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# POLICY ESSAY

## MILESTONE OR TOMBSTONE: THE WAGNER ACT AT FIFTY

PAUL C. WEILER\*

If one observation can be made with some confidence during this, the fiftieth anniversary year of the National Labor Relations Act (NLRA),<sup>1</sup> it is that the authors of the Act would be very surprised to hear who is saying what about their offspring.<sup>2</sup> The business community, which excoriated the Wagner Act as the most radical feature of the New Deal, now praises the balanced and constructive character of our national labor legislation. The National Labor Relations Board (NLRB), referred to by *Fortune* magazine in 1938 as the "God-damned Labor Board," is now applauded by management attorneys for its moderate and evenhanded jurisprudence. Meanwhile, the Democratic supporters of the union movement in Congress have recently issued a report entitled "Has Labor Law Failed?"; their answer to this question is, most emphatically, "Yes!" At the same time, more and more union leaders, up to and including Lane Kirkland, President of the AFL-CIO, are saying that labor would be better off if the Board were disbanded, the Act were repealed, and labor-management relations were "to return to the law of the jungle."

I suspect that one explanation for these differing views is that the two sides are talking about very different facets of our labor

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<sup>1</sup> National Labor Relations Act of 1935, ch. 372, 49 Stat. 449 (codified at 29 U.S.C. §§ 151-169 (1982)).

<sup>2</sup> A revealing set of capsule comments about the Act and the Board are collected in a BNA Special Report. BUREAU OF NATIONAL AFFAIRS, INC., NLRB AT 50: LABOR BOARD AT THE CROSSROADS (1985). More detailed testimony and writings are collected in the published volumes of the Joint Subcommittee Hearings of the House of Representatives, *Has Labor Law Failed?: Oversight Hearings Before the Subcomm. on Labor-Management Relations of the Comm. on Education and Labor, and the Subcomm. on Manpower and Housing, the Comm. on Government Operations*, 98th Cong., 2d Sess. (1984) (two parts).

law system. Business leaders tend to focus on that part of the legislation which governs established labor-management relationships. In this area, I believe that our jurisprudence has become progressively more sophisticated as the relationships have become more civilized. When labor leaders assess our labor law system, however, they are concerned with those rules which regulate the "trench warfare" of the representation struggle with non-union firms who are determined to stay that way. Since American unions are now losing through normal attrition far more members than they are replacing, their leadership naturally blames the NLRA, the statute that historically was designed to encourage and protect the right to union representation.

Now fifty years old, modern labor law is a vast, intricate subject. One has to be selective in deciding what to write about. I shall focus my attention on the representation phase of the law for at least two reasons. First, this phase is the part of the NLRA actually enacted by the Wagner Act. In a sense, this part of the law has logical priority as well.<sup>3</sup> However sophisticated the legal regulation of established labor-management relationships may be, if fewer and fewer of these relationships are being created, that ornate legal edifice will eventually become no more than an elegant tombstone. As we shall see, this fear is no longer just idle speculation.

Any critical appraisal of how the law now deals with the representation contest must address a number of distinct questions:

- (i) How are American unions actually faring under the NLRA in securing representation for non-union workers?
- (ii) Is the decline in union success due simply to diminishing worker interest in unions, or is it also due to increasing employer resistance?

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<sup>3</sup> An additional reason for focusing on the representation phase is that this area is where I have done the bulk of my own research and writing. This research is contained in Weiler, *Promises To Keep: Securing Workers' Right To Self-Organization Under The NLRA*, 96 HARV. L. REV. 1769 (1983) [hereinafter cited as Weiler, *Promises to Keep*], which deals with the representation campaign, and Weiler, *Striking A New Balance: Freedom Of Contract And The Prospects For Union Representation*, 98 HARV. L. REV. 351 (1984) [hereinafter cited as Weiler, *Striking a New Balance*], which deals with the negotiation of the first contract. In this Policy Essay I will try to distill my earlier analyses and place them in a somewhat broader perspective. Since those articles canvassed much of the relevant material and literature, I shall not here repeat the citations to all of my sources, but will update some of the earlier evidence in footnotes.

(iii) To the extent that the law has failed to contain illegitimate management tactics, what are the specific weaknesses in the Act?

(iv) Whatever the cause, is the erosion of private sector collective bargaining actually such a bad thing that we should be prepared to undertake serious reform of the NLRA to give union representation a fairer chance?

(v) If we are inclined to revise the statute so as to fulfill the promise made by Senator Wagner and his colleagues fifty years ago, what general strategies and specific measures offer the best prospects for success?

As this list indicates, a serious appraisal of just the representation phase of our national labor law is a challenging undertaking. In this Policy Essay I can do little more than sketch the evidence and arguments relevant to each of these issues.

## I. THE DECLINE IN UNION REPRESENTATION

Union representation under the NLRA has displayed an astonishingly split personality during the Act's fifty-year life. For the first two decades, total union membership increased at a phenomenal rate, with a more than five-fold jump in absolute numbers and growth from less than fifteen percent of the total workforce to more than thirty-five percent. Since 1955, however, private sector union membership has not only declined somewhat in absolute numbers, but its share of the ever-increasing labor force has been cut fully in half: from over thirty-eight percent in 1954 to just nineteen percent in 1984.<sup>4</sup> Absent some

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<sup>4</sup> I should note some of the complications in tracing union membership figures over time. Because 1935–1955 Bureau of Labor Statistics (BLS) data is not broken down into public and private sectors, these numbers are for the economy as a whole. Nevertheless, the bulk of union membership and union density during that period was concentrated in the private sector (15.9 out of 16.8 million union members in 1955). From 1955 to 1978, BLS reported that private sector union membership increased slightly from 15.9 to 16.6 million members. See BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, DIRECTORY OF NATIONAL UNIONS AND EMPLOYEE ASSOCIATIONS 59 (1979). The discontinuation of the BLS series has left the Consumer Population Survey (CPS) as the alternate source. See generally Adams, *Changing Employment Patterns of Organized Workers*, 108 MONTHLY LAB. REV. 25 (1985). As of 1984, the CPS reports that there were 11.8 million private sector wage and salary workers who were union members, or 15.6% of that segment of the labor force. *Id.* at 29. The problem is that the CPS surveys only "employed wage and salary workers," and thus does not count the roughly 10% of union members who are now self-employed, unemployed, laid off or retired. Even if we were to add the additional two million of these union members to bring the total "private sector" union membership to nearly 14 million, union density under the NLRA would still be less than 19%.

dramatic changes in this trend, the supposed right to engage in collective bargaining will be largely illusory by the turn of this century for non-union private sector workers. No wonder labor leaders, politicians and many others have made such highly uncomplimentary remarks about a federal labor law which appears to have allowed this decline to happen.

In my own view, one must look beyond the Wagner Act for an adequate explanation of these trends. A comparison with Canadian labor law provides initial support for this claim. Soon after it was passed, the Wagner Act model was imported into Canada, and it has remained at the core of Canadian labor law ever since. Initially, overall union density in Canada tracked the American figures very closely, both during the rise from 1935 through 1955, and then through the slight dip into the early 1960's. Since that time, however, union representation in Canada has continued to grow, unlike the union representation in the United States. In the early 1980's, approximately forty percent of the Canadian work force are now union members and forty-five percent are covered by collective agreements. The contrast is even more startling when one examines the international unions which operate in manufacturing, construction, and other areas of the private-sector economy in both Canada and the United States: unions such as the Teamsters, the Steelworkers, the Carpenters, the Electrical Workers and the Auto-workers. The same unions whose ranks have been decimated in the United States have enjoyed average growth rates in Canada of three to four percent a year for the last two decades.<sup>5</sup> I believe the Canadian experience is a useful mirror to hold up to the American experience to sharpen our sense of precisely what role the current law might have played in decreasing union strength in the United States, as well as our views about possible reforms of the American system.

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<sup>5</sup> The sources for these Canadian union density figures can be found in the comprehensive review by P. Kumar, *Union Growth in Canada: Retrospect and Prospect* (Dec. 1984) (study prepared for the Royal Commission on Economic Union and Development Prospect for Canada). Should anyone suspect that this much higher level of union density in Canada is due to its industries and jobs being concentrated in traditionally unionized sectors, the fact is that if Canada had the same industrial distribution as the United States, its union density would actually be higher. See N. Meltz, *Labor Movements in Canada and the United States, Are They Really That Different?* (paper prepared for the MIT/Union Conference of June 19-21, 1983) (on file at HARV. J. ON LEGIS.).

## II. CHANGES IN THE WORK FORCE

Knowing what the statistics show is only a first step toward understanding this issue. Interpreting what they mean is the more important task. One natural reaction might be that American workers, unlike their Canadian counterparts, are no longer interested in union representation. Gallup Polls have shown a considerable drop in the general public approval of unions over the last thirty years.<sup>6</sup> Additionally, the older, male, blue-collar workers in the "smokestack" industries in the northern United States, the traditional stronghold of American unionism, are a declining proportion of the work force. At the same time, the younger, female, white-collar workers employed in the service industries in the south, where unions have always been weak, have shown the sharpest employment growth. Given that the purpose of national labor law is to protect worker choice about union representation, not to foist the institution upon groups which would rather not have it, these additional factors suggest that while the unfavorable trends in union density certainly do represent a major problem for unions and their leaders, they are not something which public policy can or should do anything about.

Further scrutiny, however, shows that there is much more to the story. In-depth polling indicates that much of the general public disapproval of unions concerns the actions and performance of their leaders, a frequent complaint being their allegedly undue influence upon public affairs. The public continues to show a very high level of acceptance of the right of workers to join unions and an appreciation of the need for union representation in voicing and solving employee grievances in the workplace. Indeed, a remarkably high percentage of union members, who see how it operates firsthand, approve of the performance of their institution.<sup>7</sup> Finally, roughly one-third of the non-union

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<sup>6</sup> The Gallup Poll in 1953 found that 75% of Americans approved of unions while 18% disapproved. In 1981, the ratio was 55% to 35%. Thus, the approval/disapproval margin in favor of unions dipped from 63% to 20% over the same three decades in which the union share of the workforce declined dramatically. For these statistics and other polling data reported in this Part, see J. MEDOFF, *THE PUBLIC IMAGE OF LABOR AND LABOR'S RESPONSE* (1984).

<sup>7</sup> A Lou Harris poll in the summer of 1984 found an 81% to 11% acceptance of the right of workers to join unions, and an 82% to 15% endorsement of unions as the necessary voice of employees in solving their grievances at work; union members answered in the affirmative by even higher margins. Also, a recent study found that

labor force—more than twenty-five million workers—say they would presently vote for union representation if offered the opportunity.

The newer, female, white-collar, and service sectors of the work force do not hold any particular antipathy towards collective bargaining. Indeed, these workers—e.g., teachers and nurses—have been at the vanguard in the rise of public sector unionism in the United States. Moreover, among the non-union work force as a whole, they are currently more likely than male, blue-collar manufacturing sector workers to be interested in union representation. Thus, notwithstanding substantial changes in both public attitudes and the composition of the workforce, American workers continue to have strong interest in collective bargaining.

### III. EMPLOYER RESISTANCE TO UNION REPRESENTATION

The inability of unions to tap this pool of employee interest is due at least in considerable part to their own failings. Some unions are guilty of a lack of interest in organizing, or an inability to organize effectively, particularly outside traditional union bailiwicks. Others are also unwilling to address some of the blemishes that repel otherwise interested employees. But I would be loathe to put too much weight on this factor alone. Recall that the Canadian figures show that the self-same international unions grew steadily in Canada from the early 1960's through the 1980's, while membership levels in their American sections first stagnated and then began to erode.

One situation in particular provides an opportunity to test this hypothesis that the decline in American unionism is due to something more than employee disinterest in the institution. Whatever the general reluctance of American workers to join unions or the incapacities of our unions, several thousand successful organizing drives *are* conducted every year under the NLRA. Even after the union signs up a significant number,

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among male workers, 87% of current union members would vote for union representation. Indeed, fully 82% of workers who were covered by a collective agreement but had chosen not to join their union would vote for collective bargaining nonetheless. See Hills, *The Attitudes of Union and Non-Union Male Workers Towards Union Representation*, 38 *INDUS. AND LAB. REL. REV.* 179 (1985). Also, 28% of the work force—or 27 million workers—is made up of former union members, almost all of whom are no longer in a union because they left earlier jobs in union shops.



usually a sizeable majority, of employees in a shop, the law presents two further hurdles. The union first must win a secret ballot election to get NLRB certification as the legal bargaining agent for the unit.<sup>8</sup> Then it must win a first collective bargaining agreement from the employer in order to secure a real presence within the plant: with the union having an influence on wage rates and working conditions, deploying stewards and grievance committees, and enjoying some form of union security.

In the early 1950's, American unions won certification elections for about eighty percent of the workers in potential bargaining units, and then obtained first contracts in nearly ninety percent of those units (roughly the same percentages as obtain in Canada today). By 1980, though, American unions were winning certifications covering fewer than forty percent of the potential unit members, and translating those hard-won certifications into first contracts barely more than half the time. Remarkably, then, the current NLRA procedures yield meaningful representation rights for only about one-fifth of the workers who enter into this process, even when the union has conducted an apparently successful organizing drive only a few months before.

Throughout this process another important, but as yet unmentioned, factor is present: employer resistance to collective bargaining by and for its employees. I am not referring to the benign employer which provides its employees with both decent pay and working conditions and satisfactory procedures for hearing their concerns and settling their grievances, all of which might make the union alternative seem unnecessary. Such an employer is rarely the subject of a successful union organizing drive, and thus does not even appear in the NLRB statistics that I have presented. I am concerned, rather, with the employer whose pay and working conditions do produce sufficient discontent among its employees that they are fertile ground for wooing by the union organizer; but whose management launches a vigorous campaign to make union representation seem unpalatable when notice of the certification petition is received from the NLRB. Of course, the Act does make many of these tactics clearly illegal. For my purposes here, what is important is the actual incidence of this behavior and its effects in the real world.

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<sup>8</sup> See National Labor Relations Act § 9, 29 U.S.C. § 159 (1982).

Since the mid-1950's, when the decline in overall union density first set in, the statistics have demonstrated a clear and pronounced trend. Suppose we ignore the relatively marginal section 8(a)(1)<sup>9</sup> violations by employers (threats, interrogation, benefits and inducements) and focus on discriminatory discharges and other forms of tangible reprisal against union supporters. Such complaints under section 8(a)(3) of the NLRA<sup>10</sup> increased six-fold from 1955 to 1980. If we control for the increase in the number of representation elections in that period, the increase was still well more than three-fold, from seven section 8(a)(3) complaints per ten elections in 1955 to twenty-five per ten elections in 1980. And the incidence of employer bargaining in bad faith seems to have risen twice as much during the same period, from four charges under section 8(a)(5)<sup>11</sup> per ten new certifications in 1955 to twenty-eight per ten new certifications in 1980 (or a seven-fold increase).

Of course, it is one thing to file a charge under the Act and another to substantiate it. In fact, the majority of unfair labor practice charges are *not* valid. The proportion of charges against employers which the Board rated as "meritorious," however, rose by one-third between 1955 and 1980, while the absolute number of charges was also spiralling. As tangible a measure as one can find of this phenomenon is that the Board secured reinstatement in 1980 for more than 10,000 illegally fired workers, over ten times the number reinstated annually during the mid-1950's. When one puts this figure side by side with the total of 200,000 workers who voted for union representation elections in 1980, the current dimensions of such employer action are dismaying indeed.<sup>12</sup>

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<sup>9</sup> 29 U.S.C. § 158(a)(1) (1982).

<sup>10</sup> 29 U.S.C. § 158(a)(3) (1982).

<sup>11</sup> 29 U.S.C. § 158(a)(5) (1982).

<sup>12</sup> See Weiler, *Promises to Keep*, *supra* note 3, at 1780-81. I must add two qualifications to these figures. First, some proportion of section 8(a)(3) discharges do occur outside the representation campaign, and this proportion was probably increasing in the late 1970's. At the same time, there are a substantial number of employees who are fired during an organizing drive, but either do not make a section 8(a)(3) claim or will settle for backpay without reinstatement because they do not want to go back to that job (a total of 15,642 fired employees who received backpay in fiscal year (FY) 1980 versus a total of 10,033 fired employees who were reinstated). See 45 NLRB ANN. REP. 249 (1980). To some extent at least, this latter group will offset the portion of the "reinstated" category which stems from incidents outside the representation campaign.

Second, the basic research which I have reported extends through FY 1980 (which extends to September 30, 1980). The last Annual Report which the NLRB has issued is for FY 1981, which extends through September 1981. In that latter year, the number of reinstates dropped by over a third, to 6463 (though at the same time, the total of

Given this remarkable rise in illegal employer resistance to collective bargaining for its employees, the natural assumption is that such resistance has played a major role in unions' declining success in securing certification or first contracts, even in units of employees where initially there was substantial interest in union representation. That inference is not inevitably correct, though. One might also surmise that employer pressure is either not that influential in changing employee minds, or that it is as likely to backfire as it is to succeed. On that view, the two statistical trends which I have traced over the last three decades would be just coincidence. This position seemed to find firm support in the research effort of Getman, Goldberg & Herman, *Union Representation Elections: Law and Reality*.<sup>13</sup> These three scholars conducted an in-depth study of thirty-one election campaigns and were unable to find any statistically significant proof that illegal employer behavior made employees less likely to vote for union representation. Certainly that analysis, if true, would suggest a quite different point of view about the current status of American labor law and the need for its reform.

A considerable body of empirical research, however, now provides evidence to the contrary. Some of this research consists of econometric studies of the incidence of both unfair labor practices and election outcomes over time and across states, all of which find significant causal connections between the two patterns of behavior.<sup>14</sup> Another in-depth study of a different

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backpay recipients jumped by two-thirds, to 26,091). 46 NLRB ANN. REP. 13 (1981). However, the number of elections also dropped, as did the number of votes cast for unions. Thus the ratio of section 8(a)(3) charges to certification elections continued to rise, from 2.50 in FY 1980 to 2.73 in FY 1981, and that of section 8(a)(5) charges to new certifications rose even faster, from 2.82 to 3.30. While the ratio of reinstated employees to union voters dropped somewhat, from one in 20 to one in 26, the ratio of backpay recipients to union voters doubled, from one in 13 to one in 6.5 voters. Clearly, then, unions can find no aid and comfort in the recent data.

<sup>13</sup> J. GETMAN, S. GOLDBERG & J. HERMAN, *UNION REPRESENTATION ELECTIONS: LAW AND REALITY* (1976); see also Goldberg, Getman & Brett, *Union Representation Elections: Law and Reality: The Authors Respond to the Critics*, 79 MICH. L. REV. 564 (1981).

<sup>14</sup> See D. ELLWOOD & G. FINE, *THE IMPACT OF RIGHT-TO-WORK LAWS ON UNION ORGANIZING 18-22* (Nat'l Bureau of Economic Research, Working Paper No. 116, 1983) (states with a rate of unfair labor practices per election which was one standard deviation higher than the national average had union organization rates that were 10% lower than the national average); R. FREEMAN & J. MEDOFF, *WHAT DO UNIONS DO?* 238 (1984) (a 10% increase in unfair labor practices per election reduced the proportion of workers newly-organized in NLRB elections by either 2.5%, 3.4%, or 6% depending on the measure used; these results imply that this factor produced somewhere between 28% and 49% of the total decline in union density from 1950 through 1980); Seeber & Cooke, *The Decline of Union Success in NLRB Representation Elections*, 22 INDUS. REL. 34 (1983) (each 1.0% decrease in "consent" elections by employers was associated with a

sample of elections found that discriminatory discharges did have a marked effect on union success, not only in the representation contest but also in the union's ability to secure a first contract for those units in which it did win certification.<sup>15</sup> Indeed, the data used by Getman and his co-authors has been thoroughly reanalyzed in order to determine the effect of employer behavior on the actual election outcome, rather than just on the change in average employee voting behavior. This study concluded that even in this sample, vigorous and illegal management resistance to unionization did have a pronounced impact on the overall election results, in particular because representation elections are usually decided by a narrow margin.<sup>16</sup>

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0.5% decline in the proportion of workers voting for union representation in all elections; this factor alone would account for 20% of the overall decline in union election success from 1963 through 1978); W. COOKE, *ILLEGAL DISCHARGE OF UNION ACTIVISTS: ITS TOLL ON UNION ORGANIZING AND POLICY IMPLICATIONS* (1985) (a § 8(a)(3) charge reduced union election success by 17% in Indiana in 1979-80).

<sup>15</sup> See Cooke, *The Failure To Negotiate First Contracts: Determinants and Policy Implications*, 38 INDUS. AND LAB. REL. REV. 163 (1985) (one or more discriminatory discharges would reduce the likelihood of a union getting a first collective agreement by 44%).

<sup>16</sup> Dickens, *The Effect of Company Campaigns on Certification Elections: Law and Reality Once Again*, 36 INDUS. AND LAB. REL. REV. 560, 572-73 (1983). Dickens found that in the Getman, Goldberg and Herman sample, if all employers had engaged in the most intense and illegal campaign found in the sample, unions would have won 4% to 5% of the elections studied; if no employers had committed any unfair labor practices at all, the unions would have won 44% to 47% of all these elections; and if there had been no employer campaign at all, the union would have won 66% to 67% of the time. I must add that, since this paper was written and delivered, Professors Getman, Goldberg and Brett have published an article, *The Relationship Between Free Choice and Labor Board Doctrine: Differing Empirical Approaches*, 79 NW. U.L. REV. 721 (1984), which takes issue both with Dickens's critical revision of their empirical findings and my contrary policy proposals for reform of the representation campaign. Clearly this Policy Essay is not the occasion for an extended rejoinder to their latest arguments: Dickens and I do plan to publish such a reply separately.

I do want to note for the record, though, that Getman, *et al.*, still seem to me to be defending an untenable set of positions. They assume as a premise for major revision of the legal policy of the NLRA that even the most egregious employer threats and reprisals against union supporters in the campaign have no effect on employee voting behavior. They do so just because their research could not discern absolutely statistically reliable proof of such a connection in the single sample of elections which they studied (and I should add that even in their sample much of the employer violations actually occurred sometime *before* their pre-campaign interviews which were supposed to establish the employees' benchmark voting intentions). Getman, *et al.*, imply that one need not worry about what would seem at best to be a rather small impact of the campaign upon the average likelihood of individual employees voting one way or the other, though the typically narrow employer victory margin in NLRB elections means that just a slight change in average voter propensities can translate into sizeable swings in overall election trends. Yet even if, as they suppose, the content of the campaign contributes little or nothing to the employees' decision, we are told we must still preserve this campaign (which admittedly gives a considerable number of unscrupulous employers the opportunity and the incentive to fire over 10,000 union supporters every year), because the campaign is necessary to preserve employee "free choice." Finally, their favorite cure

In the end, we are safe in relying on our common sense intuition that so many employers would not have invested so much in fighting unions in the representation campaign if this strategy did not significantly decrease the probability of union success.

