholders now have to worry not only about how much money they can raise, but also about how much will go to their opponents. And with such a vast number of disparate groups handing out the money, virtually every move a politician makes is likely to come under the scrutiny of one or another of them.

What these interests gain from their contributions is seldom the quid pro quo of specific legislation. This is how the approach today differs from the less subtle corruption of the past. Rarely is a politician approached with an offer of "vote for this bill and I'll give you $10,000." Instead, the commodity gained through campaign contributions is access. Most issues before Congress do not involve high moral principles or directly effect important constituency groups. In such cases, the member of Congress is generally open to persuasion. Large campaign givers get the first claim to a member's limited time, and he who has access is most likely to persuade—especially when the wrong move means that the member will likely lose the contributor in question to an opponent and thus have to find new sources of money.

The detrimental effects of this rise in importance of the special interest groups are two-fold. First, it leads to a nationalization of political campaigns in that contributions are tending more and more to come from outside the state or congressional district. With this development comes a pre-emption of constituents by the interests. Second, it clearly harms the legislative process. This effect might take one of several forms. Needing money or fearing a well-financed opponent, a member of Congress might be led to vote a certain way on a piece of legislation, to try to avoid a vote on the matter, to forestall consideration of it altogether, to speed or stall its progress in committee, or to alter it in some way. Legislation with no real merit backed by a particularly strong interest might sail through Congress, while legislation involving important issues is often so buffeted by the efforts of competing interests that Congress is paralyzed. Rather than draw the wrath of one or another of the interests involved, Senators and Congressmen prefer not to act on an issue or to delay consideration of a specific proposal.

The role of money, Drew argues, has thus undermined the ability of politicians to compromise, to reach a consensus, and most importantly to lead. They think less and less about broad questions. "The Burkean ideal—the ideal of the politician leading his constituents, rather than simply reacting to 'the convenience of the hour,'" she writes, "has almost disappeared" (p. 98).

Commendably, Drew goes beyond her critique of the current system to outline reforms aimed at making the electoral process such that it will produce the kind of representation "best at representing the public interest and producing public officials who, on the basis of experience and judgment, would make decisions that would not always represent passing public attitudes or be affected by financial contributions" (p. 146). She proposes 1) a system of public financing of congressional campaigns, including limits on total spending and on the amount that a candidate can accept from political action committees; 2) a ban on the purchase of air time and the provision of equal and limited free air time for political advertisements; and 3) measures to close the loopholes presently being exploited to eviscerate the laws passed in the early 1970's to govern the contributions and expenditures for Presidential campaigns (pp. 147, 149–50).

Drew's proposals are not new, as she readily admits. Long ago, President Roosevelt—Theodore the Republican, not Franklin the Democrat—proposed the public financing of campaigns. No nation in Western Europe allows the purchase of television time for political broadcasts. And in Great Britain the major parties are given free air time in equal quantities. Ideas, however, do not have to be new in order to be good. On a practical level, all three of these proposals are appealing. Especially attractive is a corollary proposal, again modeled on the rule in Great Britain, that would require the free air time be used in segments of at least five or ten minutes. Such a requirement might force candidates to make significant policy statements rather than allow them to exploit the medium to create the aura of leadership through the manipulation of their "image."

Yet Drew's proposals suffer from a theoretical defect: they would, in effect, constitutionalize the status of the two great political parties. In the absence of such a limitation, anyone could claim the public financing and free air time whether or not he or she was a legitimate candidate. Indeed, such a status has been the effect of the British laws that she uses as models. Nevertheless, this theoretical problem should detract little from her recommendations because the reality of the situation is that any candidate with some chance of election can work within one or the other of the two major parties due to their very nature as political rather than ideological organizations.

In this election year, we have already had further signs that Drew's prognosis as to the effects on politicians of interest group money is correct. That the positions of politicians can be profoundly altered by campaign contributions is illustrated by the case of Representative Albert Gore, Jr. (D-Tenn.). A leading sponsor of legislation in the House to severely limit the activities of PACs, Gore is now the prohibitive favorite to fill the Senate seat being vacated by Senate Majority Leader Howard Baker (R-Tenn.). Because PACs like to bet on winners, Gore is currently second in the nation in total campaign receipts from political action groups. Not coincidentally, Gore is now rethinking his unswerving opposition to PACs.[2] Such developments not only reinforce Drew's conclusions, but also lend a sense of urgency to her calls for reform. Her proposals are intended not as comprehensive plans but as provocation to further thought, and, more importantly, with every such widening of the realm of interest group influence, also as calls to action.

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[2] *See* Wall St. J., Feb. 15, 1984, at 60, col. 1; New York Times, Feb. 14, 1984, at A24, col. 6.

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