Although I have emphasized the significance of employer violations of the National Labor Relations Act, I do not mean to impugn the reputation of American employers generally. In fact, only a minority of firms take retaliatory action against union supporters.<sup>17</sup> Indeed, considering how successful this tactic can be and how weak the tangible legal sanctions against it are (as discussed *infra*), the level of voluntary employer adherence to the principles of the Wagner Act is remarkably high.

At the same time, one must not assume that the impact of anti-union discrimination is felt only in those units where the behavior occurs. After all, the non-union state is the "natural", pre-existing employment regime. Even with an entirely hands-off approach by management, it takes a strong level of dissatisfaction before a group of employees will venture into the uncharted waters of collective bargaining to try to improve their situation. As it stands, a large proportion of American workers believe that their employers will strongly resist that step, that there will be a heated and divisive campaign within the unit, and that there is a real chance of retaliation against those identified as union supporters.<sup>18</sup> There is nothing paranoid about this fear; the vast majority of employers do strongly oppose unionization in the campaign, and a substantial minority resort to dirty tactics to try to win the battle. Widespread knowledge of these facts must have a strongly inhibiting effect on any group of workers entertaining the idea of union representation, even if their own management would religiously respect the NLRA's guarantee of worker self-determination. In my own view, this

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for any such ailments in the current system is the addition of yet another legal rule. Getman, *et al.*, would require employers to invite union organizers into their plants to campaign against them, and thus give determined anti-union employers still another doctrine which they might flout with relative impunity. As this admittedly jaundiced synopsis of the claims of Getman, *et al.* would suggest, I am still not persuaded.

<sup>17</sup> I calculate that in 1980 and 1981 the NLRB obtained either reinstatement or a position on a preferential hiring list for illegally-discharged employees in roughly one-third the representation cases of those years.

<sup>18</sup> The Lou Harris poll asked non-union workers why they are not now members of unions. While 33% of the respondents said they did not want to join a union, another 38% said it was because of company pressure. Apparently 59% of non-union, non-managerial workers feel that there would be trouble during the campaign between union supporters and opponents, and fully 43% believe that *their* employer would fire, demote, or otherwise make life miserable for union supporters in a representation campaign.

subtler, indirect effect of the rise of illegal employer resistance to collective bargaining may be an even more important barrier to the exercise of that option by non-union, private sector workers.

#### IV. THE WEAKNESS OF NATIONAL LABOR LAW

##### A. *The Board*

The conclusions of the previous Part simply raise the next set of questions. After all, this kind of employer behavior is supposed to violate a statute enacted fifty years ago. The NLRA announces, clearly and unmistakably, that workers have the right to union representation, if they want it, without any employer interference, let alone coercion or discrimination. Why, then, has national labor law apparently done so poorly in making good on the promise of the Wagner Act?

In the last two or three years, a number of politicians, pundits, and even some labor leaders who should know better, have singled out as a prime culprit the "Reagan" Labor Board. Admittedly, the Reagan appointees are fairly pro-employer in their sentiments. They came to the Board with a definite program to roll back a number of decisions of their Carter-appointed predecessors which they felt had been overly favorable to unions and workers. But whatever one might say about the Reagan Board's jurisprudence (and I for one find much of it attractive),<sup>19</sup>

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<sup>19</sup> I do so at least to the extent that many of these decisions pare away some of the elaborate network of legal regulation of the collective bargaining and employment relationship. See, e.g., *Meyers Indus., Inc.*, 268 N.L.R.B. 493 (1984) *remanded sub. nom.* *Prill v. NLRB*, 118 L.R.R.M. (BNA) 2649 (D.C.Cir. 1985); *Sears, Roebuck & Co.*, 274 N.L.R.B. No. 55, 118 L.R.R.M. (BNA) 1329 (1985) (these cases exclude from the scope of protected concerted activity under § 7 of the Act the claims of non-union workers when the latter are basically acting on their own); *United Technologies Corp.*, 268 N.L.R.B. 557 (1984); *Olin Corp.*, 268 N.L.R.B. 573 (1984) (these cases hold that union members covered by collective agreements should be required to rely primarily on the grievance arbitration procedure to secure their statutory rights under the Act); *Midland Nat'l Life Ins. Co.*, 263 N.L.R.B. 127 (1982) (this case removes the Board from the time-consuming job of scrutinizing the accuracy of the literature and speeches in the campaign).

I do not mean to naively depict the Reagan Board as engaged in no more than the neutral deregulation of labor law, rather than substantively shifting labor law toward the employer side. See e.g., *International Ass'n. of Machinists & Aerospace Workers, Local Lodge 1414 (Neufeld Porsche-Audi, Inc.)*, 270 N.L.R.B. 1330 (1984) (tightening the legal controls on union discipline of strike breakers); *Gulton Electro-Voice, Inc.*, 266 N.L.R.B. 406 (1983) (expanding the legal regulation of superseniority clauses freely negotiated by unions and employers). My point, simply, is that whatever the actual

their decisions have nothing to do with the plight of union organizing under the Act. The steep rise in employer resistance and the steady decline in union success before the Board had been going on for twenty-five years before President Reagan was even elected. These trends were especially pronounced during the Carter Administration, notwithstanding the numerous victories awarded by the "Carter Board" to unions and their attorneys. The lesson from this history is that the flaws in our national labor law are buried deep within the structure of the statute, and they will continue to take their toll regardless of the current political complexion of the Board.

### B. *The Act*

The problem with the Act does not lie in the substantive rules that define the scope of permissible behavior in the campaign and at the bargaining table. Even after some discreet pruning by the Reagan Board, there is no shortage of such legal doctrines, nor of work to be performed by labor lawyers. Indeed, the major contemporary problem is the threat and reality of discriminatory discharge of union adherents, something which the statute clearly prohibits on its face. The problem is that this standard of behavior which Congress wrote into the Wagner Act a half century ago, and which the Supreme Court ratified in *Jones and Laughlin*<sup>20</sup> two years later, seems no closer to realization now than it was then. To understand why, we must focus on the NLRA's remedial scheme.

Any remedial regime consists of two components: the ultimate sanctions for violating the law and the procedural mechanisms for administering them. The precise source of the weakness of our labor law is the conjunction of certain characteristic weaknesses in both components.

To the outside observer, the legal consequences of violating the Act might seem quite mild. An employer which deliberately

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motivation of the Reagan Board, at least one thread running through its rulings should not only be applauded but expanded. The Board needs to sharply curtail its use of the cumbersome, badly-clogged NLRB administrative machinery, rather than employing it to resolve every plausible grievance which employees may have in the work place. Only in this way can the Board give the necessary priority to the central focus of section 8(a) of the Act, the ban on discriminatory discharge of union supporters at the representation and first contract stage.

<sup>20</sup> NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1 (1937).

fires a number of key union members during a representation campaign faces no criminal consequences, not even monetary fines. Victimized employees have only a right to civil compensation. Even then, discharged employees have no right to sue for general damages for resulting economic loss or emotional trauma; they can only collect the net backpay they have lost, subject to a duty to mitigate these losses by finding other work in the interim. Such backpay awards under the Act now average about \$2000 apiece, hardly a meaningful deterrent to an employer determined to keep a union out of its plant by fair means or foul.

This feature is no accident. From the outset, our national labor policy has deliberately followed its own remedial tack. The emphasis is on repairing the harm to the victim rather than imposing punitive sanctions upon the violator. More importantly, the harm is repaired in kind rather than in cash. Thus, if a key union supporter is fired, the primary relief offered by the Board is reinstatement of the employee in his former job, rather than a large lump sum award for the permanent loss of that job. If the union loses the election as well, the typical remedy from the Board is installation of the union as bargaining agent for the employees in the plant, rather than a monetary award designed to make whole the bargaining unit for the loss of the opportunity to have collective bargaining.

In principle, this line of attack seems well-suited to secure the purposes of the Act. The Board reproduces the situation which the law was supposed to guarantee, rather than just calculating and awarding a financial substitute. More importantly, perhaps, an employer that violates the law finds that its illegal tactics have backfired. The employer must take the union supporters back in the plant with their union installed as bargaining agent. Even worse from the employer's perspective, the rest of the employees have been taught the lesson that collective worker action backed up by national labor law really can trump the exercise of management's hitherto absolute power. The further assumption of the law, of course, is that when other employers see this course of events, this will serve as ample incentive to conform to the Act.

Unfortunately, at this stage the other characteristic weakness of NLRA remedies manifests itself. The Act establishes an elaborate four-step administrative process. First, a formal complaint from a regional office of the NLRB is brought, followed by a



trial-type hearing before an administrative law judge. Then a decision and order are issued by the Board itself. Finally, the Board order must be legally enforced by a circuit court of appeals. The problem is that whatever value this painstaking procedure may add to the legal quality of the verdict, it more than subtracts from the efficacy of the ultimate order. Any employer prepared to invest the legal fees necessary to secure all the administrative and judicial process due to it can postpone the legal day of reckoning for one thousand days or more. This delay would be bad enough for someone awaiting a cash award for the loss of his job. The real problem is that it renders the "in kind" remedies of reinstatement and bargaining order largely illusory.<sup>21</sup>

I realize, of course, that only a tiny handful of the tens of thousands of charges against employers traverse this entire procedural journey. Indeed, the vast majority of even the meritorious charges are settled well before then, usually just before or just after the issuance of a formal complaint by the NLRB regional office. This response to the concern about delay, however, is insufficient for at least two reasons. First, any settlement prior to the completion of the full legal process depends upon the voluntary acceptance by the employer. I am sure that consent to a decent settlement is often forthcoming from firms that generally respect the Act but who still find themselves responding to an unfair labor practice charge, perhaps due to the actions of an overly zealous manager at a particular location. But any firm that consciously chooses to violate national labor law in order to undermine a union organizing drive will likely concede only the type of relief that will not frustrate that strategy: for

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<sup>21</sup> In *Promises To Keep*, *supra* note 3, I review research about reinstatement by Aspin and by Stevens & Chaney which found that only 40% of employees who win the right of reinstatement actually do go back to their old jobs; of those who do, four out of five are gone by the end of the year, most blaming vindictive treatment by their employer. *Id.* at 1791-93 & nn.80-86. I refer as well to research about *Gissel* bargaining orders by O'Shea which indicates that only one in three reported *Gissel* orders is translated into a first contract, and of these, only one in six was likely to be renewed. *Id.* at 1795 n.94. In *Striking a New Balance*, *supra* note 3, I review additional research by Ross, McDonald & Wolkinson which found much the same lack of union success following judicial bargaining orders in the late Fifties and early Sixties. *Id.* at 361, 410-12. These studies did find better results if the bargaining orders were secured early and voluntarily; a first contract was won two-thirds of the time if the order was the product of a pre-hearing settlement and half the time if the order followed a Board decision without the need for judicial enforcement. *Id.* at 361 n.31. However this research covered a period when overall first contract achievement rates were considerably higher than they are now. McDonald reports that a bargaining order from the Board will now produce a first contract less than one-third of the time. *Id.*

example, a settlement which pays the dismissed union members their lost wages if the latter drop any claim for reinstatement in the shop.

Second, an employer strategy of just dragging its heels in settlement negotiations at the Board is likely to prove successful, because the amount of time which a determined employer needs to win a representation struggle is measured in months, not in years. If the firm and its counsel spin the process out for a modest three or four months, the employees involved will be likely to have found other jobs which they will be reluctant to exchange for a possibly unpleasant reception in their old work place. Meanwhile, the momentum of the union's organizing drive will have subsided, the election will have been lost or postponed, the work force will be gradually turning over under the auspices of a now watchful management, and the union will be on the outside looking in. None of these conditions are conducive to a union being able to wield effective authority in winning a first contract from this employer even if the latter were grudgingly to accept a bargaining order before a final Board order and/or court enforcement. In reflecting on how easy it might be for the employer to win the breathing space it needs, it is sufficient to note that the first hearing date for the charge will not be scheduled until some six months or more after the events in question.

These pessimistic appraisals of the efficacy and the durability of the standard Board remedies are now being documented by systematic empirical research. They have always been intuitively evident, however, to any shrewd employer and its advisors. The in-kind remedies favored by the Act now evoke little more concern than the comparatively trivial cash awards for lost backpay. Thus the failure of the NLRA to stem the tide of illegal resistance by determined anti-union employers is easily explained. Indeed, the more remarkable fact may be that the majority of American employers still do comply with our federal labor law even while they vigorously combat the union for the hearts and minds of their employees. Unfortunately, any such equilibrium may be somewhat uneasy. The successful use of dirty campaign tactics by even a few firms puts considerable competitive pressures on other firms to resort to the same tactics. What may lie beneath the surface, then, of the recent jump in the rate of increase of discriminatory discharges and similar employer behavior is a form of Gresham's Law of labor rela-

tions, under which the "bad" firms and managers are driving out the "good" ones.

## V. THE ALTERNATIVE OF EMPLOYMENT REGULATION

This Policy Essay has presented a rather bleak picture of how effectively the NLRA is now governing the representation contest. At the level of the individual unit and firm, the standard Board remedies are largely ineffective. In the aggregate, employer violations of the Act have spiralled, and as a result unions have been increasingly unable to win either certifications or first contracts. The stark reality is that private sector unions are now able, through NLRA procedures, to replace only one-quarter of the members that they lose through the normal attrition process in an economy in which existing plants are constantly being closed or moved, and replaced by new business enterprises. With fewer union members, existing unions have fewer resources with which to win new recruits, while employers face greater incentives to stay or to become non-union in order to meet the competition. Under the best projections from current trends, union representation will be available to less than ten percent of private sector workers by the turn of this century, and still falling.

This is simply a factual projection. Whether this trend is to be considered good or bad ultimately depends upon a value judgment about the virtues or vices of union representation. I suspect that most people have somewhat mixed feelings on this issue. On the one hand, few will deny the historic contributions of collective bargaining: employee compensation and working conditions have been tangibly improved, mechanisms have been devised through which grievances are resolved, and employees exert meaningful influence in their workplace. On the other hand, there is perennial concern about the propensity of some trade unions to act as cartels that obstruct the efficient operation of our labor markets, occasionally even threatening the very survival of certain firms and industries. To the extent that these latter concerns are valid, one can perhaps understand the reaction of the owner of a business who feels compelled to preserve his non-union status, even though it means flouting our national labor laws. And as if in counterpoint to this growing societal attitude, a strong critique of contemporary labor law

from the right has emerged in the law reviews. This scholarship celebrates the virtues of employment at will, and of management's prerogative to set the terms of employment at the level the firm finds necessary to recruit and retain a qualified workforce. It questions the central tenet of the Wagner Act, that workers should have the unilateral right to choose union representation and collective bargaining if that is what they want, with the employer having no business denying them that option as the price for retaining their jobs with the firm.<sup>22</sup>

This subject is too large and complicated to fully pursue here; it is mentioned mainly to make my own position clear. I do not believe it to be self-evident that collective bargaining is an institution worth saving, that just because the NLRA has made worker self-determination the litmus test for union representation for the last half-century, it should continue to be so for the next, or that the only question for serious labor law reform is how to make the current legal policy work better, instead of assessing the value of having any such protective policy at all. I plan to explore these crucial and complex questions more fully at a later time.

I should allude, though, to one rather artificial assumption of this recent critique from the right: that the choice we face is between the 19th Century norm of an *unfettered* labor market, in which the firm sets its terms and conditions of employment at the point necessary to remain competitive both in keeping its work force and in selling its product, and the New Deal/Wagner Act alternative of a *reconstructed* labor market, in which the employees of the firm develop a cohesive bargaining group through which they can participate in setting their terms of employment. There is a third option through which workers may assert influence on their terms of employment: the political process that produces a legally *regulated* labor market.

While that alternative has been around for a long time—the Fair Labor Standards Act was also a product of the New Deal<sup>23</sup>—traditionally, it has stayed discreetly in the background,

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<sup>22</sup> The best exposition of this position is Epstein, *A Common Law for Labor Relations: A Critique of the New Deal Labor Legislation*, 92 YALE L.J. 1357 (1983). This evoked a vigorous response by Getman & Kohler, *The Common Law, Labor Law, and Reality*, 92 YALE L.J. 1415 (1983), which in turn provoked a rejoinder by Epstein, *Common Law, Labor Law, and Reality*, 92 YALE L.J. 1435 (1983).

<sup>23</sup> Fair Labor Standards Act of 1938, ch. 676, 52 Stat. 1060 (codified as amended at 29 U.S.C. §§ 201–219 (1982)); see also I. BERNSTEIN, *A CARING SOCIETY: THE NEW DEAL, THE WORKER, AND THE GREAT DEPRESSION* 116–45 (1985) (treating the development of fair labor standards in the 1930's).

fixing only the bare minimum standards of employment. Collective bargaining was supposed to provide the major impetus for improving work conditions. However, the situation has changed dramatically in the last couple of decades. As politicians and judges have realized that worker self-help through unionization is no longer a viable option for the vast majority of the labor force, they have moved to provide governmental help through direct legal regulation of the employment relationship. Actually, I would not date this change in attitude back so far as the enactment of the Equal Pay Act of 1963, the Civil Rights Act of 1964, or the Age Discrimination in Employment Act of 1967,<sup>24</sup> each initially exhibiting a rather discreet anti-discrimination policy. The more searching changes came with the activist affirmative action policies of the early 1970's, as seen both in the judicial interpretation of Title VII and administrative action under Executive Order 11,246,<sup>25</sup> as well as the later enactment of statutes such as the Occupational Safety and Health Act (OSHA) and the Employee Retirement Security Act (ERISA),<sup>26</sup> and comparable initiatives at the state level. The growing judicial willingness to restrict the firing of at-will employees, and even the flirtation of a few judges with some form of "comparable worth" theory of wage discrimination to try to tackle the gender gap in wages, shows how far the law is now prepared to go in scrutinizing management's personnel and pay practices.

I find it rather ironic that the business leaders who decry these government intrusions into the workplace are many of the same people who have vigorously fought the collective bargaining alternative, or who helped defeat the Labor Reform Act, which would have made it somewhat more difficult for other employers to fight off unionization. Just as ironically, union leaders, who should be emphasizing the virtues of their reconstructed market approach to workplace problems, are usually at the forefront of the effort to obtain more and more employment regulation which will benefit non-union workers as much as union members, thus making the union alternative seem less attractive or necessary.

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<sup>24</sup> Equal Pay Act of 1963, Pub. L. No. 88-38, 77 Stat. 56 (codified as amended at 29 U.S.C. § 206 (1982)); Civil Rights Act of 1964, Pub. L. No. 88-352, 78 Stat. 253 (codified at 42 U.S.C. §§ 2000e to 2000e-17 (1982)); Age Discrimination in Employment Act of 1967, Pub. L. No. 90-202, 81 Stat. 602 (codified at 29 U.S.C. §§ 621-634 (1982)).

<sup>25</sup> See Fallon & Weiler, *Firefighters v. Stotts: Conflicting Models of Racial Justice*, 1984 SUP. CT. REV. 1, 10-27.

<sup>26</sup> Occupational Safety and Health Act of 1970, Pub. L. No. 91-596, 84 Stat. 1590 (codified at 29 U.S.C. §§ 651-78 (1982)); Employee Retirement Income Security Act of 1970, Pub. L. No. 93-406, 88 Stat. 832, (codified at 29 U.S.C. §§ 1001-1461 (1982)).

On the merits, I tend to agree with many of the business concerns about modern social regulation of the workplace. Take the comparable worth issue, for example.<sup>27</sup> There is a strong popular perception, with some empirical basis, that traditionally "female" jobs are undervalued and underpaid, although the available empirical evidence does not expose a problem as serious as the popular mythology would have it. This problem is not likely to be left to be solved by the pure "competitive" labor market, even if we wanted to do so. Political pressure for administrative, judicial, and legislative responses at both the federal and state level is slowly building. There is real ground for concern, though, that the kind of regulation contemplated would cause more harm than good. My own research persuades me that the collective bargaining approach exhibited by the recent contract settlement in the City of Los Angeles is much to be preferred to the judicial imposition of new wage scales, as was attempted for the state of Washington. Such an approach will strike a much better balance between the legitimate claims of the workers involved and the threat of economic dislocation to the employer. Serious reflection on this example should evoke somewhat greater appreciation for the New Deal preference for collective bargaining as the primary instrument for preserving and reshaping the operation of our decentralized, pluralistic labor market.

## VI. STRATEGIES FOR REFORMING THE NLRA

If we recognize that union representation is gradually being squeezed out of the private sector of our economy, and if we believe that collective bargaining is an institution worth saving, the next question is whether and how we might change our labor laws in order to accomplish that latter goal. I shall not canvass in detail any particular proposals, having done so at length elsewhere.<sup>28</sup> Rather, I shall sketch some alternative strategies for labor law reform that provide some perspective for appraising particular suggestions.

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<sup>27</sup> See P. Weiler, *The Uses and Limits of Comparable Worth in the Pursuit of Pay Equity for Women* (1985) (unpublished manuscript) (canvasses the "comparable worth" issue in depth).

<sup>28</sup> See, e.g., Weiler, *Promises to Keep*, *supra* note 3, at 1804-22; Weiler, *Striking a New Balance*, *supra* note 3, at 404-19.

### A. *The Regulatory Model*

I shall refer to the traditional American strategy, exemplified in the variety of specific proposals in the abortive Labor Reform Act of the late 1970's, as the *regulatory* model. By this term, I mean the effort to specify by law certain undesirable forms of behavior and then to enforce legal prohibitions against them. For reasons given earlier, one would hardly give much priority in labor law reform to adding new substantive rules of behavior in the representation campaign. This is not to deny that, to take one favored reform proposal, an intuitively plausible and empirically supportable case can be made for giving unions some right of access to the plant to reply to the employer in the campaign (especially if we were to move, as I think we should, toward major deregulation of the content of the campaign). But what proponents of this feature of the Labor Reform Act never really explained was how the Board could possibly enforce such an ambitious new "right" when the Act has so miserably failed to contain crude and obvious employer coercion during the campaign. Ultimately, the focus of any regulatory approach to labor law reform must be on improving the implementation of the current rules, not on adding new ones.

The essential task is to enhance the speed and the effectiveness of NLRB remedies for violations of the Act. I have two favorite candidates for reform. First, the law should allow automatic NLRB petitions for immediate interim federal injunctions, especially against serious forms of misconduct under the Act. Like the majority in Congress who supported the Labor Reform Act, I would target in particular discriminatory discharges during the representation campaign and the negotiation of the first contract. The key is to obtain reinstatement within the short month or two that the employee would realistically be able to take advantage of this remedy, and, not incidentally, to get this union supporter back in the plant at a time when an employer which has violated the Act would thereby suffer a considerable set-back in its continuing contest with the union.

Still, I am pessimistic about the ability even of the federal courts to regularly and successfully implement the in-kind remedy of reinstatement, let alone the much more delicate instrument of the *Gissel* bargaining order<sup>29</sup> (and certainly not the new

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<sup>29</sup> NLRB v. *Gissel Packing Co.*, 395 U.S. 575 (1969).

Canadian remedy of first contract arbitration after egregious bad faith bargaining). Thus, the regulatory approach needs an additional provision entitling the union to sue on behalf of itself and the bargaining unit for at-large damages for an employer's willful denial to its employees of their right to union representation and good faith bargaining. This proposal for civil damage suits maintains the statute's traditional focus upon reparative rather than punitive measures. However, it would remove the artificial constraint limiting the scope of the legally-cognizable harm suffered by the employees to backpay. Instead the community, speaking through the jury, should hear of the employer's entire pattern of behavior throughout the campaign,<sup>30</sup> and then be able to award the level of monetary redress appropriate for the denial of this group of workers' federal rights. I might add in passing that a reform strategy such as this concedes defeat for the New Deal commitment to the administrative over the judicial process. Rightly or wrongly, even fifty years after its creation, we simply are not prepared to entrust the NLRB with the minimal tools necessary to enforce the NLRA.

Some might question the legitimacy of enlisting the federal judiciary to fight employers' anti-union tactics. Perhaps a sufficient response is that this scheme is essentially the remedial strategy adopted by the Congress in 1947 to enforce Taft-Hartley's new ban on the secondary boycott, which was seen as an especially abusive union tactic for the coercive "top-down" organizing of workers. If we really believe what the Wagner Act says, that employer intimidation of its employees in their decision about union representation is equally indefensible, then it is hard to see what principled arguments can be made against the adoption of comparable measures for enforcing the employer's legal obligations during the campaign.

### B. *The Environmental Model*

Nevertheless, there are important differences in practice, if not in principle, between the law's ability to control union tactics such as the secondary organizational boycott and its ability to regulate the various forms of employer coercion and discrimination. Any one case of anti-union retaliation is inherently more

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<sup>30</sup> See, e.g., *United Dairy Association*, 257 N.L.R.B. 772 (1981); *Conair Corp.*, 261 N.L.R.B. 1189 (1982).



difficult to detect in the flow of management decisions made in a plant where life and work must go on during the campaign. As well, in aggregate terms, illegal employer action has now reached such dimensions that any new judicial remedies would likely be overwhelmed, rendering them ineffective from the outset.

Thus, though these two key implications of the regulatory model law are necessary, they are far from sufficient. If we are serious about saving the institution of private sector collective bargaining, we shall have to think considerably more unconventional thoughts about labor law and its reform. In particular, we shall have to step outside our traditional regulatory mind-set and pursue what I call, for want of a better term, the *environmental* approach.

What I mean by this can be put quite simply. The NLRA assumes the desirability of a vigorous representation campaign between employer and union, followed by hard bargaining about the first contract. Because each of these contests engenders strong incentives to use questionable tactics to win the struggle, the law establishes legal counter-incentives to try to reduce the incidence of such behavior and to repair any damage done whenever it does occur. While the legal system can and should do a considerably better job on the latter score, there are intractable limits to what labor law can so accomplish. In effect, the help which the government can bring to fledgling bargaining units of employees struggling for union representation too often comes too little and too late. Thus, we need to restructure the underlying environment both to reduce the employer's initial incentive to engage in illegal action, and also to enhance the ability of workers to help themselves when it occurs. Needless to say, any such steps require a major rethinking of some entrenched assumptions of American labor law. Here I will describe briefly some specific details of what I have in mind.

### 1. Eliminate the Representation Campaign

My favorite illustration of this theme is drawn from Canadian labor law: the elimination of the pitched representation campaign. I would not, however, recommend the standard Canadian technique of certifying unions solely on the basis of a majority of workers signing union membership cards and paying minimum initiation fees. Instead, I prefer an immediate representa-

tion vote, after a petition from a union that has already signed up more than a majority in the unit. In British Columbia, for example, the provincial labor board now conducts representation elections ten days after receipt of the union's petition, and unions are winning roughly 80% of these votes. More importantly for our purposes, because firms have little opportunity to engage in discharges or other coercive tactics, the relative incidence of this behavior in British Columbia (and elsewhere in Canada) is only a fraction of what it is in the United States. This experience also provides an ironic but telling index of the different attitudes towards labor law in our two countries. When this new voting procedure was enacted in British Columbia last year, critics in Canada assailed it as a retrograde, anti-union step by a right-wing Social Credit government. As someone who has advocated this step for the last several years on both sides of the border, I can only reiterate my position that this step is a justifiable one to take for any government, whatever its political stripe.

## 2. Enhance the Right to Strike for a First Contract

I have always felt comfortable with a truncated representation contest, in part because I view the certification of a trade union as having comparatively little practical significance; basically, certification simply licenses the union to sit down with the employer at the bargaining table to try to hammer out a contract. When disagreement and deadlock occur, as almost invariably will happen in any relationship where the employer would have fought the union in a long campaign, a system of free collective bargaining means that the union has to persuade the work force to go on strike in order to win a better offer from their employer. That willingness to strike is the real "laboratory test" of whether a unit of employees actually wants to have collective bargaining or not. While that may allay our concern about easing the certification decision, it simply raises the next question of how the unit can get a first contract from an employer which may be prepared to wage a fierce struggle for a union-free shop by stonewalling at the bargaining table.

Any solution to this problem must respect and maintain the basic principle of free collective bargaining: that the parties themselves, and not the state, are entitled to shape and agree to the terms of their contract. There are, however, steps which

the law can and should take to enhance this principle of freedom of contract. In particular, it should give some real-life force to the exercise of the right to strike by smaller, weaker units, so that these workers can have some actual influence upon the contract to which they must formally agree. As I have argued in detail elsewhere, I would try to achieve this result by guaranteeing that strikers who have been replaced would have the right to get their jobs back after the strike is over. I would also permit strikers to ask other *workers* not to handle the struck product if the employer continues to operate during the strike (just as the Supreme Court held in *Tree Fruits* that strikers were entitled to ask *consumers* not to buy the struck product).<sup>31</sup>

I am aware, of course, not only that these proposals are quite controversial, but also that they raise serious issues that I am unable to address here with the care they deserve. I do want to add this general observation about the “environmental” strategy for labor law reform. Ultimately, this approach stems from a marked skepticism about what the law can accomplish in the often turbulent world of labor relations. Inevitably, we must establish some priorities in the use of our legal resources, and not dissipate them in the pursuit of relatively marginal problems, such as inaccurate campaign literature. Even as to the more serious problems like discriminatory discharges, we must avoid placing too much emphasis on purely legal measures to curb them. The better alternative is to imagine ways of subtly reshaping the setting in which such illegitimate behavior occurs, in the hope of producing a more satisfactory equilibrium between private employer action and employee reaction. In this respect, an environmental approach resembles the attempt by the Wagner Act itself to facilitate the exercise of private countervailing power in collective bargaining to solve the problems of the labor market.

## VII. THE USES OF FEDERALISM IN LABOR LAW REFORM

The inevitable response to this thesis is to characterize it as political “pie in the sky”. If the combination of a Democratic President and Democratic Congress could not pass the modest package contained in the Labor Reform Act of the late seven-

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<sup>31</sup> NLRB v. Fruit and Vegetable Packers Local 760, 377 U.S. 58 (1964).

ties, how could one even contemplate the enactment of the more sweeping changes under the current political climate.<sup>32</sup> One response is that no reform of the National Labor Relations Act will occur in the 1980's, whether modest or major, pro-employer or pro-union. Thus, the task of the scholar is to return to fundamentals, to develop the case for more profound but more worthwhile changes which practical politicians could consider when labor law reform returns to the political agenda. But this answer is too easy. One can say some significant things about the process as well as the substance of legal change. I shall touch briefly on one such theme, namely the potential virtues of federalism for labor law reform.

For me, at least, the source of that lesson is again the Canadian experience. From the mid-1930's through the mid-1960's, Canadian labor legislation was largely derivative of American laws. During the last two decades, however, Canada has experienced a remarkable burst of innovation, while American labor law has been becalmed.<sup>33</sup> One reason for this activism north of the border is that constitutional federalism in Canada leaves the provinces primarily in charge of labor-management relations. For example, Ontario controls its auto and steel industries and British Columbia its forest product and mining industries. That large responsibility has given provincial governments both the opportunity and the incentive to act, in Brandeis's phrase, as "laboratories for social experimentation" in labor law. Each jurisdiction can try out innovative ideas within its borders. If they are successful others can adopt them. For example, first contract arbitration was first used in British Columbia and then adopted in Quebec, while expedited representation votes were initially tried out in Nova Scotia and recently implemented by British Columbia. Thus, while I think there is a characteristically "Canadian" approach to labor law, it comes not from a single statutory framework imposed by the central government, but rather from the eleven governments across the country grappling with their common problems, and learning from each other what is useful and worth emulating, and what is unhelpful and needs discarding.

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<sup>32</sup> See T. EDSALL, *THE NEW POLITICS OF INEQUALITY* (1984) (especially Ch. 4, Labor Unions and Political Power).

<sup>33</sup> See generally P. WEILER, *RECONCILABLE DIFFERENCES: NEW DIRECTIONS IN CANADIAN LABOR LAW* (1980).

Needless to say, there is nothing un-American about the uses of federalism. Indeed, for the last two decades the United States has experienced essentially the same creative experimentation by state governments in public sector labor law, which does not come under NLRA jurisdiction. Such state activity has not been possible, though, in the private sector, where the NLRA occupies practically the entire field.<sup>34</sup> Of course, the NLRB has always had the authority to decide how much of its sweeping constitutional/statutory jurisdiction it will exercise. Since the 1950's, the bulk of its jurisdictional requirements have been expressed in monetary terms. Unfortunately, Congress froze the nominal dollar value of these jurisdictional thresholds in the *Landrum-Griffin* Act of 1959.<sup>35</sup> Twenty-five years of inflation have produced a gradual but continuous creep in the Board's jurisdiction; now the cut-off points are only one-third of their original level. Those few commentators who have noted this phenomenon have done so primarily to lament its effect on the burgeoning caseload of the Board and thus on the efficient functioning of the national administrative apparatus. I suggest that a more subtle, perhaps more important, consequence is that this phenomenon has removed almost all prospects for state responsibility and innovation in private sector labor law.

Consider this very different approach. The basic thresholds for NLRB jurisdiction would be raised sharply, not just to restore the real values as of 1959, but to lift them even higher (and I would express them in terms of a minimum number of employees rather than the firm's volume of business). These broader exclusions from the NLRA, however, would be available only in states that have enacted private sector labor laws giving workers the right to choose union representation and bargaining. Aside from the caveat that the states must act in some manner, I would leave them entirely free as to how they define and protect that right. In effect, the states would resume the responsibility for labor law and labor relations in the small business sector.<sup>36</sup> The challenge, to those states which were so

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<sup>34</sup> Actually, there is one important exception which stems from the exclusion of farm workers from the NLRA. This exclusion permitted California to enact its Agricultural Labor Relations Act, which has successfully used many of the innovations proposed in the abortive Labor Reform Act: a right of union access to workers on the employer premises, expedited representation votes, and "make whole" remedies for bad faith.

<sup>35</sup> 29 U.S.C. § 164(c)(1) (1982).

<sup>36</sup> Firms with less than twenty-five employees employ fully 35% of the private sector labor force. These workers are paid considerably less and enjoy far fewer benefits than their counterparts in bigger companies, but only 6% of them are now unionized.

inclined, would be to devise more effective ways of protecting the right of their workers to have collective bargaining if that is what they want.

The trade union movement and its supporters will immediately respond that far too many states would not be so inclined. Can you imagine, they ask, what kind of labor law would be passed in North Carolina or in Utah? Ever since the passage of the Wagner Act, unions have felt that they must rely on the congressional delegations from New York or California, for example, to secure national legal standards that both extend their benefits to workers in the more conservative states, and protect those in the more progressive states from being "whip-sawed" by mobile capital seeking the weakest levels of labor legislation.

Whatever may have been true thirty years ago, though, the current trends in employer resistance to union organization are not appreciably better in the north than in the south. To the extent that the law is a factor, the political fact of life is that senators from states such as Utah and North Carolina will block even modest federal labor reform. In the representation area, at least, our national labor law is now the lowest common denominator, not the progressive standard. In their current straits, union leaders no longer have the luxury of defending the federalism shibboleths of the New Deal. In my own view, if there is any prospect at all of breaking the political logjam over serious labor law reform, it is to be found in certain state capitals, not in Washington, D.C.

### VIII. CONCLUSION

When I look back on my analysis in this Policy Essay, and on the research I have done on this subject during the last three to four years, I am struck by the conclusions to which my argument has taken me. If labor law is really to make good on its promise to American workers that they can enjoy union representation if that is their wish, we shall have to rely more on the states than on the national government, on the judicial rather than the administrative process, and on collective self-help by employees rather than legal help from the government. Taken together, these principles would seem to form the basis for a possible Republican platform for labor law reform; that is a final ironic commentary on the current state of the Wagner

Act, one of our most important legal legacies from the Democrats' New Deal.

Even as unconventional an approach to labor law reform as I have suggested here is by no means enough, though. The union movement itself needs to undergo some profound self-reflection and self-renewal. Along one front, in its dealings with employers, such a change of course seems to be well underway. Union leaders generally recognize in the 1980's that they have to be much more realistic in scrutinizing and adjusting the contract standards and bargaining practices inherited from the 1950's, where these no longer fit with new technology or new competition.<sup>37</sup> Such a change in attitude is needed not only to protect the jobs of current union members, but also to allay somewhat the concerns of employers that lead them to strongly resist the spread of collective bargaining into non-union plants. I might add that the more astute union leaders have attempted to trade such economic concessions for some form of "neutrality clause": a provision that seeks to respond to some of the ailments of the NLRA by, in effect, "contracting out" of the statute.<sup>38</sup>

While I have dwelt here on the phenomenon of employer resistance under the Act, I do not want to leave the impression that this is anywhere near the whole story of the decline of private sector union representation. This is the part which lawyers tend to see, especially in its pathological form; after all, these are the cases which come within the purview of the NLRB after a union has been successful in an initial organizing drive. In fact, from the mid-1950's through the mid-1970's, union success in organizing out in the field did continue to increase (at least as measured by the growth in NLRB representation elections, which nearly doubled in number between 1955 and 1975), while the union yield from these organizing drives, in the form of new certifications and first contracts, was sharply diminishing. For the last several years, however, the number of union petitions to the Board has also dipped markedly, thereby compounding the overall problem.<sup>39</sup> To some extent, I am sure, the

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<sup>37</sup> See, e.g., the new contract negotiated by the United Auto Workers for General Motors's new Saturn Project.

<sup>38</sup> See Guzick, *Employer Neutrality Agreements: Union Organizing Under a Non-adversarial Model of Labor Relations*, 6 INDUS. REL. L.J. 421 (1984).

<sup>39</sup> See Dickens and Leonard, *Accounting for the Decline in Union Membership, 1950-1960*, 38 INDUS. & LAB. REL. REV. 323 (1985).

drop in union organizing is due to the economic downturn during this same period, with its concomitant effects on both union resources and on the willingness of workers, faced with double-digit unemployment, to take their chances with collective bargaining. But it is probably also due to the inability of many unions to evoke a sufficiently responsive chord among unorganized workers. To the extent the latter is true, unions must take actions that will make themselves more attractive to American workers.

I shall make only a few brief observations about one line of analysis of this problem. Polls indicate that there is a sizeable but as yet untapped pool of worker sentiment for union representation. Other evidence suggests that this sentiment is due not so much to dissatisfaction with current wages and benefits as to more subtle objections to the way that individual workers are treated by their supervisors, and to the lack of employee influence in the workplace. But although concerns such as these can motivate workers to look for alternative forms of protection and voice, they are no guarantee that union representation will be the route actually taken. I suspect that one reason for the reluctance to follow the union route is the widespread feeling that employees will face some of the same risk of arbitrary treatment at the hands of union officials as from management, and that union members do not have significantly more democratic input into the actions of their union than of their employer. These feelings may or may not accurately reflect the typical conduct of union affairs; the polls do show a high level of satisfaction on the part of current members with the operation of their own unions.<sup>40</sup> But the *existence* of these feelings, which reflect certain well-publicized real-life incidents, is as important as their *truth*.

If these observations are correct, American unions must think seriously about some very substantial changes in their mode of governance, such as more widespread adoption of constitutional mechanisms such as the Public Review Board of the United Auto Workers. Such action is warranted not only because we have a right to expect better guarantees of protection and participation from trade unions, whose *raison d'etre*, after all, is to

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<sup>40</sup> See *supra* note 6 and accompanying text.



ensure fair treatment and employee voice in the workplace.<sup>41</sup> Rather, dramatic steps such as these are necessary to persuade the American people, and the politicians whom they elect, that union representation is a sufficiently worthwhile institution to once again merit the kind of legal lifeline which it received in the Wagner Act fifty years ago. Otherwise, I fear, fifty years from now there will be few union supporters left to celebrate the centennial of our national labor law.

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<sup>41</sup> I do not mean to downplay the difficulties many unions now face in displaying both economic restraint towards management and democratic accountability towards their membership. For a sustained argument that the latter value should always trump the former, see Hyde, *Democracy in Collective Bargaining*, 93 YALE L.J. 793, 833-54 (1984).



# ARTICLE

## COLD POWER: ENERGY AND PUBLIC HOUSING

STEVEN FERREY\*

*The Department of Housing and Urban Development (HUD) provides assistance to the poor in meeting their energy needs through a number of federal programs. The United States Housing Act of 1937 created a regulatory scheme whereby the federal government provides utility allowances to local Public Housing Authorities (PHAs). In 1984, HUD promulgated regulations which granted PHAs the authority to establish utility allowances independent of any federal standards. Energy inefficiency and waste, however, continue to plague the vast public housing sector, compounding the burden imposed upon the poor by the general rise in energy costs of the last decade.*

*In this Article, Professor Ferrey reviews the history of public housing energy regulations and argues that they have actually contributed to the present energy inefficiency of the public housing stock. He also details recent litigation by public housing tenants to increase the utility allowances provided to them by HUD. Finally, Professor Ferrey proposes an innovative program of action whereby PHAs may exploit the recent HUD deregulation of utility allowances to finance the investments necessary to increase energy efficiency in public housing.*

In the last decade regulatory tremors shook public housing. Increasing energy costs caused major aftershocks in public housing in more than 2000 communities across the country. When the tremors ceased, after executive, legislative and judicial intervention, the policy edifice of public housing was permanently altered.

Trapped in inefficient dwellings and equipped with inefficient appliances, the poor continue helplessly to endure skyrocketing energy costs, while their financial resources to meet these increased expenses have not kept pace.<sup>1</sup> For more than 3 million tenants in 1.2 million public housing units,<sup>2</sup> the past decade exposed technological and policy-related errors which were set in the very foundations of public housing. These errors were compounded by subsequent administrative missteps.

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<sup>1</sup> See Ferrey, *Solar Banking: Constructing New Solutions to the Urban Energy Crisis*, 18 HARV. J. ON LEGIS. 483, 501-04 (1981).

<sup>2</sup> See *infra* notes 5-8 and accompanying text.

Recent regulatory changes have unexpectedly created opportunities to remedy some of the damage of the past decades and to plan for the future. Local public housing authorities are in a unique position to take advantage of these regulations, as well as technological improvements in energy efficiency and creative financing, to greatly improve this essential aspect of public housing.

This Article compares the past and present structures of public housing regulations which govern energy efficiency. Part I presents the background of energy costs and tenant demographics in public housing. Part II examines the federal attempt to regulate the construction and thermal quality of public housing over the last three decades. Part III examines federal regulation of meter conversions and fuel choices, as well as the judicial limitations placed upon the resulting administrative discretion. Part IV analyzes the complex federal-local interrelationship which forms the framework for public housing energy regulation—including subsidies, performance incentives, and appliance procurement practices. Part V analyzes the utility allowance link between local public housing authorities and tenants, and explores the impact of federal regulatory changes on this relationship. Finally, Part VI offers innovative strategies to public housing authorities for financing energy efficiency improvements in the current regulatory environment.

A new regulatory system has emerged to deal with public housing energy use. Regardless of whether this federal policy change was intentional or inadvertent, it offers an opportunity to improve dramatically future energy efficiency in the vast public housing sector.

## I. FOR WHOM THE BILL TOLLS: ENERGY COSTS IN PUBLIC HOUSING

It is the best of times; it is the worst of times. Amid the cornucopia of American abundance, the poor face difficult energy choices. There are 12.3 million American households living on incomes below the federal Office of Management and Budget poverty guidelines; 16.2 million households' incomes fell below the U.S. Department of Labor lower living standard;<sup>3</sup> and

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<sup>3</sup> In 1985, the federal poverty level was \$5250 for a single person and \$10,650 for a family of four. 50 Fed. Reg. 9518 (1985). Any methodological determination is further

19 million households' incomes are below 150 percent of the federal poverty level.<sup>4</sup> Therefore, depending on the measure used for calculation, between thirteen percent and eighteen percent of all American households are living at or near the poverty level. More than half of the poor are children and about thirty-five percent of poor households are headed by elderly persons.<sup>5</sup>

A significant number of poor households receive assistance from the federal government to meet their housing needs. For example, the Department of Housing and Urban Development (HUD) administers a public housing program through which 1.2 million poor households live in dwellings directly owned and subsidized by the government.<sup>6</sup> These household units provide housing to about 3.4 million individuals in 9900 separate housing projects located in roughly 2300 communities across the nation.<sup>7</sup> As the largest identifiable block of federally-assisted housing serving the poor, public housing represents almost twenty percent of the low-income rental housing stock.<sup>8</sup>

Although the figures vary widely depending upon the region of the country, the heating requirements of the climate, and the type of heating fuel consumed by the poor household, the poor spend at least fifteen percent of their incomes on residential energy alone.<sup>9</sup> A comparison with similar figures for the general population is startling. One study indicates that the general population devotes 5%–10% of their income to household energy requirements, while the poor devote 25%–40% of their income

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complicated by problems with the statistical base. Data on household income derived from U.S. census data is itself inherently limited and incomplete. U.S. CONGRESS, OFFICE OF TECHNOLOGY ASSESSMENT, ENERGY EFFICIENCY OF BUILDINGS IN CITIES 154 (1982) [hereinafter cited as OTA].

<sup>4</sup> National Consumer Law Center, *Cold—Not by Choice: A State-by-State Analysis of the Impact of Energy Prices on the Poor, Elderly, and the Unemployed* 14 (Apr. 1984) (available from the National Consumer Law Center, Washington, D.C.) [hereinafter cited as *Cold—Not By Choice*].

<sup>5</sup> U.S. BUREAU OF THE CENSUS, CHARACTERISTICS OF THE POPULATION BELOW THE POVERTY LEVEL: 1977, CURRENT POPULATION REPORTS, SERIES P-60, NO. 922, at 189, 194 (Mar. 1979); E. Grier, *Colder . . . Darker: The Energy Crisis and Low-Income Americans* 3 (1977) (prepared for the Community Services Administration) (available from the Grier Partnership, Bethesda, Md.).

<sup>6</sup> OTA, *supra* note 3, at 154.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* In addition, the Department of Housing and Urban Development (HUD) assists private market housing under such programs as the Section 8 Housing Assistance Payments Program, 42 U.S.C. § 1437f (1982), 24 C.F.R. §§ 882.101–606, the Section 202 program, 12 U.S.C. § 1701q (1982), and other programs.

<sup>9</sup> OTA, *supra* note 3, at 144. Other estimates are higher. *See infra* notes 10–11.

to the same expenditures.<sup>10</sup> In the poorest households, household energy costs consume 30%–50% of total family income.<sup>11</sup> Low-income families using electric heat or air conditioning face even greater costs.<sup>12</sup> Thus, the percentage of income devoted to household energy consumption by the poor ranges from almost 200 percent to more than 300 percent of that percentage devoted by higher income groups in the population.<sup>13</sup>

Energy price increases alone account for a major portion of the financial shortfall experienced by low-income families. Energy prices have risen faster than the cost of living during the past decade:<sup>14</sup> electricity prices have nearly tripled, natural gas prices have increased four-fold, and fuel oil prices have increased by a factor of six.<sup>15</sup> During the same period, the consumer price index increased roughly 120 percent.<sup>16</sup> This energy cost escalation burden falls more heavily on the poor than on the general population.<sup>17</sup> A Congressional staff study calculates that the poor lost almost \$15 billion in purchasing power due to increased energy prices between 1979 and 1981 alone.<sup>18</sup>

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<sup>10</sup> *Hearings on Review of Federal Policies and Buildings Standards Affecting Energy Conservation in Housing Before the Subcomm. on Hous. and Community Dev. of the House Comm. on Banking, Fin., and Urban Affairs*, 98th Cong., 2nd Sess. 34 (1984) (statement of Mark Cooper, former President of the Consumer Energy Council of America, speaking on behalf of the Council).

<sup>11</sup> *Hearings on the Economics of the President's Proposed Energy Policies Before the Joint Economic Comm.*, 95th Cong., 1st Sess. 22 (1977) (statement of Lester Thurow, Prof. of Economics at the Mass. Inst. of Technology); The Grier Partnership, *High Fuel Oil Prices: The Impact on Low-Income Households* 16 (1978) (available from The Grier Partnership, Bethesda, Md.).

<sup>12</sup> E. Vine & S. Gold, *Low-Income Households and Energy Use in California* 12 (Mar. 1985) (available from Lawrence Berkeley Laboratory, Univ. of Cal., Berkeley, Cal.) (citing customer data of the Pac. Gas & Elec. Co.). Vine and Gold's data is from 1983 customer data by income of the Pacific Gas & Electric Co. in California and from 1979 data of the San Diego Gas & Electric Co. in California.

<sup>13</sup> OTA, *supra* note 3, at 144; *see also* E. Vine & S. Gold, *supra* note 12, at 19, 21–22.

<sup>14</sup> *See* U.S. BUREAU OF THE CENSUS, *STATISTICAL ABSTRACT OF THE UNITED STATES* 482, Nos. 803, 807 (105th ed. 1985) [hereinafter cited as *STATISTICAL ABSTRACT*].

<sup>15</sup> During the period 1979–1983, the decontrol of domestic oil prices and the phased deregulation of natural gas prices allowed prices of these fuels to rise to higher levels. *See generally* Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301–3432 (1982).

<sup>16</sup> *See* *STATISTICAL ABSTRACT*, *supra* note 14, at 476, No. 791.

<sup>17</sup> E. Vine & S. Gold, *supra* note 12, at 12; S. Ferrey, et al., *Energy Conservation and the Poor 2–3* (1983–1984) (unpublished report) (on file at HARV. J. ON LEGIS.); E. Grier & G. Grier, *Poor + Old = Cold 1* (Apr. 1981) (report to the Nat'l Council of Senior Citizens, Inc.) (available from The Grier Partnership, Bethesda, Md.).

<sup>18</sup> *Impact of Energy Prices on the Poor: Hearings Before the Subcomm. on Fossil and Synthetic Fuels of the House Comm. on Energy and Commerce*, 97th Cong., 2d Sess. 272 (1982) (Staff of the Subcomm. on Investment, Jobs, and Prices of the Joint Economic Comm., *Oil Price Decontrol and the Poor: A Social Policy Failure*).

The impact of energy price increases on the unemployed and the elderly is particularly severe.<sup>19</sup> In thirty-five states, single-person elderly households receiving Supplemental Security Income (SSI) during the winter of 1984 had less than \$50 per week to spend on basic necessities after paying their household energy bill.<sup>20</sup> In forty-seven states, an elderly SSI recipient had less than \$61 left per week from her SSI check after paying winter heating bills.<sup>21</sup>

In thirty-two states, families with unemployed breadwinners had 1984 winter energy bills which consumed all but \$100 per week of the average unemployment compensation benefit to the household.<sup>22</sup> In sixteen states, families with unemployed breadwinners had less than \$75 per week to pay for all non-energy expenses necessary to support a family.<sup>23</sup> These cold realities for both SSI recipients and the unemployed are displayed in Table 1.<sup>24</sup>

The rising and often seemingly uncontrollable costs of household energy burden both tenants and building managers. In 1983, more than 4.7 million people in 1.6 million households had their natural gas service terminated because they failed to pay their gas bills.<sup>25</sup> Between 1981 and 1984, the amount of money owed but unpaid by consumers to gas utilities tripled; almost 5 million households in 1984 were sixty days or more in arrears on payment of their natural gas bills.<sup>26</sup> The problem is especially severe for the poor, even though they consume a "market basket" of commodities forty-five percent less energy intensive than the general population<sup>27</sup> and use less energy than the general population.<sup>28</sup>

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<sup>19</sup> Approximately 35% of public housing units are occupied by elderly households; most of the remainder of the units do not have full-time employed heads-of-household. U.S. DEP'T OF HOUS. AND URBAN DEV., STATISTICAL YEARBOOK 221-22 (1978). In many cases, government assistance is the only income realized by public housing tenants.

<sup>20</sup> Cold—Not By Choice, *supra* note 4, at 2. This 1984 study corroborates the findings of an earlier 1983 report: R. Saul, E. Grier & G. Grier, Out in the Cold: The Expected Impact of Rising Natural Gas Prices on the Poor, Elderly, and Unemployed (Jan. 1983) (available from the Nat'l Consumer Law Center, Washington, D.C.).

<sup>21</sup> Cold—Not By Choice, *supra* note 4, at 2.

<sup>22</sup> *Id.* at 1.

<sup>23</sup> *Id.*

<sup>24</sup> Table 1 is taken from Cold—Not By Choice, *supra* note 4, at 10, 12.

<sup>25</sup> National Consumer Law Center, Homes Without Heat: A Nationwide Study of Disconnected Natural Gas Users 1 (Oct. 31, 1984) (available from the Nat'l Consumer Law Center, Washington, D.C.) [hereinafter cited as Homes Without Heat].

<sup>26</sup> *Id.* at 1-2.

<sup>27</sup> E. Vine & S. Gold, *supra* note 12, at 2.

<sup>28</sup> *Id.* at 12 (the poor household consumes 49% of the household energy consumption of the average income household); OTA, *supra* note 3, at 145-46, Table 49.

**Table 1**  
*SSI Benefits, Unemployment Benefits and Low-Income Energy Expenditures*

	<i>SSI BENEFITS</i>			<i>UNEMPLOYMENT BENEFITS</i>		
	<i>Max. Mo. SSI Benefit—Single Elderly</i>	<i>% Spent for Energy in Winter Months</i>	<i>Amt. Left Each Wk. in Winter</i>	<i>Avg. Mo. Benefit</i>	<i>% Spent for Energy in Winter Months</i>	<i>Amt. Left Each Wk. in Winter</i>
Alabama	\$304	34.9%	\$46	\$380	27.9%	\$ 63
Arizona	\$304	22.1%	\$55	\$439	15.3%	\$ 86
Arkansas	\$304	40.2%	\$42	\$418	29.3%	\$ 68
California	\$461	11.5%	\$94	\$476	11.1%	\$ 98
Colorado	\$364	28.7%	\$60	\$672	15.6%	\$131
Connecticut	\$471	41.2%	\$64	\$557	34.8%	\$ 84
Delaware	\$304	52.9%	\$33	\$456	35.3%	\$ 68
Dist. of Col.	\$319	47.0%	\$39	\$643	23.3%	\$114
Florida	\$304	18.8%	\$57	\$409	14.0%	\$ 81
Georgia	\$304	34.4%	\$46	\$429	24.4%	\$ 75
Idaho	\$387	33.0%	\$60	\$508	25.1%	\$ 88
Illinois	\$315	45.2%	\$40	\$595	23.9%	\$104
Indiana	\$304	44.6%	\$39	\$390	34.0%	\$ 59
Iowa	\$304	46.6%	\$37	\$582	24.4%	\$102
Kansas	\$304	36.8%	\$44	\$560	20.0%	\$103
Kentucky	\$304	43.6%	\$40	\$460	28.9%	\$ 75
Louisiana	\$304	30.8%	\$49	\$687	13.6%	\$137
Maine	\$314	71.4%	\$21	\$472	47.6%	\$ 57
Maryland	\$304	51.4%	\$34	\$426	29.7%	\$ 85
Massachusetts	\$433	43.8%	\$56	\$543	35.0%	\$ 81
Michigan	\$327	44.8%	\$42	\$634	23.1%	\$113
Minnesota	\$339	55.7%	\$5	\$609	31.0%	\$ 97
Mississippi	\$304	33.9%	\$46	\$383	26.9%	\$ 65
Missouri	\$304	37.3%	\$44	\$399	28.4%	\$ 66
Montana	\$304	37.7%	\$44	\$565	20.3%	\$104
Nebraska	\$397	33.3%	\$61	\$412	32.1%	\$ 65
Nevada	\$341	26.3%	\$58	\$530	16.9%	\$102
New Hampshire	\$331	67.1%	\$25	\$448	49.6%	\$ 52
New Jersey	\$331	52.7%	\$36	\$557	31.4%	\$ 88
New Mexico	\$304	33.5%	\$47	\$490	20.8%	\$ 90
New York	\$365	50.0%	\$42	\$509	35.9%	\$ 75
N. Carolina	\$304	40.7%	\$42	\$474	26.1%	\$ 81
N. Dakota	\$304	57.7%	\$30	\$581	30.2%	\$ 94
Ohio	\$304	43.4%	\$40	\$594	22.2%	\$107
Oklahoma	\$373	33.8%	\$57	\$586	21.5%	\$106
Oregon	\$306	32.5%	\$48	\$553	18.0%	\$105
Pennsylvania	\$337	45.6%	\$42	\$631	24.4%	\$110
Rhode Island	\$355	49.6%	\$41	\$484	36.4%	\$ 71
S. Carolina	\$304	35.8%	\$45	\$407	26.8%	\$ 69
S. Dakota	\$319	48.9%	\$38	\$512	30.5%	\$ 82
Tennessee	\$304	39.8%	\$42	\$381	31.7%	\$ 60
Texas	\$304	32.1%	\$48	\$594	16.5%	\$114
Utah	\$314	29.9%	\$51	\$561	16.7%	\$108
Vermont	\$354	64.7%	\$29	\$476	48.1%	\$ 57
Virginia	\$304	47.0%	\$37	\$482	29.7%	\$ 78
Washington	\$343	30.3%	\$55	\$607	17.1%	\$116
W. Virginia	\$304	49.5%	\$35	\$616	24.5%	\$107
Wisconsin	\$404	39.9%	\$56	\$581	27.8%	\$ 97
Wyoming	\$324	34.9%	\$49	\$533	21.2%	\$ 97



During the 1970s, energy costs for multifamily apartments more than doubled as a percentage of total operating expenses.<sup>29</sup> Moreover, building operating costs rose 115%–160% while rents rose on the average by only 74%.<sup>30</sup> In public housing, the cash squeeze of utility costs is even more pronounced: during the 1970s, energy costs in public housing rose 400%.<sup>31</sup> For large public housing authorities, 40% of the operating budget is devoted to direct energy costs.<sup>32</sup> In some jurisdictions, 50% of the operating budget is devoted to utility expenses.<sup>33</sup>

The current energy problems in public housing result from the corners cut and pennies saved during construction of these housing projects. The situation has been further complicated by both legislative and administrative missteps over the last decade.

## II. THE PROBLEM'S ORIGIN: FEDERAL ATTEMPTS TO REGULATE CONSTRUCTION AND THERMAL QUALITY

### A. *The Minimum Property Standards*

Energy operating costs for public housing were never a significant factor in construction planning prior to 1973. Most of the public housing stock was constructed when energy was cheap and seemingly inexhaustible, and insulation was not considered a necessity.<sup>34</sup> The federal government maintained a fief-

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<sup>29</sup> OTA, *supra* note 3, at 102, Table 30.

<sup>30</sup> *Id.* at 117.

<sup>31</sup> *Id.* at 154.

<sup>32</sup> W. Sherwood, et al., CLPHA Survey of Energy Consumption in Public Housing Authorities: 1978–1981, Report No. 82-3, at 1 (June 25, 1982) (available from the Council of Large Public Housing Authorities, Boston, Mass.) [hereinafter cited as CLPHA Survey].

<sup>33</sup> *Id.*; P. Levy, N. Rosso & W. Schermer, A Conservation Plan for Public Housing in Philadelphia i (preliminary draft of report prepared for Office of Housing and Community Development, Philadelphia, Pa.) (May 7, 1982).

<sup>34</sup> A survey by the author of the housing stock of the San Francisco Housing Authority found that three-quarters of the units were built prior to 1963, and that the remaining units were built primarily during the succeeding decade. S. Ferrey, HUD Utility Policy: A Critical Examination of Metering Switchover and Project Insulation Alternatives in Public Housing 47 (Sept. 1976) [hereinafter cited as S. Ferrey, HUD Utility Policy] (on file at HARV. J. ON LEGIS.). A moratorium by the Nixon administration in 1973 on new conventional public housing construction halted further building. *Oversight on Housing and Urban Development Programs: Hearings Before the Subcomm. on Hous. and Urban Affairs of the Senate Comm. on Banking, Hous. and Urban Affairs*, 93rd Cong., 1st Sess. 2 (1973) (statement of Sen. John Sparkman (D-Ala.)). Limited funds have subsequently retarded additional construction.

dom of "minimums," which today bear cold legacy to the importance of foresight, planning, and enforcement in federal housing and energy policy. Until 1973, the Federal Housing Administration regulated federally-assisted housing<sup>35</sup> and the Public Housing Administration devised federal property regulations controlling construction of new public housing.<sup>36</sup> HUD consolidated these two agencies.<sup>37</sup> These agencies made several efforts to regulate residential energy use and conservation over the last four decades.

Construction advisories for thermal quality were first issued in 1950.<sup>38</sup> They appeared in the form of informative bulletins concerning the benefits of structural insulation for conservation. These advisories were not binding on local public housing authority (PHA) construction practices.

In 1963 the Public Housing Administration revised its bulletins twice. In May, the Administration "suggested" that local housing authorities might benefit from installing insulation in new construction up to the point where annual fuel savings demonstrate a return on initial investment of eight percent.<sup>39</sup> Although it was a guideline rather than a regulatory requirement, this target figure, if voluntarily followed, would have resulted in a more efficient utilization of building insulation. Two months later, the Administration released another bulletin which announced that "[a]s a guide, [the Public Housing Administration] recommends not over the following loss in BTU per hour per

<sup>35</sup> United States Housing Act of 1937, ch. 896, 50 Stat. 888 (codified as amended at 42 U.S.C. § 1437 (1982)).

<sup>36</sup> Reorg. Plan No. 3 of 1947, 12 Fed. Reg. 4981 (1947), reprinted in 61 Stat. 954 (1947).

<sup>37</sup> Department of Housing and Urban Development Act of 1965, Pub. L. No. 89-117, 79 Stat. 496 (codified as amended in scattered sections of 12, 15, 20, 31, 40 & 42 U.S.C. (1982)).

<sup>38</sup> U.S. PUB. HOUS. ADMIN., THERMAL ENVIRONMENT AND COMFORT: PART I—PLUMBING, HEATING AND VENTILATION, BULL. LR-7 (1950); U.S. PUB. HOUS. ADMIN., THERMAL INSULATION: PART XI—STRUCTURAL DESIGN, MATERIALS AND METHODS, BULL. LR-5 (1950). When the Public Housing Administration published its 1950 advisories, *Thermal Environment and Comfort* and *Thermal Insulation*, they appeared in the form of informative, non-binding bulletins concerning the benefits of structural insulation for energy conservation. Although they suggest cost savings which will result from varying amounts of insulation, these bulletins caution that "as a matter of practical building, insulation should not be overdesigned." *Id.* at A-3. Direct evidence is sketchy, but the opinions of those federal officials who remember local property compliance suggest that, as a matter of practical reality, little energy efficiency in new construction resulted. Interview with Wes LeRond, Energy Specialist, HUD San Francisco Regional Office, in San Francisco (Sept. 1976).

<sup>39</sup> U.S. PUB. HOUS. ADMIN., STRUCTURAL DESIGN, MATERIALS AND METHODS: PART XI—THERMAL INSULATION: GENERAL PRINCIPLES AND ECONOMICS, BULL. LR-5 I (1963).

square foot of living dwelling unit floor area: more than 3 story height buildings, 30; 2 and 3 story, 40; 1 story, 50."<sup>40</sup>

This later revision effectively replaced the suggested eight percent return on investment with concrete guidelines; fuzzy formulae were simplified into exact numbers. Although these guidelines established minimum energy efficiency thresholds, they accomplished little real energy efficiency.<sup>41</sup>

The July 1963 Public Housing Administration guidelines state that in *any* climate, the walls, windows, floor, ceiling and air spaces in the building may lose<sup>42</sup> no more heat into the outside air than the above specified BTUs per hour, multiplied by the dwelling's interior floor area.<sup>43</sup> These standards are almost seventy percent more strict for high-rise design than for low-rise, although high-rise buildings are inherently more heat-energy efficient than low-rise ones.<sup>44</sup> In addition, regardless of the climate within which the dwelling is situated, these standards demand a constant threshold of thermal integrity. When the July 1963 standards are applied to actual PHA buildings and real

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<sup>40</sup> U.S. PUB. HOUS. ADMIN., PLUMBING, HEATING, AND VENTILATION: PART I—THERMAL ENVIRONMENT AND COMFORT, BULL. LR-7 1 (1963) [hereinafter cited as 1963 BULL. LR-7]. One British Thermal Unit (BTU) of energy equals 0.000293 kilowatt hours of electricity or 1/100,000 therm of natural gas. CRC Handbook of Chemistry and Physics, F-298 (R. West 65th ed. 1984-1985). Crude oil, for example, contains 5,800,000 BTU per barrel, coal contains between 6,000–15,000 BTU per pound (depending upon the grade of the coal), and natural gas contains just over 1,000 BTU per cubic foot. CLPHA Survey, *supra* note 32, at app.

<sup>41</sup> See *infra* notes 46–50 and accompanying text.

<sup>42</sup> 1963 BULL. LR-7, *supra* note 40, at 1.

<sup>43</sup> Heat loss occurs through all building surfaces exposed to unheated spaces—windows, walls, ceilings, and floors. The rate of loss through these surfaces is relative to the differential between indoor and outdoor temperatures, the quality of insulation and building materials, and the surface area exposed to the outside. Buildings also lose heat to the exterior via air infiltration, or the passage of air through cracks and gaps around windows, doors, and other openings. The rate of heat loss through air infiltration is relative to the volume of living space as well as to the quality of construction, weatherstripping, caulking, and to the differential between indoor and outdoor temperatures. See generally S. Ferrey, HUD Utility Policy, *supra* note 34.

<sup>44</sup> The rate at which space heating dissipates from a living unit is relative to the difference between indoor and outdoor temperatures, given the quality of insulating materials separating inside from outside. In severe winter climates with low outside temperatures, interior space heating will dissipate more quickly than in warmer climates, unless extra insulation is employed. In high-rise construction, the ceiling heat loss, which is a major component of total heat loss, occurs only on the top level despite the multiple levels of living space. In other words, the first level's ceiling heat loss is the second level's floor heat gain, continuing until the top floor, where ceiling heat loss occurs vertically to the outside. High-rise design also mitigates air infiltration. Therefore, the actual heat loss per unit of a high-rise design is much less than that per unit of a low-rise design, everything else being equal. See S. Ferrey, HUD Utility Policy, *supra* note 34, at 35–36.

climatic conditions,<sup>45</sup> the inadequacy of this single threshold appears clearly:<sup>46</sup>

—In the mild San Francisco climate, the standards require no insulation of *any* type in *any* component (walls, ceiling, floor) of either a low-rise or high-rise building.<sup>47</sup>

—In the severe Chicago winter climate, for a low-rise structure, the standards would require double-glazing, and no more than one inch of insulation in the ceiling.<sup>48</sup> No wall insulation would be required if building materials of average or good thermal quality were used.<sup>49</sup>

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<sup>45</sup> With the assistance of San Francisco Housing Authority staff, the author selected a typical low-rise and a typical high-rise project in the actual housing stock. Architectural blueprints of these two projects were used to determine their exact specifications. The selected representative buildings were:

*Low-Rise:* A three-level two-unit wood frame duplex (known as Lundy's Lane), containing two three-level three-bedroom units of approximately 1330 square feet heated living space each (the ground interior floor area is 850 square feet, the ceiling on the third level is 960 square feet, and gross wall area is 3147 square feet). Assuming 15% window area, there are 472 square feet of window area and 2675 square feet of net wall area. The gross volume of living space is 22,621 cubic feet.

*High-Rise:* A 100-unit 13-floor reinforced concrete building (known as 666 Ellis Street), containing a total of 100 studio and one-bedroom apartments, averaging 653 square feet of heated living space per unit (The lowest heated floor and the ceiling have a floor area of 6693.5 square feet each. The gross exterior wall area is 40,834 square feet). Assuming 15% window area, there are 6125 square feet of window area and 34,709 square feet of net exterior wall area. The total volume of living space is 716,205 cubic feet.

The author selected San Francisco to represent a mild winter climate, and selected Chicago to represent a severe winter climate. San Francisco experiences 3175 Fahrenheit (F.) or 1764 Centigrade (C.) winter degree days (a measure of winter severity). Chicago is rated at 6167 F. or 3426 C. winter degree days. S. Ferrey, HUD Utility Policy, *supra* note 34, at 15, 17.

HUD circulars on heat loss calculations, U.S. DEP'T OF HOUS. AND URBAN DEV., HEAT LOSS CALCULATIONS, FHA G 4940.6 (1973) [hereinafter cited as HEAT LOSS CALCULATIONS], were followed in calculating heat loss under the 1963 HUD standards in the study. S. Ferrey, HUD Utility Policy, *supra* note 34, at 17.

<sup>46</sup> The method of applying the 1963 standards is mathematical transposition using local climate data. Window, floor, and air infiltration heat losses are computed initially from the project blueprints and subtracted from allowable heat loss under the standards. The remainder represents permissible total wall and ceiling heat loss under the standard.

As a simplified generalization, heat loss through any building component (walls, windows, etc.) is a product of the transmission area of the component, multiplied by the relevant heat transmission coefficient for the component, multiplied by the temperature differential between indoor and outdoor temperatures for the climate. HUD's specified methodology of heat loss calculation is followed explicitly. *See* HEAT LOSS CALCULATIONS, *supra* note 45, at app. 5. The complete calculus of this process is performed step by step in S. Ferrey, HUD Utility Policy, *supra* note 34.

<sup>47</sup> S. Ferrey, HUD Utility Policy, *supra* note 34, at 43–45, 47–48.

<sup>48</sup> *Id.* at 46.

<sup>49</sup> *See, e.g.*, HEAT LOSS CALCULATIONS, *supra* note 45, at app. 4, 23.

-In the Chicago climate, for a high-rise structure, wall materials of good thermal quality would not even be necessary.<sup>50</sup> Where insulation was required, materials as minimal as Saran Wrap would suffice.

In 1973, with energy no longer inexpensive, HUD replaced the voluntary guidelines by promulgating regulations with respectable mandatory thermal requirements.<sup>51</sup> The Nixon administration placed a moratorium on new public housing construction,<sup>52</sup> however, and relatively few public housing units have been constructed since 1973.<sup>53</sup> The first effective regulations thus came too late to correct the inefficiencies built into housing already constructed and they were not extensively utilized.

### B. Building Energy Performance Standards

The Energy Conservation and Production Act (ECPA) required the federal government to develop energy efficiency standards for newly-constructed dwellings.<sup>54</sup> In response, the De-

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<sup>50</sup> S. Ferrey, HUD Utility Policy, *supra* note 34, at 47.

<sup>51</sup> U.S. DEP'T OF HOUS. AND URBAN DEV., MINIMUM PROPERTY STANDARDS FOR ONE AND TWO FAMILY DWELLINGS, HANDBOOK 4900.1, § 607-3 (1973); U.S. DEP'T OF HOUS. AND URBAN DEV., MINIMUM PROPERTY STANDARDS FOR MULTIFAMILY HOUSING, HANDBOOK 4910.1, § 607 (1973).

<sup>52</sup> See *supra* note 34.

<sup>53</sup> *Id.*

<sup>54</sup> Energy Conservation and Production Act of 1975, Pub. L. No. 94-385, § 304, 90 Stat. 1125, 1146 (1976) (codified at 42 U.S.C. § 6833 (1982)) [hereinafter cited as ECPA]. ECPA required the federal government to develop and issue BEPS for public comment within three years of ECPA's enactment. 42 U.S.C. § 6833(a)(2) (1982). This three-year period expired August 14, 1979. The federal government missed the issuance date by several months. 44 Fed. Reg. 68,120 (1979) (to be codified at 10 C.F.R. § 435). Final standards were to follow within six months of issuance; implementation of BEPS was required within one year after publication. 42 U.S.C. § 6833(a)(2) (1982). The deadlines could be extended as long as the final standards were delayed no more than a total of six months. *Id.* § 6833(d); see *Hearings on S.2862 Before the Subcomm. on Energy Regulation of the Senate Comm. on Energy and Natural Resources*, 96th Cong., 2nd Sess. (1980) (discussion of issues associated with the building energy performance standards program) [hereinafter cited as *Hearings on S. 2862*].

ECPA also included a \$200 million grant program to permit low-income persons to weatherize their homes, *id.* at §§ 413-22, a \$2 billion loan guarantee program to encourage energy conservation-related investments in public and commercial buildings (which never received appropriated funds), *id.* at § 451, and a \$200 million demonstration program to identify incentives to encourage home owners to make energy conservation investments, *id.* at § 509. The ECPA was one in a series of Congressional energy mandates designed to promote greater efficiency, which included: Energy Policy and Conservation Act of 1975, 42 U.S.C. § 6201 (1982); National Energy Conservation Policy Act, 42 U.S.C. §§ 8201-8378 (1982); Public Utility Regulatory Policies Act of 1978, 16 U.S.C. §§ 2601-45 (1982); Power Plant and Industrial Fuel Use Act of 1978, 42 U.S.C. §§ 8301-8483 (1982); Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301-3432 (1982); Energy Tax Act of 1978 (codified in scattered sections of 26 U.S.C. (1982)).

partment of Energy (DOE) and HUD promulgated draft Building Energy Performance Standards (BEPS) in 1979.<sup>55</sup> ECPA required that the standards for new buildings "achieve the maximum practicable improvements in energy efficiency and increases in the use of non-depletable sources of energy."<sup>56</sup> ECPA also required the Secretary of HUD to monitor state and local adoption and implementation of BEPS and to impose sanctions upon those agencies that failed to comply.<sup>57</sup> The BEPS would preempt the HUD Minimum Property Standards.<sup>58</sup>

Although the BEPS proposed by the government included Resource Utilization Factors which would tolerate less efficient sources of heating (for example, electric resistance heating) only if the most efficient building shells were constructed around these heating sources,<sup>59</sup> they did not establish standards based on a comparison of the costs and savings of energy efficiency measures.<sup>60</sup> Therefore, the BEPS would not result in construction standards based on the most cost-effective allocation of dollars between initial construction efficiency and eventual energy expenses. Instead, by basing the standards at the thirtieth percentile of a not particularly efficient cross-section of post-1973 buildings,<sup>61</sup> the BEPS merely ratified the state of inefficiency.

Opposition from electric utilities eventually led Congress to push for the withdrawal of the BEPS on the eve of their promulgation.<sup>62</sup> This continuing inadequacy of energy efficiency regulation caused HUD to respond in a schizophrenic manner to soaring PHA energy bills.<sup>63</sup> Operating inefficiencies are the cold legacy of decades of regulatory inattention to cost effective construction practices.

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<sup>55</sup> 44 Fed. Reg. 68,120 (1979) (to be codified at 10 C.F.R. § 435).

<sup>56</sup> ECPA, *supra* note 54, § 302, 90 Stat. 1125, 1144 (1976) (codified at 42 U.S.C. § 6831(a)(2) (1982)).

<sup>57</sup> Federal aid was broadly defined to include direct federal grants or loans and any loan made by a bank subject to federal regulation (i.e., most banks). Sanctions imposed against any state would effectively eliminate construction financing for most new buildings. ECPA, *supra* note 54, § 305, 90 Stat. 1125, 1147 (1976), repealed by Pub. L. No. 97-35, § 1041(b), 95 Stat. 357, 621 (1981).

<sup>58</sup> *Cf.* 42 U.S.C. § 6835 (1982).

<sup>59</sup> 43 Fed. Reg. 54,523, 54,605 (1978).

<sup>60</sup> *Id.* at 54,606.

<sup>61</sup> *Id.* at 54,512, 54,548, 54,915.

<sup>62</sup> See *Hearings on S. 2862, supra* note 54.

<sup>63</sup> See *infra* notes 101-123 and accompanying text.

## C. Current "Minimum" Standards

The Department of Housing and Urban Development currently requires that new residential construction meet a series of minimum standards, periodically adjusted to reflect its interpretation of construction standards and state of the art practices.<sup>64</sup> In theory, these standards are base levels and local housing authorities may increase the requirements to meet particular local thermal construction needs. In practice, however, these minimum standards become maximums.<sup>65</sup> In some cases, even these minimum standards have been ignored during construction.<sup>66</sup>

Local housing authorities, which must operate under limitations based upon per unit cost, have no incentive to provide greater thermal integrity to dwellings than required by the minimum federal standards. In fact, local authorities are faced with several disincentives: extra insulation or better building materials translate into greater front-end construction costs; the mathematical calculations necessary to compute optimal insulation and weatherization levels are relatively complex; and the entire costs that the housing authority incurs for utility operating expenses are typically automatically reimbursed by HUD.<sup>67</sup>

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<sup>64</sup> See generally 24 C.F.R. § 3280 (1984).

<sup>65</sup> Traditionally, state requirements have not been particularly strict. In response to diminishing energy resources, however, many states have tightened their requirements. For example, after the 1973-1974 energy crisis, California tightened its regulations to require that walls exhibit  $U_{wall} = .08$  and ceilings  $U_{ceiling} = .05$  in all new construction or additions to structures subject originally to these standards. 24 CAL. ADMIN. CODE T20-1403 (1978) (energy insulation standards). The U value is the overall coefficient of heat transference. It is equal to the amount of heat, expressed in BTUs, transmitted in one hour through one square foot of a building section, for each degree Fahrenheit temperature difference between temperature on either side of the building section. Another way of expressing the U value is  $1/R$  (R being the measure of heat resistance). Therefore, low U values and high R values denote well-insulated or heat-resistant building surfaces. The American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE) again proposed revisions in its thermal construction standards to multifamily buildings in mid-1985. ASHRAE, Energy Efficient Design of New Non-Residential Buildings and New High-Rise Residential Buildings, 90.1 P (June 10, 1985) (public review draft) (available from ASHRAE, Atlanta, Ga.). These proposed revisions tighten the existing 1980 standard by 20%-30%.

<sup>66</sup> HUD management personnel stated to the author that in some cases in past years no heat loss calculations were performed or submitted by builders, as required by HUD regulations. Construction was completed despite this omission. Sometimes when older buildings in cold climates are razed, no insulation is found in the building shell despite standards at the time of construction requiring some insulation. Interview with Wes LeRond, Energy Specialist, HUD San Francisco Regional Office, in San Francisco (Sept. 1976).

<sup>67</sup> See *infra* notes 227-28.

### III. PATCHING THE ENERGY QUILT: FEDERAL ATTEMPTS TO STITCH A REMEDY

#### A. Utility Metering Alternatives

Historically in public housing, the choice of utility metering, the choice of fuel, the design of heating systems, and the utility subsidy provided to tenants all have been tightly interwoven. The metering alternative chosen in many situations constrains the available options for heating systems and fuels. It also dictates the amount of utility subsidy provided to tenants.<sup>68</sup>

When subsidy considerations become paramount, hardware decisions, such as choosing heating systems and meters, are made for regulatory reasons. These decisions reflect rational policy choices only so long as neither the technologies, nor the role of energy in the regulation of public housing, change.<sup>69</sup>

The role of energy in public housing and the technologies available to supply and consume energy, however, have changed radically in the past decade. While sectors of the private economy adjusted—if somewhat painfully—to these changes, HUD has become entangled in a multitude of knotty public housing problems.<sup>70</sup> HUD's attempt to address the issues of meters, heating systems, heating and fuel choices, and subsidies resulted in regulatory, statutory, and judicial inefficiencies. These inefficiencies rent the fabric of HUD regulatory policy.

There are three basic types of tenant utility metering: master meters,<sup>71</sup> submeters (which are also known as check-

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<sup>68</sup> See *infra* text accompanying notes 274–79.

<sup>69</sup> In 1975, HUD acknowledged that the rapid escalation in energy costs changed the energy regulatory assumptions for public housing. 40 Fed. Reg. 44,159–61 (1975).

<sup>70</sup> HUD's primary response to the call for more efficient use of energy was to implement a nationwide program to convert utility meters in public housing to individual metering. *Id.*

<sup>71</sup> Master metering denotes a system in which the utility supplier officially meters the utility service entering the building through a single meter and does not meter the service to each individual tenant unit. The building owner is the only direct customer of the utility supplier, so no means exist to differentiate or bill the actual consumption of individual units. Under such a system, tenants are not responsible for establishing individual accounts with the utility supplier and generally do not risk termination of service even if they do not pay their rent or the building owner does not pay the common utility bill.

Some owners allocate a percentage of the total master-metered bill to various tenants based on the percentage of total floor space which each tenant occupies. See generally Institute of Behavioral Science, Univ. of Colo., Encouraging Energy Conservation in Multifamily Housing: RUBS and Other Methods of Allocating Energy Costs to Residents, Vol. 1: Background, Methods, Results (June 1980).



meters),<sup>72</sup> and individual meters.<sup>73</sup> By combining the advantages of individual and master metering, submetering appears to offer the best of both worlds to tenants and building owners.<sup>74</sup>

Potential problems with submetering, however, trouble state regulators. The building owner, for example, becomes a retailer of utility service purchased through the master meter. It would be almost impossible for a state utility commission to regulate the volume of resales to tenants by multifamily building owners.<sup>75</sup> Utility regulatory commissions typically regulate only a few monopoly energy suppliers. A critical role of every regulatory commission is to protect consumers' procedural and substantive rights to quality service, accurately billed at fair prices. Protection would be virtually impossible to ensure if thousands of individual building owners step into the shoes of a few regulated utility companies. Resellers violate the utilities' exclusive franchise to sell energy supplies at retail, thus posing a conflict for state regulators. States have adopted a myriad of solutions

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<sup>72</sup> Submetering, also called check-metering, denotes a system in which the building owner maintains a private, unofficial submeter or checkmeter on each individual dwelling unit's utility service. Utility service to the building is still master metered by the utility supplier, but the submeters are in series with the master meter. The building owner remains the customer of the utility, but uses the private submetering system to monitor and bill tenants for individual usage. The sum of submeter usage plus usage for building common space should equal the usage billed through the master meter.

<sup>73</sup> Individual metering denotes a system in which each dwelling unit is individually metered by the utility supplier, as is typical in single family service. This system is also called retail service. The individual tenant is the direct customer of the utility. The building owner is individually metered for energy usage in the common areas of the building, but otherwise has nothing to do with the energy use of individual tenants. The individual tenant may be required to post a security deposit by the local utility supplier, and is also subject to any late payment fees or termination of service penalties for nonpayment.

<sup>74</sup> Because the entire building is served through one master meter, submetered tenants receive the price advantages of commercial rate structures, which in most states are less expensive per unit of energy consumed than are residential rate structures. See Midwest Research Inst., *Energy Conservation Implications of Master Metering* Vol. I, Project No. 4008-E, at 1-2 (Oct. 1975) (final report) (on file at HARV. J. ON LEGIS.); Booz, Allen & Hamilton, *Alternative Metering Practices* I-21 (June 1979) (on file at HARV. J. ON LEGIS.). In addition, a significant number of states still maintain declining block rate structures, where the price per unit of energy consumed decreases with increases in the volume of consumption through any given meter. See *id.* Therefore, purchasing all energy service through a single master meter can result in bulk discounts. On the other hand, building owners are able to individually assess tenants the costs of their individual consumption when submeters are used in series with a master meter.

<sup>75</sup> At best, a commission may be able to police complaints of particularly egregious, unfair or deceptive practices committed by building owners in the resale of utility service. But commissions would not have the resources to police the problems prospectively; responding to complaints would be the most that could be undertaken without creating an impossible burden. And the process of resolving complaints itself can be a laborious and time-consuming matter.

to this problem. Some states allow building owners to resell utility service as long as the amount collected from the tenant does not exceed the actual costs to the owner;<sup>76</sup> or to resell utility service at wholesale cost plus administrative costs incurred by the building owner;<sup>77</sup> or to establish "micro utilities" to generate power and resell cogenerated or self-generated power or heat to other parties.<sup>78</sup>

A 1979 survey found that thirty-one states flatly prohibit submetering and resale of utility service by building owners. A listing of these states is shown in Table 2.<sup>79</sup>

**Table 2**  
*Utility Regulatory Authority Metering Policies*

<i>State</i>	<i>M-M Policy</i>	<i>Permit S-M?</i>	<i>Any Ongoing Metering Experiments?</i>	<i>Comments</i>
Alabama	No law	Yes	No	I-M most prevalent
Alaska	No law	No law	No	Submetering used in boat marinas only
Arizona	No law <sup>a</sup>	Yes	No	I-M most prevalent, hearings held
Arkansas	No law	No	No	Utilities retrofit mostly I-M
California	M-M banned	Yes	Yes	
Colorado	No law	No	No	Informal policy against M-M
Connecticut	No law	Yes	No	Hearings to be held to ban M-M
Delaware	No law	Limited	No	PSC can prohibit S-M
Wash., D.C.	M-M allowed	No	Yes	
Florida	M-M banned	No	Yes	
Georgia	No law	Yes	No	Utilities have decided to ban M-M
Hawaii	No law yet	No	No	In the process of completing generic hearings on M-M
Idaho	No law yet	Yes	No	Favor ban on M-M
Illinois	No law	No	No	Most new apartments have individual meters
Indiana	M-M discouraged	No	No	Most new apartments have individual meters
Iowa	Proposed ban	No	No	
Kansas	No law	No	No	Municipal utilities allow submetering

<sup>76</sup> See Colorado Pub. Util. Comm'n, Decision No. C80-1827, at 2 (Sept. 23, 1980). Colorado takes an anomalous regulatory position. On the one hand, it prohibits "submetering," defined as the "resale of energy by a person who is responsible for paying a master metered bill." *Id.* However, the Commission allows "check-metering," which it defines as an "allocation based upon usage among tenants or other lessees of the master-metered customer of his bill which does *not* result in the collection of any revenues over and above that necessary to pay the master metered utility bill." *Id.* (emphasis in original).

<sup>77</sup> MD. ANN. CODE, art. 78, § 54G(c)(1) (1957 and Supp. 1984).

<sup>78</sup> See, e.g., CAL. HEALTH & SAFETY CODE §§ 41515-20 (West Supp. 1985).

<sup>79</sup> This data is taken from Booz, Allen & Hamilton, *supra* note 74, at 6.

**Table 2 (Continued)**  
**Utility Regulatory Authority Metering Policies**

<i>State</i>	<i>M-M Policy</i>	<i>Permit S-M?</i>	<i>Any Ongoing Metering Experiments?</i>	<i>Comments</i>
Kentucky	No law	No	No	
Louisiana	Electric M-M banned <sup>b</sup>	Yes	Yes	
Maine	No law	No	No	Concerned with oil heat meter
Maryland	Electric M-M banned	Yes <sup>c</sup>	Yes	
Massachusetts	Electric M-M banned	No	No	No ban on gas M-M, considering S-M
Michigan	M-M banned	No <sup>d</sup>	Yes	M-M allowed if owner can prove cost effect
Minnesota	Electric M-M banned	No	Yes	Studying gas M-M ban
Mississippi	M-M discouraged	No	No	M-M discouraged
Missouri	No law	No	No	M-M ban would have few impacts
Montana	No law	No	No	
Nebraska	No law	Yes	Yes	
Nevada	M-M discouraged	Yes	Yes	Encourage individual metering
New Hampshire	M-M allowed	Yes	Yes	
New Jersey	Electric M-M banned	No	Yes	
New Mexico	No law	Yes	No	Mostly concerned with mobile homes
New York	Electric M-M banned	No	Yes	In new buildings utilities are not to be included in rent
N. Carolina	M-M banned	No	No	
N. Dakota	M-M discouraged	No	Yes	Encourage individual metering
Ohio	No law	Yes	Yes	
Oklahoma	M-M banned	No	No	
Oregon	Electric banned	Yes	No	
Pennsylvania	No law	Yes	Yes	Encourage individual metering
Rhode Island	M-M banned	No	Yes	
S. Carolina	No law	No	No	
S. Dakota	No law	No	No	
Tennessee	No law	No	No	
Texas	M-M banned	Limited	Yes	
Utah	No law	No	No	
Vermont	No law	No	No	
Virginia	M-M allowed	Limited	No	Will permit individual submetering
Washington	No law	No	Yes	
W. Virginia	M-M allowed	No	No	
Wisconsin	No law	No	Yes	
Wyoming	No law	Yes	No	

I-M = Individual Metering

M-M = Master Metering

S-M = Submetering

<sup>a</sup>Order for mobile homes

<sup>b</sup>For new construction only

<sup>c</sup>For existing dwellings only

<sup>d</sup>May allow in special cases

	Summary	57%
		14%
M-M:	No law	14%
	Banned	8%
	Electric Ban only	8%
	Allowed	61%
	Discouraged	39%
S-M:	Banned	
	Allowed	

**Table 3**  
*Heating Fuels and Metering Types as a Percentage of All  
 Multifamily Units (2 or more units)*

<i>Fuel</i>	<i>Heating Fuel: Percentage of Multifamily Units</i>	<i>Percentage Master Metered</i>	<i>Percentage Individual Metered</i>
Natural gas	50%	58%	42%
Fuel Oil	25%		
Electricity	20%	20%	80%
Other or Unknown	5%		
Totals	100%		

Despite these prohibitions, there is substantial evidence that submetering is widespread, even in public housing.<sup>80</sup> In light of this reality, one state (New York) is experimenting with the reintroduction of restricted submetering, imposing stiff penalties for abusive practices by landlords.<sup>81</sup>

Table 3<sup>82</sup> displays the various metering types and heating fuel sources of the general housing stock. Less than half of the tenants in multifamily housing stock pay individually for their fossil-fired space and water heating. There are regional variations in metering data: in the Northeast, only thirty percent of tenant space and water heating are individually metered; more than half are individually metered in other regions.<sup>83</sup>

Multifamily buildings can be master-metered for one type of utility service and individually metered for another. About twenty-nine percent of all multifamily buildings are master-metered for heating by fossil fuels while simultaneously individu-

<sup>80</sup> In Massachusetts, for example, the Springfield Housing Authority submeters and charges tenants, despite an unyielding state prohibition on submetering dating back thirty years. See *In Re Frank Properties*, Mass. Dep't of Pub. Util., Docket No. 15715 (Jan. 29, 1968); *In Re Boston Edison Co.*, Mass. Dep't of Pub. Util., Docket No. 8862 (Mar. 4, 1953) *aff'd sub nom.* Boston Real Estate Board v. Mass. Dep't of Pub. Util., 334 Mass. 477 (1956).

<sup>81</sup> New York Pub. Serv. Comm'n Case No. 26998 (1984).

<sup>82</sup> This data is taken from U.S. DEP'T OF ENERGY, CHARACTERISTICS OF THE HOUSING STOCK AND HOUSEHOLDS Table 28 (1979); Midwest Research Inst., *supra* note 74, at vii; U.S. BUREAU OF THE CENSUS, ANNUAL HOUSING SURVEY: 1979 Table U-53-54 (1982) [hereinafter cited as ANNUAL HOUSING SURVEY: 1979]. Because there are variations in the estimates of percentages, this table presents the author's reconciliation.

<sup>83</sup> See L. McClelland, *Tenant-Paid Energy Costs in Multifamily Rental Housing: Effects on Energy Use, Owner Investment, and the Market Value of Energy E-9* (Nov. 1983) (available from Inst. of Behavioral Science, Univ. of Colo., Boulder, Colo.).

ally metered for electric service for other purposes.<sup>84</sup> This split service reflects the use of master-metered, fossil fuel-fired, central heating equipment in a large number of multifamily buildings. The incidence of individual metering is a function of the heating equipment used: fifty-four percent of gas heated, seventy-four percent of electric heated, and less than ten percent of oil heated multifamily units are individually metered for billing purposes.<sup>85</sup>

### B. *The Federal Regulatory Response: Meter Conversions and Fuel Choices*

The experience in public housing illustrates the delicate balance of regulatory policy and technology. A single federal regulation, combined with local codes, affects the delivery of, and payment for, energy in the largest identifiable block of multifamily rental housing in the nation.<sup>86</sup>

As energy prices increased dramatically in the mid-1970's, market forces promoted individual metering in new construction. The limited data available suggests that a lower percentage of master-metered units are constructed each year: of new multifamily (five or more) units completed annually, the percentage with master-metered electricity declined from 27% to 9% between 1973 and 1979.<sup>87</sup> For space heating, the percentage of new construction which was master-metered declined from 61% to 30% between 1973 and 1977.<sup>88</sup>

The federal government augmented market forces with direct regulatory intervention. As part of the Public Utility Regulatory Policies Act of 1978 (PURPA),<sup>89</sup> for example, the federal government required states to consider prohibiting the master metering of electricity in newly-constructed multifamily buildings.<sup>90</sup>

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<sup>84</sup> OTA, *supra* note 3, at 119.

<sup>85</sup> L. McClelland, *supra* note 82, at 4.

<sup>86</sup> See *supra* note 8.

<sup>87</sup> L. McClelland, *supra* note 82, at 5.

<sup>88</sup> *Id.*

<sup>89</sup> Public Utility Regulatory Policies Act of 1978, Pub. L. No. 95-617, 92 Stat. 3117 (codified in scattered sections of 15, 16, 30 & 42 U.S.C. (1982)).

<sup>90</sup> *Id.* 16 U.S.C. § 2625(d) (1982) requires state consideration of individual *electricity* metering only for new construction. It also applies only where the occupant of each unit has control over a portion of the electric energy used and where it is determined that the long-run benefits of individual metering exceed the costs of separate meters. Despite this narrow application, many states used this standard as a general springboard for the individual metering of many types of energy in both new construction and existing buildings. 2 U.S. DEP'T OF ENERGY ANN. REP. 61 (1980).

Initially this provision was struck down by a United States district court in Mississippi,<sup>91</sup> but it was subsequently upheld by a narrow majority of the United States Supreme Court.<sup>92</sup>

Many states used the hearings required by PURPA as a forum to assess the scope of permissible metering. Some states extended the limited purpose of the PURPA provision to require the individual metering of natural gas in newly-constructed multifamily buildings or to encourage conversion to individual metering in existing master-metered multifamily buildings.<sup>93</sup>

The choice of metering technology, however, is not only a matter of federal regulatory discretion or builder choice. Local building and safety codes can incorporate fuel considerations through the choice of metering systems. Some local codes prohibit the running of natural gas or oil pipes within a building above a few stories in height.<sup>94</sup> In an existing building which contains a fossil-fueled, master-metered central boiler supplying heat and/or domestic hot water, a decision to convert to individual meters poses significant engineering<sup>95</sup> and economic problems.<sup>96</sup>

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<sup>91</sup> *Mississippi v. FERC*, No. J79-0212(c) (S.D. Miss. Feb. 20, 1981), *rev'd*, 456 U.S. 742 (1982).

<sup>92</sup> *FERC v. Mississippi*, 456 U.S. 742, 771 (1982). For a discussion of the policy and legal issues concerning the legality of this provision of the Public Utility Regulatory Policies Act (PURPA), see the Brief for Amicus Curiae, the State of Md., Consumers' Union, Nat'l Consumer L. Center, Nat'l Wildlife Fed'n, Natural Resources Defense Council and Solar Lobby, Inc., *FERC v. Mississippi*, 456 U.S. 742 (1982) (written by the author and others).

<sup>93</sup> Even before the enactment of PURPA, individually metered electric heating established a foothold as the preferred heating system for developers of newly-constructed residential buildings. In every year since the mid-1970's, more than half the newly constructed units were electric heated. The preponderant type of the electric heating installed each year still is electric resistance, with the more efficient heat pumps being installed in less than 20% of the electric heating in new construction. U.S. DEP'T OF ENERGY, *THE FUTURE OF ELECTRIC POWER IN AMERICA* 3-6 (1983).

<sup>94</sup> See Ferrey, *Fostering Equity in Urban Conservation: Utility Metering and Utility Financing*, in U.S. CONGRESS OFFICE OF TECHNOLOGY ASSESSMENT, *ENERGY EFFICIENCY OF BUILDINGS IN CITIES*, VOL. II: WORKING PAPERS 33 (1981) [hereinafter cited as Ferrey, *Fostering Equity*].

<sup>95</sup> Local codes may prohibit the placing of individual furnaces above the second or third floor. *Id.* The heat distribution systems in older buildings often are not engineered to allow conversion to individual metering. Pipe runs often are vertical, running straight up and down through multiple stories. The apartments are usually laid out horizontally on one floor. Metering one of these pipe runs would not register the consumption for a single unit, but rather for all living room radiators vertically stacked above one another in the layout of an apartment building.

<sup>96</sup> Sufficiently accurate BTU (or flow) meters, which measure the warm air or water delivered past a certain monitor (and to a particular unit) from a central boiler, have not traditionally been available at an economical cost. See Booz, Allen & Hamilton, *supra* note 74, at 13-14, IV-9. More accurate flow meters at prices as low as \$75 (installed) and BTU meters as low as \$300 are now available. The cost of replumbing

For high-rise multifamily structures subject to local codes prohibiting fossil fuel pipes being run above a few stories in height, the practical choice of heating systems is often between a central hydronic or steam fossil fuel-fired boiler (which distributes its energy to upper stories as warm air or warm water operating through a master meter) and an individual electric heating system for each apartment, individually metered, which requires running electric wires but no pipes to upper stories (in which case, the heating source is either a heat pump or the prevalent electric resistance heating).

Pressure to retrofit individual meters to an existing master-metered central heating system in a multifamily building is, in many jurisdictions, tantamount to pressure to convert to individually metered electric heating, since the installation of electric resistance heat in a building already served by electricity is relatively inexpensive.<sup>97</sup> This pressure results in a predominant conversion to electric resistance heating in high-rise units. Unfortunately, electric heating is generally less cost-efficient than fossil fuels.<sup>98</sup> This phenomenon is even more pronounced in public housing. Tight capital budgets in PHAs encourage the minimization of up-front capital investments, often at the expense of long-term, least-cost investment and operating strategies.<sup>99</sup>

If it had foreseen this result, the federal government would probably not have promoted policies which resulted in a costly conversion to the most expensive heating source for the poorest segment of society. The federal government either directly (through subsidies to public housing utility budgets) or indirectly

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or reducing the heating system of an existing multistory, multiunit building to accommodate individual metering of fossil fuel-fired heating systems can be prohibitively expensive, unless the building is undergoing substantial rehabilitation.

Benefit/cost studies by public housing authorities (PHAs) in 1976-77 indicate that \$1000 per unit was not an atypical cost for meter conversion at that time, with estimates ranging from zero up to \$4160 per unit. *Id.*; Ferrey, *Fostering Equity*, *supra* note 94, at 10.

<sup>97</sup> Because the installation of electric resistance heating components in a building already served by electricity is a relatively inexpensive process, individual metering may be accomplished at least cost to the building owner by shutting down the central boiler and converting to electric heat. L. McClelland, *supra* note 82, at E-9.

<sup>98</sup> If the heating system is electric resistance heating, it will deliver heat at approximately twice the cost of direct application of fossil fuels for heating. *Id.*

<sup>99</sup> A least-cost strategy minimizes the sum of initial capital costs to purchase heating equipment and energy operating costs over the estimated life of the system. The method used to compute the least-cost strategy is a life cycle cost analysis. This method is described in more detail in U.S. GEN. SERV. ADMIN., LIFE CYCLE COSTING WORKBOOK (1977) [hereinafter cited as GSA].

**Table 4**  
*Public Housing Metering Types*

	<i>Master Meter</i>	<i>Submeter</i>	<i>Individual Meter</i>
Natural Gas	59%	12%	29%
Electricity	42%	33%	25%

(through increased welfare assistance benefits) pays the greater costs of this inefficiency in public housing units.<sup>100</sup>

The public housing metering policy articulated by HUD is quixotic. HUD originally encouraged the installation of master-metered centralized heating systems in public housing.<sup>101</sup> In some cases, buildings were altered after construction from individual to master meters.<sup>102</sup> HUD did not treat energy operating costs differently from other operating costs for public housing.

HUD, which traditionally provides differentiated annual operating subsidies based on the type of utility metering employed,<sup>103</sup> does not know the precise proportion of metering types employed in the 1.2 million units of public housing under its jurisdiction.<sup>104</sup> Table 4<sup>105</sup> illustrates that the majority of utility service in public housing is not individually metered.

When HUD metering policy changed abruptly in the mid-1970's, individual metering suddenly became the preferred alternative. Congress allowed individual metering for HUD-subsidized non-public housing.<sup>106</sup> Without any statutory command, but "in support of national energy conservation goals," HUD required that all public housing utility service be individually metered to tenants unless impracticable, illegal, or financially

<sup>100</sup> For a discussion of the HUD subsidization of PHA utility budgets, see *infra* notes 220-244 and accompanying text. Ironically, although HUD's meter conversion policy did not explicitly consider the repercussions for tenants of possible conversions to more expensive fuel sources, litigation has reimposed many of the resulting higher fuel costs on HUD, rather than on tenants. See *infra* notes 157-159 and accompanying text.

<sup>101</sup> See National Ass'n of Hous. and Redev. Officials, Comment on Proposed Amendment to 24 C.F.R. § 865, HUD Doc. No. R-75-354 (Oct. 29, 1975).

<sup>102</sup> See *id.*

<sup>103</sup> 24 C.F.R. §§ 990.107, 965.470-482 (1983).

<sup>104</sup> Pursuant to court order in *Massachusetts Union of Pub. Hous. Tenants v. Pierce*, No. 78-1895 (D.D.C. Oct. 30, 1984) (order granting plaintiffs' motion for post-judgment discovery) [hereinafter cited as *Mass. Union*, Post-Judgment Order], HUD is currently subject to post-judgment discovery which should better reveal the extent of different metering configurations.

<sup>105</sup> The data is taken from Ferrey, *Fostering Equity*, *supra* note 94, at 47.

<sup>106</sup> 12 U.S.C. § 1715z-1(f)(1) (1982).



ill-advised.<sup>107</sup> HUD proposed a rule that all PHAs be required to assess the costs and benefits of conversions to individual meters.<sup>108</sup>

Despite criticisms of the proposed rule,<sup>109</sup> HUD proceeded to finalize and implement the rule virtually unchanged from its proposed form.<sup>110</sup> PHAs performing mandatory benefit/cost assessments were required to assume that the conversion of existing master-metered heating systems to individual meters would, without any other efficiency investments, save thirty-five percent of the current space heating bill, and a lesser percentage of savings for other energy end uses,<sup>111</sup> as illustrated in Table 5.<sup>112</sup>

Other efficiency measures could not be considered under this procedure. If the required benefit/cost test showed that conver-

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<sup>107</sup> 40 Fed. Reg. 44,159-61 (1975).

<sup>108</sup> *Id.*

<sup>109</sup> Comments to HUD's proposed individual metering requirement questioned the claimed energy savings, and pointed to studies showing actual savings far below HUD's numbers. See Massachusetts Union of Public Hous. Tenants, Comment on Proposed Amendment to 24 C.F.R. § 865, HUD Doc. No. R-75-354, (Oct. 27, 1975) (study showed that, at the most, there was a 13% savings in energy consumption); National Ass'n of Hous. and Redev. Officials, Comment on Proposed Amendment to 24 C.F.R. § 865, HUD Doc. No. R-75-354, (Oct. 29, 1975) (conversion to check-metering diverts funds away from other expenditures with potentially greater savings). The economics of alternatives to meter conversion that would save 60% of heating energy at less cost than a meter conversion is documented in Anderson, *Benefit/Cost Analysis of Utilities at Gateway Gardens PHA, Kokomo, Indiana*, in Natural Resources Defense Council & Nat'l Consumer L. Center, Petition for Rulemaking at app. 33 (Aug. 7, 1978) (concerning Part 865—PHA Utility Metering).

The comments also questioned the feasibility of meter conversions. See Lawrence Berkeley Laboratory, Comment on Proposed Amendment to 24 C.F.R. § 865, HUD Doc. No. R-75-354 (Oct. 24, 1975) (conversion would curtail the incentives for management efficiency investments after conversion while singling out tenants to bear the brunt of the efficiency responsibility); Housing Auth. of the City of New Haven, Conn., Comment on Proposed Amendment to 24 C.F.R. § 865, HUD Doc. No. R-75-354 (Oct. 28, 1975) (conversion would result in higher vacancy rates, greater turnover, tenant complaints and create administrative problems); National Ass'n of Hous. and Redev. Officials, Comment on Proposed Amendment to 24 C.F.R. § 865, HUD Doc. No. R-75-354 (Oct. 29, 1975) (there would be problems for tenants required to post security deposits in order to obtain individually metered service); Massachusetts Union of Public Hous. Tenants, Comment on Proposed Amendment to 24 C.F.R. § 865, HUD Doc. No. R-75-354 (Oct. 27, 1975) (conversion wastes scarce funds in performing the benefit/cost analyses). These problems were highlighted in the subsequent correspondence between Ora Simmons, Director, Keyser, Pa. Public Housing Authority, and R. Easley, HUD Pittsburgh Area Office, which indicates that 50% of the Keyser PHA tenants would not receive gas service after a conversion to individual meters because of security deposit requirements. Letter from Ora Simmons to R. Easley (Nov. 4, 1976), in Natural Resources Defense Council & Nat'l Consumer Law Center, Petition for Rulemaking at app. 27 (Aug. 8, 1977).

<sup>110</sup> 41 Fed. Reg. 20,276-78 (1976).

<sup>111</sup> 24 C.F.R. § 965.404(a) (1984).

<sup>112</sup> The assumptions are taken from *id.*

**Table 5**  
*Required Assumed Savings by End Use for Conversion  
 to Individual Metering or Submetering in Public  
 Housing*

<i>End Use</i>	<i>Individual Meters</i>	<i>Submeters</i>
Space Heating	35%	25%
Domestic Hot Water Heating	25%	15%
Cooking	25%	15%
Lighting and Refrigeration	25%	15%

sion to individual metering saved as little as one dollar over twenty years,<sup>113</sup> then the PHA was required to proceed with capital funding for the meter conversion.<sup>114</sup> Meter conversions were, in the process, elevated to a priority for the use of so-called HUD "Modernization Funds," equalled only by the priority for funds used to repair code violations and serious safety hazards.<sup>115</sup> Once the assumption of a thirty-five percent heating energy savings over twenty years is accepted, conversion to individual metering usually appeared beneficial to HUD.<sup>116</sup> Data indicate that actual energy saved could be much less, if any at all.<sup>117</sup>

The costs of meter conversion can be quite significant. Not only are the meters expensive, but necessary rewiring, repiping, venting, cosmetic work, and the cost of complying with applicable codes can also be expensive.<sup>118</sup> PHAs also incur hidden

<sup>113</sup> *Id.* § 965.404(c).

<sup>114</sup> *Id.* § 965.405. The benefit/cost test was required to be conducted within 18 months and actual conversion was required to be accomplished within 12 months thereafter. *Id.* § 965.408 (1984).

<sup>115</sup> See *infra* note 405.

<sup>116</sup> HUD in fact approved conversions where the net calculated savings over 20 years were only \$36 (Union Springs, Alabama), where the net savings were only 18 cents per unit per year (El Paso, Texas), and where there were no savings but the benefit/cost calculation was "adjusted" to make it appear that savings existed (Childersburg, Alabama). See *Massachusetts Union of Pub. Hous. Tenants v. Pierce*, No. 78-1895 (D.D.C. Sept. 26, 1978) (Affidavit of Richard Alpers at ¶ 3(i)).

<sup>117</sup> The data indicate that for space and water heating, a conversion to individual metering can result in savings of approximately 5% (conversion effects range from consumption *increases* to savings of up to 20% when controlled for weather), while for electricity not used for heating the savings average 15%. See OTA *supra* note 3, at 119; Booz, Allen & Hamilton, *supra* note 74, at I-21 (June 1979); U.S. DEP'T OF ENERGY, CHARACTERISTICS OF THE HOUSING STOCK AND HOUSEHOLDS, Table 28 (1979); Midwest Research Inst., *supra* note 74, at vii; L. McClelland, *supra* note 82, at 8.

<sup>118</sup> For example, 49 C.F.R. §§ 192.463-465 (1984) requires cathodic protection of gas lines against corrosion, as well as inspection of lines.

costs: meter conversion triggers a recalculation of the amount of subsidy the PHA receives from HUD, which may work to the PHA's detriment.<sup>119</sup>

The conversions brought higher utility costs to tenants, non-payment of bills, an increase in utility arrearages, and potential termination of service. A report by the National Consumer Law Center in 1984 revealed that:

-In 1983 alone, 4.7 million people in over 1.6 million households using natural gas for heating had their service disconnected.

-Between 1981 and 1984, the amount of money owed by households facing termination of service increased more than 200 percent (averaging \$368 nationwide and \$460 in the Northeast and Midwest).

-In 1982, almost 4 million households were sixty days or more in arrears in the payment of gas heating bills; in 1984, the number rose to more than 4.8 million households.<sup>120</sup>

Since 1972, with natural gas prices increasing three times faster than inflation, many low-income consumers have been unable to keep pace with current energy bills. A substantial increase in the Low Income Home Energy Assistance Program provided some relief for the general population.<sup>121</sup> Some states, however, declared public housing tenants ineligible to receive this assistance.<sup>122</sup> Moreover, meter conversions lowered PHA tenant utility subsidies<sup>123</sup> and in many cases increased dramatically the per unit cost of energy for these tenants. Litigation then challenged HUD's regulatory scheme.

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<sup>119</sup> 24 C.F.R. § 990.107(c)(3)(i)(B) (1984). When a meter conversion occurs, HUD can recalculate the Performance Funding System allocation to lower the amount of subsidy received by the PHA. *See infra* notes 220-38 and accompanying text.

<sup>120</sup> Homes Without Heat, *supra* note 25, at 1-2.

<sup>121</sup> For a discussion of the Low Income Home Energy Assistance Program, see *infra* notes 337-395 and accompanying text.

<sup>122</sup> For a discussion of this practice and legal challenge, see *infra* notes 357-95 and accompanying text.

<sup>123</sup> *See infra* text accompanying notes 288-301.

C. *Litigation: The Limits of Administrative Indiscretion*

Having exhausted all formal<sup>124</sup> and many informal channels,<sup>125</sup> a group of public housing tenants, joined by the Natural Resources Defense Council, Inc., initiated suit on October 11, 1978 in *Massachusetts Union of Public Housing Tenants, Inc. v. Harris*.<sup>126</sup> The suit alleged violations pertaining to the Part 865 regulation:<sup>127</sup>

—HUD violated the requirements of the National Environmental Policy Act (NEPA) to consider alternatives<sup>128</sup> by not itself comparing or allowing local PHAs to compare meter conversion to other conservation measures, and by not preparing an Environmental Impact Statement or Negative Declaration;<sup>129</sup>

—The regulation was arbitrary, capricious, and an abuse of discretion violating the requirements of the Administrative Procedure Act (APA)<sup>130</sup> because there was no factual or rational basis on the record, or in any of the technical literature, for requiring that PHAs assume that 25%–35% of heating energy would be saved merely by converting to individual meters.<sup>131</sup> In addition, HUD did not properly con-

<sup>124</sup> Plaintiffs prepared a 400-page Petition for Rulemaking that was filed with the HUD Secretary on August 7, 1978. Natural Resource Defense Council & Nat'l Consumer Law Center, Petition for Rulemaking (Aug. 7, 1978). This Petition described the illegal elements of the Part 865 regulation, the superior conservation alternatives to meter conversions documented by data in HUD's possession, and the impact on tenants of meter conversions. The Petition, which asked HUD to resolve these issues administratively before suit was initiated, was denied by the HUD Secretary. Cf. *Massachusetts Union of Public Hous. Tenants, Inc. v. Pierce*, No. 78-1895 (D.D.C.) (undated Affidavit of Steven Ferrey in Support of First Motion for Preliminary Injunction at ¶ 2(c)) [hereinafter cited as *Mass. Union, Ferrey Affidavit*].

<sup>125</sup> On June 7, 1977, and again on March 18, 1978, plaintiffs met with HUD Assistant Secretary Lawrence Simons, HUD Deputy Assistant Secretary Nancy Chisholm, and HUD counsel to discuss these issues. *Mass. Union, Ferrey Affidavit*, *supra* note 124, at ¶ 2(a), (b). Later meetings between the parties were also held in 1978. *Id.* at ¶ 2(d).

<sup>126</sup> *Massachusetts Union of Pub. Hous. Tenants, Inc. v. Harris*, No. 78-1895 (D.D.C. Oct. 11, 1978) (Complaint) [hereinafter cited as *Mass. Union, Complaint*]. Defendants were the Secretary of HUD, HUD, and the National Capitol Housing Authority in the District of Columbia. *Id.* The litigation spanned the tenures of three Secretaries of HUD: Patricia Harris, Moon Landrieu, and Samuel Pierce. The name of the case changed accordingly.

<sup>127</sup> 24 C.F.R. §§ 865.400–.410 (1984).

<sup>128</sup> 42 U.S.C. §§ 4321, 4332 (1982).

<sup>129</sup> *Mass. Union, Complaint*, *supra* note 126, at 13–14.

<sup>130</sup> 5 U.S.C. § 706 (1982).

<sup>131</sup> *Mass. Union, Complaint*, *supra* note 126, at 12–13.

sider comments submitted in response to the proposed rulemaking;<sup>132</sup>

—HUD and the National Capitol Housing Authority violated the Brooke Amendment<sup>133</sup> by causing tenants to pay more than the statutory ceiling for shelter expenses after conversion to individual metering and the consequent decrease in tenant utility subsidies.<sup>134</sup>

On May 7, 1980, in response to the litigation, HUD finalized and enacted a reformed Part 865 regulation which added twenty conservation and solar energy measures to the meter conversion option.<sup>135</sup> The large savings assumptions for meter conversions contained in the original regulation, however, remained and were integrated into the new rule.<sup>136</sup>

HUD submitted four reports<sup>137</sup> to the court as the technical bases for the savings values in the regulation. Six years after

<sup>132</sup> *Id.* at 12. For an overview of critical comments, see *supra* note 109.

<sup>133</sup> 42 U.S.C. § 1437a (1981).

<sup>134</sup> *Mass. Union*, Complaint, *supra* note 126, at 10.

<sup>135</sup> Energy Audits and Energy Conservation Measures, 45 Fed. Reg. 30,346 (1980) (codified at 24 C.F.R. § 865.305). The rule was published in proposed form on December 28, 1978, at 43 Fed. Reg. 60,854.

<sup>136</sup> The mandatory assumption found in 24 C.F.R. § 965.404 (1984), that a 25%–35% energy savings results from heating system meter conversion, was carried over untouched into the revised regulation. In this revised regulation, *only* the meter conversion option required that PHAs factor in a presumed automatic energy savings. For the 20 other measures, PHAs were left unfettered to determine actual savings, rather than a regulatorily prescribed level. *Id.* § 965.305. This requirement to assume a generous 25%–35% savings typically made meter conversions appear as the “quickest payback” investment of the 21 alternatives. The HUD regulations require that the quickest payback measures be funded first. *Id.* § 965.306. Because modernization and other HUD funds are extremely limited, the preference for meter conversion (as the “quickest payback”) could mean that of the 21 eligible conservation measures, only meter conversions might actually receive funding. Once meter conversion shifted the energy responsibility from PHA to tenants, owner motivation to make additional conservation investments decreased. See L. McClelland, *supra* note 83, at E-7.

<sup>137</sup> The court initially examined four studies of metering data supplied by HUD and concluded that the data was not founded on an empirical basis:

. . . HUD initially submitted four documents to the Court which were certified as the administrative record of rulemaking for promulgation of 24 C.F.R. § 865.404. These four documents are *Bulletin LR-II*, a report by the American Gas Association entitled *Selection of Utilities*, *HUD Multi-Family Housing Bulletin*, a report by the Southern California Edison Company entitled *Selection of Utilities*, and a report by the Midwest Research Institute entitled *Energy Conservation Implications of Master Metering*.

The United States Court of Appeals for the District of Columbia held that “[n]one of these studies provides statistical data showing that meter conversion produces 25–35% savings in fuel used for space-heating . . .” Memorandum Opinion, *Massachusetts Union of Public Housing Tenants, Inc. v. Moon Landrieu, et al.*, No. 80-1332 (D.C. Cir. April 7, 1981).

*Massachusetts Union of Pub. Hous. Tenants v. Pierce*, No. 78-1895, slip op. at 1–2 (D.D.C. May 20, 1983) (order granting summary judgment to plaintiffs) [hereinafter cited as *Mass. Union*, Summary Judgment].

the rulemaking and four years after suit was initiated, HUD discovered two additional reports which it claimed were the basis of the original regulation's values, but which it had somehow omitted to bring to the court's attention.<sup>138</sup> The court created an empirical standard of proof to ascertain the legality of HUD's exercise of administrative discretion: when HUD forces action based on a numerical or scientific conclusion, it must demonstrate an empirical basis for the values relied on by the regulation.<sup>139</sup>

Plaintiffs voluntarily dropped prosecution of their NEPA claim upon enactment of the revised energy regulation in 1980. Resolution of the litigation, therefore, turned on the rational basis of the mandatorily-presumed 25%-35% energy benefits of meter conversion. The court found that HUD had not met its burden to demonstrate any empirical basis for the presumption.<sup>140</sup>

In fashioning a remedy, the court held illegal any conversion of heating system meters<sup>141</sup> in any public housing project where the conversion was "authorized, contracted for or commenced after April 7, 1981" pursuant to the assumptions of the regulation.<sup>142</sup> The court invalidated only those meter conversions which occurred after HUD was "notified" (by Order of the D.C. Circuit Court of Appeals in April 1981) that there was no demonstrated factual basis for the regulation.<sup>143</sup> The APA, however, provides procedural and substantive legal requirements which

<sup>138</sup> The court found that these additional studies were not actually considered by the agency in promulgation of the regulation, contrary to HUD's *post hoc* assertions, and also provided no factual basis for the assumption:

. . . the two studies submitted to the Court after remand to the agency were not identified as part of the original certified record, therefore, this Court may not consider them in reviewing the basis for the assumption of 24 C.F.R. § 865.404. . . . even if the two additional documents produced after remand are properly considered by this Court as part of the administrative record, neither document provides a factual basis for the space heating assumption of 24 C.F.R. § 865.404.

*Id.* at 2-3.

<sup>139</sup> The court, in evaluating the savings figures from meter conversion in one of the HUD documents, concluded that "the figures are of illustrative value only, as they are not based on empirical data." *Id.* at 3.

<sup>140</sup> *Id.* at 5.

<sup>141</sup> *Id.* at 5-6. Since in most PHA projects the domestic hot water system will be operated by the same fuel source as the heating system, and perhaps even through the same utility meter, preventing remetering of the heating source also prevents remetering of the domestic hot water source, which together comprise perhaps 75%-85% of the utility usage in a typical PHA dwelling. Booz, Allen & Hamilton, *supra* note 74, at I-29.

<sup>142</sup> *Mass. Union*, Summary Judgment, *supra* note 137, at 4.

<sup>143</sup> *Id.* at 4.

are either satisfied or violated at the time a rule is promulgated<sup>144</sup>—in this instance, May 17, 1976. If the rule was defective in its promulgation, all meter conversions pursuant to its commands should have been invalidated. Notice to the agency by a court does not start the running of the period of illegality;<sup>145</sup> it is by its act of creation either rational or void. The remedy adopted by the court does prevent any additional expenditure on heating system meter conversions after March 1982.<sup>146</sup> It also declares heating system meter conversions “authorized, contracted for or commenced” after April 1981 illegal and void;<sup>147</sup> prevents tenants from paying any additional utility charges or expenses as a consequence of an illegal meter conversion;<sup>148</sup> and strikes the provisions of 24 C.F.R. § 865.404 as to heating system conversions.<sup>149</sup>

In October 1984, Judge Harold Greene<sup>150</sup> found preliminary evidence of possibly contumacious conduct by HUD in not stopping all meter conversions covered by the Order, not accurately reporting the status of meter conversions to the court, failing to stop PHA surcharges or increased tenant utility expenses occasioned by illegal conversions, and failing to provide rebates to tenants whose utility expenses increased as a function

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<sup>144</sup> 5 U.S.C. § 706 (1982).

<sup>145</sup> Even if some event were a prerequisite, it would appear in this matter that notice was provided in August 1978, when plaintiff/petitioners filed a 400-page petition for rulemaking with HUD outlining the illegality of the rule and requesting its rescission, or when plaintiffs' counsel met with the HUD Assistant Secretary on June 7, 1977. See *supra* notes 124–25.

<sup>146</sup> The court entered an interim injunction on March 3, 1982, prohibiting expenditure of “any monies for conversion of utility meter systems for space heating fuels,” regardless of when commenced or how justified. *Massachusetts Union of Pub. Hous. Tenants v. Pierce*, No. 78-1895 (D.D.C. Mar. 3, 1982) (order to further specify remand) [hereinafter cited as *Mass. Union, Remand*]. On August 8, 1983, this interim injunction was replaced by a permanent injunction which applied only to conversions performed pursuant to the 24 C.F.R. § 865.404 assumption of a 25%–35% energy savings and commenced after April 7, 1981. *Massachusetts Union of Pub. Hous. Tenants v. Pierce*, No. 78-1895 (D.D.C. Aug. 3, 1982) (order granting defendant's motion for amendment of judgment). Therefore, there is a two-tiered injunctive ban: prevention of the expenditure of any monies for a 17-month period in 1982–83, and a declaration of the illegality of certain conversions if “commenced” after April, 1981.

<sup>147</sup> *Mass. Union*, Summary Judgment, *supra* note 137, at 4–6.

<sup>148</sup> “[C]ompletion of any utility meter conversion which was contracted for, or commenced after April 7, 1981, pursuant to the 24 C.F.R. § 865.404 space heating assumption, is void for purposes of implementing or continuing a direct charge, or surcharge to tenant systems at public housing projects.” *Id.* at 4; see *infra* text accompanying notes 288–301 (discussion of utility allowance calculations).

<sup>149</sup> *Mass. Union*, Summary Judgment, *supra* note 137, at 5–6.

<sup>150</sup> Judge George Hart, Jr., died during the pendency of plaintiffs' Motion for Contempt (post-judgment); Judge Harold Greene assumed the docket.

of illegal conversions.<sup>151</sup> Over HUD's objections, additional discovery was ordered and is still ongoing.<sup>152</sup>

*D. Potential Hazards of a Remedy: Rebates and Ineligibility for Assistance*

The *Mass. Union* litigation produced a balanced energy program following a decade of change in public housing energy use. There are now complex, but clear, interpretations of the consequences of heating system meter conversions based on time of commencement: conversions commenced before April 1981 on any grounds are legal; conversions started after April 1981 based on the suspect regulation can be retained physically but may not be used for determining tenant charges, and may have been prematurely implemented and require partial tenant rebates; interim conversions, begun prior to April 1981, or if independently justified and commenced between March 1982 and August 1983, may be used for determining future tenant charges; and new conversions, independently justified after August 1984, are legal. The litigation also created opportunities for local public housing energy initiatives.

A refund or rebate may be required to remedy previous underfunding of utility allowances caused by a failure to establish a reasonable allowance level or a reduction of allowances after an illegal meter conversion. Such a refund could be made in a variety of ways: by cash payments to tenants, by credits on tenant rent accounts at the PHA, or by set-offs against other tenant charges in arrearage. Tenants usually prefer the cash payment, although PHAs may prefer one of the other methods. In related areas of the law when the federal government confers a benefit, courts have disfavored automatic set-offs against miscellaneous charges allegedly owed or in arrears.<sup>153</sup>

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<sup>151</sup> *Mass. Union*, Post-Judgment Order, *supra* note 104, at 2-3.

<sup>152</sup> *Id.* There were several affidavits provided by plaintiffs which alleged HUD's failure to monitor PHAs or to cause the cessation of additional charges and provide rebates to overcharged tenants. The discovery ordered by the court includes a HUD survey of all 2300 PHAs under HUD's jurisdiction. *Id.* The discovery is expected to be completed in early 1986. At that time, the court will order additional sanctions as necessary, based on the evidence discovered.

<sup>153</sup> See *Interstate Natural Gas Ass'n of Am. v. FERC*, 756 F.2d 166, 170-71 (D.C. Cir. 1985). But see *Lugo v. Schweiker*, No. 85-1066 (3d Cir. 1985) (available Nov. 21, 1985 on LEXIS and WESTLAW, Genfed library, FedCir file) (Social Security Administration may net its underpayments and overpayments of benefits and apply them against the recipient's accounts due to the agency).



Rebates in a lump-sum payment may imperil tenants' eligibility for other federal assistance programs. There are both income and resource limitations on household eligibility for participation in the Aid to Families with Dependent Children (AFDC), Supplemental Security Income (SSI), and Food Stamp programs. For example, the SSI and Food Stamp programs would regard a lump-sum utility rebate as a resource, rather than income. If the rebate, added to other resources of a household total more than one thousand dollars, it could disqualify a household from the programs.<sup>154</sup>

A household which exceeds the resource limit loses its eligibility for the program until it spends down (consumes) this resource. If a state treats this payment as income rather than as a resource, it could disqualify the household from AFDC program eligibility.<sup>155</sup> No judicial or administrative precedent is directly on point.<sup>156</sup>

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<sup>154</sup> The AFDC resource limit is \$1000. See 45 C.F.R. § 233.20(a)(3)(i)(B) (1984). The resource limit in the Food Stamp program is \$1500 for a non-elderly household and \$3000 for an elderly household (one with two or more persons, at least one of which is 60 years of age or older). See 7 C.F.R. § 273.8(b) (1984). The resource limit in the SSI program is \$1600 for an individual and \$2400 for a couple. Social Security Act § 1611, 42 U.S.C. § 1382 (1982), as amended by the Deficit Reduction Act, 42 U.S.C.A. § 1382 (West Supp. 1984); 20 C.F.R. § 416.1103(c) (1984).

<sup>155</sup> 45 C.F.R. § 233.20(a)(3)(ii)(D) (1984). This provision permits a non-recurring lump sum payment to be treated as income in the month of receipt, and then to be counted as available to the family in future months without regard to whether it is actually available in future months. *Id.* Thus, this provision could result in an AFDC family becoming ineligible for an assistance check and medical coverage for several months if the utility reimbursement is a substantial one.

<sup>156</sup> No judicial or administrative precedent squarely addresses the applicability of the lump sum regulation. A federal district court in Oregon recently held that personal injury awards represent replacement of lost resources, and therefore cannot be considered "income" subject to the lump sum payment provision in determining AFDC eligibility. *LaMadrid v. Hegstrom*, 53 U.S.L.W. 2352 (D. Or. Jan. 22, 1985). In its analysis, the court notes a 1976 settlement between HUD and a class of tenant plaintiffs concerning reimbursements for "unauthorized" tax and utility cost increases in which HHS instructed that refund checks paid to the public assistance tenants were to be treated as resource, not as income, for AFDC purposes. The court stated that any reimbursement for "items the recipients should not have been deprived of . . . are not income." *Id.* at 2353.

Undoubtedly the *LaMadrid* court is referring to the *Underwood v. Hills* litigation in which nationwide class relief was granted for HUD's failure to pay owners of federally-assisted housing operating subsidies to cover increases in tax and utility costs which had resulted in tenants paying higher rents. *Underwood v. Hills*, 414 F. Supp. 526 (D.D.C. 1976).

To avoid protracted administrative hearings on eligibility for assistance after receipt of a rebate, it is advisable for tenants' counsel to negotiate with the relevant government agencies. The agreement would specify that the PHA is refunding rent overpayments and allow a reasonable period of time to spend the payment before any remainder would be counted as assets.

The consequences of the *Mass. Union* litigation<sup>157</sup> are significant. HUD took a preliminary step to remove the offensive regulation.<sup>158</sup> When the discovery is completed there may be a significant number of PHA tenants who will be entitled to substantial rebates of past overpayments because of improper reduction of utility allowances by PHAs following illegal meter conversions. Moreover, there will be legal meter conversions which proceeded illegally during the period the absolute interim injunction was in effect (March 3, 1982 to August 8, 1983). For the tenants thereby affected, a partial compensating rebate would seem to be required. These amounts, plus interest thereon, provide one potential source of funding for an innovative efficiency program in public housing.<sup>159</sup>

### E. Federal Energy Efficiency Alternatives

Creative options to promote energy efficiency were available to HUD during the entire decade of controversy. These options, many of which were suggested by the commenters to the proposed HUD rulemaking in 1975,<sup>160</sup> were the basis of the Petition for Rulemaking to HUD regarding the meter conversion policy,<sup>161</sup> the Energy Tax Act of 1978<sup>162</sup> and the National Energy Conservation Policy Act,<sup>163</sup> and requirements for Building Energy Performance Standards.<sup>164</sup> These options were a major source of economic growth in this country during the past de-

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<sup>157</sup> Two other cases contesting meter conversion resulted in judgments for defendants. *See Philadelphia Hous. Auth. v. HUD*, 86 F.R.D. 448 (E.D. Pa. 1980) (dismissed without prejudice); *Thompson v. Binghamton Hous. Auth.*, 546 F. Supp. 1158 (N.D.N.Y. 1982) (no irreparable harm shown, case dismissed with prejudice).

One subsequent case successfully bootstrapped an injunction on the *Mass. Union* decision. *See Tedford v. Massachusetts Hous. Fin. Agency*, 390 Mass. 688 (1984) (utility meter conversion enjoined).

<sup>158</sup> HUD proposed regulations in 1983 to delete the rule stricken by the court and to otherwise deregulate the meter conversion choice at the federal level by dropping the requirement that all utilities consumed by tenants in PHA housing be individually metered. 48 Fed. Reg. 51,785-88 (proposed Nov. 14, 1983). HUD never promulgated this rule in final form.

<sup>159</sup> *See infra* note 405.

<sup>160</sup> *See supra* note 109.

<sup>161</sup> *See supra* note 124.

<sup>162</sup> Energy Tax Act of 1978, Pub. L. No. 95-618, 92 Stat. 3174 (codified as amended in scattered sections of 26 U.S.C. (1982)).

<sup>163</sup> National Energy Conservation Policy Act, 42 U.S.C. §§ 8201-86 (1982).

<sup>164</sup> *See supra* notes 55-56.

cade,<sup>165</sup> and include a multitude of low-cost energy efficiency measures for public housing.

Despite President Carter's declaration that the national energy crisis is the "moral equivalent of war,"<sup>166</sup> HUD failed to adopt efficiency measures in public housing. Indeed, energy efficiency measures were not given equal consideration with meter conversion measures until after the *Mass. Union* litigation began.<sup>167</sup> In 1980, HUD provided the first significant and concerted demonstration funds for energy efficiency in public housing.<sup>168</sup>

Two areas in which great improvements could be made in public housing energy efficiency are building and heating system changes and appliance replacement. Investments in energy efficiency can be implemented at less equivalent cost than constructing additional energy supply sources, thus reducing energy costs to consumers while causing less environmental disruption.<sup>169</sup>

### 1. Efficiency Improvements in Public Housing Buildings and Heating Systems

Nationwide, energy use in public housing varies widely.<sup>170</sup> Energy consumption per public housing unit varies by a factor of six.<sup>171</sup> Even controlling for differences in weather and heating

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<sup>165</sup> Energy efficiency has produced more growth in the U.S. economy in recent years than all types of energy production combined. The economy has expanded not from production of energy, but from its more efficient application. See Lovins, *Saving Gigabucks with Negawatts*, PUB. UTIL. FORT., Mar. 21, 1985, at 21.

<sup>166</sup> The Energy Problem, Address to the Nation, 1 PUB. PAPERS 656 (Apr. 18, 1977).

<sup>167</sup> *Mass. Union*, Remand, *supra* note 146.

<sup>168</sup> In 1980, HUD awarded \$23 million in grants to 47 PHAs to undertake modernization of heating systems. HUD also awarded \$5 million in 1980 to 61 PHAs for the installation of innovative energy efficiency and renewable energy systems. Goldman, Ritschard & Atkielski, *Energy Conservation in Public Housing: The San Francisco Experience*, in AMERICAN COUNCIL FOR AN ENERGY EFFICIENT ECONOMY, *DOING BETTER: SETTING AN AGENDA FOR THE SECOND DECADE* H-48, H-49 (1984) [hereinafter cited as ACEEE, 1984].

<sup>169</sup> Ferrey, *What Electricity Shortage?*, N.Y. Times, Apr. 24, 1984, at A27, col. 1; S. Ferrey, *The Changing Role of Electric Energy and Demand Forecasting: Towards the Future Darkly?* (Nov. 1983) (unpublished paper prepared for the Aspen Inst. Conference). For a discussion of the value of superinsulated dwellings for the poor, see Sackett, *Climate-Appropriate Superinsulation: A Key Strategy for Affordable Housing in the Future* in ACEEE, 1984, *supra* note 168, at H-117.

<sup>170</sup> J. Stein, Newman Public Housing Utility Study §§ 4.20, 4.30' (June 1979) (study prepared for the Ga. Legal Serv. Program); Memorandum of Geoffrey MacAdie to Wayne Sherwood 3 (Jan. 3, 1979) (Office of Planning, Pol'y & Program Dev., Mass. Executive Off. of Communities & Dev., survey of Rents, Utility Costs and Incomes in State-Aided Public Housing).

<sup>171</sup> CLPHA Survey, *supra* note 32, at 33, Table 1.

needs, the BTU energy use per unit still varies by a factor of three.<sup>172</sup>

The Office of Technology Assessment estimates that low-income, single family housing has the technical potential to conserve about fifty percent of its current energy use.<sup>173</sup> Several studies<sup>174</sup> of low-income housing show impressive cost-effective efficiency savings from utility-sponsored programs,<sup>175</sup> from federal government-sponsored conservation demonstration programs,<sup>176</sup> and from the low-income Weatherization Assistance Program.<sup>177</sup>

Many successful, cost-justified energy efficiency investments show impressive energy savings with quick paybacks. In low-income private-market multifamily buildings in Roxbury, Massachusetts; conservation retrofits demonstrated savings of 26%–55% in the first year.<sup>178</sup> These savings represent simple paybacks of less than five years on the initial capital cost of the conservation investment; the return on investments is an impressive 21%–38% annually.<sup>179</sup>

Very rudimentary conservation measuring devices installed in San Francisco Public Housing Authority buildings, as part of

<sup>172</sup> *Id.* at 6, Table 2.

<sup>173</sup> OTA, *supra* note 3, at 5, Table 1.

<sup>174</sup> See Ferrey, *Pulling a Rabbit Out of the Hat: Innovative Financing for Low-Income Conservation* in ACEEE, 1984, *supra* note 168, at H-35 [hereinafter cited as Ferrey, *Low-Income Conservation*].

<sup>175</sup> *Id.* at H-38. In utility-sponsored conservation programs, low-income homes were able to save on average 38.4 Million BTU (MBTU) annually, although a program sponsored by the Tennessee Valley Authority conserved more than 70 MBTU annually at an installed cost of \$700 per unit. See C. Goldman, *Technical Performance and Cost-Effectiveness of Conservation Retrofits in Existing U.S. Residential Buildings: Analysis of the BECA-B Data Base 32* (Oct. 1983) (available from Lawrence Berkeley Laboratory, Univ. of Cal., Berkeley, Cal.).

<sup>176</sup> Ferrey, *Low-Income Conservation*, *supra* note 174, at H-38. The Community Services Administration/National Bureau of Standards Optimal Weatherization Demonstration Program achieved an average 23 MBTU annual savings per weatherized dwelling, and 62 MBTU annual savings where weatherization was combined with heating system tune-ups. The average savings for all dwellings was 31%. *Id.*

<sup>177</sup> The federal low-income Weatherization Assistance Program created average annual savings of 35.9 MBTU per dwelling. The median payback on the conservation investment was 9.2 years, at a median cost of conserved energy of \$4.65/MBTU. C. Goldman, *supra* note 175, at 45, 51; Ferrey, *Low-Income Conservation*, *supra* note 174, at H-39. For a detailed discussion of the federal Weatherization Assistance Program's goals and accomplishments, see S. Ferrey, et. al., *Energy Conservation and the Poor*, *supra* note 17. Cf. ENERGY ADMIN., MICH. DEP'T OF COMM., *A STUDY OF WEATHERIZATION SERVICE ALTERNATIVES IN MICHIGAN* (1985).

<sup>178</sup> Morgan, *Sharing Savings in Multifamily Housing: The Incentive Dividend in AMERICAN COUNCIL FOR AN ENERGY EFFICIENT ECONOMY, SUMMER STUDY 11* (1982) [hereinafter cited as ACEEE, 1982].

<sup>179</sup> *Id.*

Pacific Gas and Electric Co.'s Zero Interest Loan Program (ZIP), resulted in savings of 7%–20%.<sup>180</sup> These savings showed four- to six-year paybacks on the initial investment and a cost of \$2.50 per million BTUs saved.<sup>181</sup> The average cost of the conservation materials installed was \$150 per dwelling unit.<sup>182</sup>

In addition to installing efficiency investments in the building shell, impressive savings are available from improvements to the efficiency of the heating system. In Trenton, New Jersey, older public housing units experienced a fifty percent reduction in heating energy use solely from the installation of a computerized heating load control system.<sup>183</sup> This savings reflects an investment of about \$250 per unit, with a payback period of less than one year.<sup>184</sup>

The DOE estimates that for oil-heating residences, simple improvements to the furnace can achieve heating energy savings of eight percent by optimizing the firing rate of the burner; sixteen percent by use of a high-speed flame-retention burner; and twenty-four percent by replacement with a more efficient boiler.<sup>185</sup> In field tests, twenty percent savings on an initial investment of \$500 have been demonstrated from installation of an oil furnace tune-up package in low-income housing.<sup>186</sup> For a capital investment of \$150 in furnace efficiency, a twelve percent energy savings can be achieved in low-income households.<sup>187</sup>

A report commissioned by HUD on the potential for energy efficiency in public housing estimates that a complete, cost-justified energy conservation program would reduce annual energy operating costs by 30%–60% (with an average 48% savings) depending on the individual project's characteristics.<sup>188</sup> These savings could be achieved for an average investment of \$800–\$2500 per unit and would produce an average payback of six

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<sup>180</sup> Goldman, Ritschard & Atkielski, *supra* note 168, at H-48.

<sup>181</sup> *Id.*

<sup>182</sup> *Id.*

<sup>183</sup> Gold, *The Page Homes Demonstration Energy Conservation Computer System* in ACEEE, 1982, *supra* note 178, at 1.

<sup>184</sup> *Id.*

<sup>185</sup> Div. of Bldgs. & Community Sys., U.S. Dep't of Energy, Fact Sheet, Energy Saving Options for Home Oil Heating Equipment (Spring 1980), *reprinted in* U.S. DEP'T OF ENERGY, INCREASING BENEFITS OF ENERGY ASSISTANCE PROGRAMS THROUGH OIL FURNACE RETROFITS B-5 (1981).

<sup>186</sup> *Id.*

<sup>187</sup> Proctor, *Low Cost Furnace Efficiency Improvements* in ACEEE, 1984, *supra* note 168, at H-200.

<sup>188</sup> PERKINS & WILL, & THE EHRENKRANTZ GROUP, ENERGY CONSERVATION FOR HOUSING: A WORKBOOK 1-6 (May 1982).

**Table 6**  
*Potential Efficiency Savings in Public Housing  
by Function*

<i>End Use</i>	<i>Potential Savings</i>
Operation and Maintenance	11%
Windows and Door Improvements	13%
Wall/Ceiling/Roof Insulation	6%
Mechanical Equipment Improvements	13%
Electrical	2%
Other	4%
National Average Savings	48%

years, with a return on investment of more than fifteen percent annually.<sup>189</sup> Table 6<sup>190</sup> disaggregates these potential public housing heating-related efficiency improvements by function. The data illustrate the significant savings in heating system and building shell efficiency available from various measures.

## 2. Appliance Efficiency in Public Housing

Public housing authorities furnish all units with major household appliances.<sup>191</sup> Since miscellaneous household appliances and water heaters are responsible for about fifty percent of primary residential energy consumption,<sup>192</sup> HUD could achieve substantial energy efficiency by enforcing appliance efficiency requirements in the PHA procurement process so as to take advantage of current technology.

For almost all household appliances, there now exist alternative American-made models at least fifty percent more effi-

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<sup>189</sup> *Id.* The Massachusetts Executive Office of Community Affairs, based on actual inspections of approximately 15,000 units of state-aided public housing, found that up to a 35% savings in energy consumption could be achieved by investments in efficiency measures and tenant education. MASS. EXECUTIVE OFF. OF COMMUNITIES & DEV., ENERGY CONSERVATION GUIDELINES FOR RETROFIT OF STATE-AIDED HOUSING 1-1 (1977).

<sup>190</sup> This data is taken from PERKINS & WILL, & THE EHRENKRANTZ GROUP, *supra* note 188, at 1-6.

<sup>191</sup> See 24 C.F.R. §§ 965.601-.605 (1984).

<sup>192</sup> Geller, *Efficient Residential Appliances and Space Conditioning Equipment: Current Savings Potential, Cost Effectiveness and Research Needs* in ACEEE, 1984, *supra* note 168, at E-119. Primary energy accounts for the total raw units of energy which are used to produce the energy service, including losses in the combustion of fossil fuels. As the building shell is made more efficient, miscellaneous household appliances account for a greater share of total household energy consumption.

cient than the model typically produced and purchased in recent years.<sup>193</sup> Controlling for differences in size and features, Japanese refrigerators now in production use approximately one-half the electric energy equivalent American models do.<sup>194</sup> Similar efficiency savings are available for lighting, water heaters, furnaces, air conditioners, and stoves.<sup>195</sup>

Investing in efficient household appliances demonstrates a rate of return on the investment of between 9%–52%.<sup>196</sup> The greater purchase costs are repaid in energy savings in 2–8.6 years depending on the appliance—in other words, in less than half the period of the appliance's lifetime.<sup>197</sup>

Since appliances are replaced after a relatively short life (unlike buildings), a successful appliance efficiency strategy can be implemented incrementally, replacing a significant fraction of the existing appliances each year. Because appliances seldom are replaced before their lifetimes are complete, however, if a PHA misses an opportunity to purchase the most efficient replacement appliances in any year, it may have to wait ten to twenty years before that appliance is replaced again. In the meantime, of course, efficiency savings will be lost.

Work on the innovative financing and the technology of energy efficiency in public housing is ongoing.<sup>198</sup> Technical assistance materials have been available to assist PHAs in taking inventory and in assessing the opportunities to improve the efficiency of their projects.<sup>199</sup> Tenant behavior in using appliances and heating systems, however, will always be a factor outside the PHAs' direct control. Usage patterns observed in public housing, such as the regular use of gas stoves for supplemental winter heating,<sup>200</sup> or where constant use of a television

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<sup>193</sup> *Id.* at E-118.

<sup>194</sup> Goldstein, *Efficient Refrigerators in Japan: A Comparative Survey of American and Japanese Trends Towards Energy Conserving Refrigerators*, in ACEEE, 1984, *supra* note 168, at E-131.

<sup>195</sup> *Id.*; Geller, *supra* note 192, at E-128. 19%–29% of natural gas use in public housing is used for cooking purposes. Goldman, Ritschard & Atkielski, *supra* note 168, at H-53.

<sup>196</sup> Geller, *supra* note 192, at E-123.

<sup>197</sup> *Id.*

<sup>198</sup> Work is currently being conducted by the author and at Lawrence Berkeley Laboratory in California on technical data and incentives.

<sup>199</sup> See generally PERKINS & WILL, & THE EHRENKRANTZ GROUP, *supra* note 188, at apps. A–B; MASS. EXECUTIVE OFF. OF COMMUNITIES & DEV., ENERGY CONSERVATION GUIDELINES FOR RETROFIT OF STATE-AIDED HOUSING (1977); MASS. EXECUTIVE OFF. OF COMMUNITIES & DEV., ENERGY RELATED IMPROVEMENTS IN STATE-AIDED HOUSING (1979).

<sup>200</sup> Diamond, *Energy Use Among the Low-Income Elderly: A Closer Look*, in ACEEE, 1984, *supra* note 168, at F-63.

consumes more electricity than the refrigerator,<sup>201</sup> cause significant variations in PHA energy use.<sup>202</sup> A controversial regulatory mechanism through which PHAs influence tenant behavior, the utility allowance, is discussed in Part V.<sup>203</sup>

#### IV. THE REGULATORY STRUCTURE OF PUBLIC HOUSING: OF INCENTIVES AND ENERGY CONSERVATION

##### A. *The Federal-Local Link: The Performance Funding System and the Annual Contributions Contract*

Publicly financed and owned housing for low-income families was created by the United States Housing Act of 1937.<sup>204</sup> To implement the program, the statute created a federal-local partnership. Public housing agencies, legally distinct agencies of local government, develop and manage public housing projects.<sup>205</sup> PHAs finance the construction or acquisition of public housing by issuing tax-exempt bonds backed by the full faith and credit of the federal government.<sup>206</sup>

The federal government also makes annual contributions to PHAs to assist with the debt service on the bonds and to subsidize PHAs' operating expenses.<sup>207</sup> This relationship is embodied in the Annual Contributions Contract between HUD and each individual PHA.<sup>208</sup> Originally, the statute allowed either debt financing or direct capital financing of PHA projects.<sup>209</sup> In 1949, however, Congress specified that debt financing was to be the primary source of PHA funding.<sup>210</sup>

<sup>201</sup> *Id.* at F-59.

<sup>202</sup> *Id.* at F-52.

<sup>203</sup> See *infra* notes 260–336 and accompanying text.

<sup>204</sup> United States Housing Act of 1937, ch. 896, 50 Stat. 888 (1937) (codified as amended at 42 U.S.C. § 1437 (1982)).

<sup>205</sup> "The term 'public housing agency' means any state, county, municipality, or other governmental entity or public body (or agency or instrumentality thereof) which is authorized to engage in or assist in the development or operation of lower income housing." 42 U.S.C. § 1437(b)(6) (1982).

<sup>206</sup> *Id.* § 1437(i). The statute authorizes PHAs to issue bonds; in practice, HUD issues pooled bond financing on behalf of PHAs.

<sup>207</sup> 24 C.F.R. § 990.101(a) (1984); 42 U.S.C. § 1437g(a) (1982).

<sup>208</sup> 24 C.F.R. § 990.102(j) (1984).

<sup>209</sup> United States Housing Act of 1937, §§ 9-11, 50 Stat. 888, 891–94. The amount of contribution was limited to the annual debt service payment on the development or acquisition cost.

<sup>210</sup> United States Housing Act of 1949, § 304, 63 Stat. 413, 424 (amending United States Housing Act of 1937). These amendments allowed PHAs to secure loans against their annual contribution contract payments from the federal government. *Id.*



The federal government historically provided payments to PHAs only for debt service.<sup>211</sup> PHA operating income was restricted to tenant rent payments, which could not exceed twenty-five percent of tenants' adjusted income.<sup>212</sup> Many PHAs were not able to raise enough revenue under these constraints to meet their operating expenses.

In 1969, Congress granted HUD the authority to make payments to PHAs to cover operating expense deficits.<sup>213</sup> Due to mechanical problems with the subsidy calculation,<sup>214</sup> Congress in 1974 further amended the statute to clarify that PHAs could receive federal subsidies to cover both unfunded debt service expenses and any shortfall in operating income.<sup>215</sup> The statute as amended currently requires HUD to consider costs of operations and reasonable projections of income in determining the annual operating subsidy.<sup>216</sup>

In 1975, after Congress expressed concern regarding poor local management,<sup>217</sup> HUD created the Performance Funding System (PFS) to control rampant utility and other cost increases and "to provide the amount of subsidy which would be needed for well-managed projects."<sup>218</sup> The PFS uses criteria and formulae representing the operations of a well-managed prototype project to determine a PHA's reasonable annual expenses, in order to provide incentives for efficient local management.<sup>219</sup>

The Performance Funding System determines the annual cash flow from HUD to each PHA, and requires PHAs to submit

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<sup>211</sup> See *supra* notes 208–209 and accompanying text.

<sup>212</sup> 42 U.S.C. § 1437(a)(1) (1982).

<sup>213</sup> Housing and Urban Development Act of 1969, Pub. L. No. 91-152, 83 Stat. 379 (codified in scattered sections of 12, 15, 20, 40, 49 U.S.C. (1982)). Section 19(b) of the Housing Act was amended to "clarify existing authority to contract for the payment of annual contributions in an amount in excess of the debt service requirements for public housing projects." S. REP. NO. 693, 91st Cong., 2d Sess. 15 (1969).

<sup>214</sup> Since a single fund existed for the payment of both debt service and operating subsidies, the payment of either from this fund counted toward the statutory maximum payments. This diminished the ability of a PHA with relatively high debt service requirements to receive operating subsidies. Debt service requirements were a function of the prevailing interest rates at the time a project was developed or acquired. See S. REP. NO. 392, 93d Cong., 2d Sess. 41 (1974).

<sup>215</sup> Housing and Community Development Act of 1974, Pub. L. No. 93-383, § 105(a)(4), 88 Stat. 641. S. REP. NO. 392, 93d Cong., 2d Sess. 41 (1974).

<sup>216</sup> 42 U.S.C. § 1437(g)(a)(2) (1982).

<sup>217</sup> The House Report stated that Congress was "deeply concerned over cases of lax management in many public housing projects which have led to high operating costs, deterioration of property and an intolerable environment for families who live there." H. R. REP. NO. 740, 91st Cong., 1st Sess. 31 (1969).

<sup>218</sup> See 24 C.F.R. §§ 990.101–.116 (1984); see also *id.* § 990.101(c)(1).

<sup>219</sup> *Id.* § 990.101(a).

prospective yearly operating budgets for HUD approval.<sup>220</sup> Utility expenses are not subject to the same calculations used to determine the funding for other PHA operating expenses; this exception reflects the wide variety of utility sources employed by PHAs and the inability of PHAs to control utility rates.<sup>221</sup> Non-utility expenses are calculated by increasing historic rental income by three percent<sup>222</sup> and factoring this inflated value into the expected percentage of unit occupancy;<sup>223</sup> allowable operating expenses are projected by reference to a base year immediately prior to imposition of the PFS system.<sup>224</sup> The PFS funding level for any given project can be no more than prototype levels.<sup>225</sup> HUD does not recapture any unspent PFS general funding at year end.<sup>226</sup>

Utility expenses are treated differently than all other PFS expenses. Utility expenses are calculated by multiplying historic energy consumption levels per unit by the expected number of occupied units.<sup>227</sup> This product is multiplied by either the current rate for utility service or the expected rate for service during the period of PFS funding.<sup>228</sup>

At year end, utility expenses are trued-up in two ways. First, heating utilities are adjusted to reflect actual weather-related heating requirements.<sup>229</sup> Second, there is a year-end recapture

<sup>220</sup> *Id.* § 990.103(b) and *id.* § 990.112(a); *see also id.* § 102(j). HUD should, but seldom does, approve the PHA budget at least 30 days before the start of a fiscal year.

<sup>221</sup>

In recognition of the rapid rises which occur in utilities costs, the wide diversity among PHA as to types of utilities services [sic] used and the manner in which utilities payments are allocated between PHAs and tenants, and the fact that utilities rates [sic] charged by suppliers are beyond the control of the PHA, the PFS treats utilities expenses separately from other PHA expenses.

<sup>224</sup> C.F.R. § 990.107(a) (1984).

<sup>222</sup> *See id.* § 990.109(b)(2), (4). This 3% increase is an estimation of expected increases in tenants' incomes.

<sup>223</sup> *Id.* § 990.114; *see id.* § 990.109. PHAs must collect as rent at least an average of 20% of the incomes of total households in a project. 42 U.S.C. § 1437g(b) (1982).

<sup>224</sup> *Id.* § 990.105; *see id.* § 990.102(a).

<sup>225</sup> *Id.* § 990.105 (1984).

<sup>226</sup> *Id.*

<sup>227</sup> *Id.* § 990.107(a). Unless it can justify a greater vacancy rate to HUD based on recent events or the physical condition of units, the assumed vacancy rate cannot be greater than 3% of habitable units. *Id.*

<sup>228</sup> *Id.* §§ 990.107(c)(1), (d)(1).

<sup>229</sup> *Id.* § 990.107(d)(1). The change factor is developed by the Department of Commerce National Climatic Center to reflect actual heating degree days which represent the heating needs of the winter. This figure reconciles the heating degree days of the immediately past winter with the heating degree days of those past winters represented in the rolling base period. This procedure corrects PFS funding for any transitory weather effects. *Id.*

(or additional funding) of variations between the projections and actual costs:<sup>230</sup> HUD recaptures or will pay fifty percent of the difference between actual and expected expenditures due to consumption variations, subject to the availability of HUD funds; if a change in rates is the cause of the difference, HUD recaptures or will pay one hundred percent of the differential subject to the availability of funds.

In an era of rising utility rates, this after-the-fact adjustment has mercurial effects on PHAs. For example, after the large utility rate increases which followed the 1979 Iranian oil interruption, HUD attempted to allow PHAs their full share of non-utility PFS operating subsidies for FY 1982 only if they "waived" their rights to seek an adjustment in their FY 1981 PFS utility subsidies.<sup>231</sup> For FY 1981, at year end HUD only agreed to provide a level of funding equal to 96.5% of PFS eligibility for PHAs which experienced greater than budgeted utility costs.<sup>232</sup> This withholding of appropriated funds was challenged by a number of housing authorities.<sup>233</sup>

In late 1983, HUD changed the PFS computation base so that it now employs a three-year rolling base of actual PHA consumption data (this base period ends more than one year prior to the start of the funding period).<sup>234</sup> Therefore, PFS funding to PHAs now reflects an energy consumption period approximately one to five years in the past. If three-years' data is not available, a two-year or one-year period is employed.<sup>235</sup> If no data is

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<sup>230</sup> *Id.* § 990.107(f). In an era of rising utility rates, after-the-fact adjustment can actually have a negative impact on PHAs. For example, HUD altered the PFS formula in 1984 to attribute to PHAs a larger share of imputed interest and other income, thus reducing the subsidy to which the PHA was entitled. *Id.* §§ 990.109(e), 990.110(e). This alteration was applied retroactively to past years' PFS funding, requiring some PHAs to return funds previously received and spent. This practice currently is subject to legal challenge in the District Court for the District of Columbia. *See* Council of Large Pub. Hous. Auths. v. Pierce, No. 84-3114 (D.D.C. filed Oct. 5, 1984) (complaint).

<sup>231</sup> Memorandum from the Ass't Sec'y for Hous., HUD, to all HUD Regional Adm'rs at 2 (Mar. 2, 1982) (on the special assignment of subsidies for operation of low-income public housing projects).

<sup>232</sup> *Id.* at 3.

<sup>233</sup> *See* Council of Large Pub. Hous. Auths. v. Pierce, No. 84-3114 (D.D.C. Oct. 5, 1984) (case filed).

<sup>234</sup> 24 C.F.R. § 990.107(c)(1) (1984); 48 Fed. Reg. 38,228 (1983). Prior to 1984, the annual projection of utility consumption was based on actual consumption during the 1973-76 fiscal years, adjusted for average weather data for the previous 30 years. 24 C.F.R. § 990.107(c) (1984). The current rolling base period must end at least 12 months before the beginning of the fiscal year for which the budget is prepared. This procedure causes the data employed to reflect a period at least 12 months before the first month of the budget year and at least 24 months before the end of the budget year.

<sup>235</sup> 24 C.F.R. § 990.107(c)(2)(i) (1985).

available or if the project is newly constructed or acquired, consumption is estimated by reference to comparable housing.<sup>236</sup>

The three-year rolling base period is not adjusted to take energy conservation investments into account. By contrast, if the PHA were to undertake conversions of the metering system or conversions to new fuel sources, the PFS funding will be recalculated based on revised estimates of utility operating expenses.<sup>237</sup> This apparently superficial distinction is, in fact, a critical element of the strategic opportunities open to PHAs.<sup>238</sup>

Recently, HUD inserted an additional factor into the PFS formula: for those PHAs which cannot demonstrate that they are achieving energy conservation, a one-time financial penalty will be imposed.<sup>239</sup> All PHAs must demonstrate that they have achieved at least a five percent conservation savings over their recent historic utility consumption (excluding water and sewer utilities), regardless of whether HUD funds were provided to finance conservation.<sup>240</sup> This one-time penalty will be imposed regardless of whether the PHA received HUD funds to make energy efficiency investments;<sup>241</sup> it will be deducted from the entire PFS subsidy entitlement due for one fiscal year;<sup>242</sup> and it will be imposed automatically if the PHA has not maintained the data needed to calculate the base period amounts.<sup>243</sup> Since utility costs can comprise forty percent or more of PHA operating budgets,<sup>244</sup> even small amounts of withheld funding or small penalties can translate into large fiscal shortfalls at the local level.

### B. Appliance Procurement and Energy Efficiency

Public housing authorities are significant purchasers of major household appliances. PHAs furnish 1.2 million tenant units

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<sup>236</sup> *Id.* § 990.107(c)(2)(ii).

<sup>237</sup> *Id.* § 990.107(c)(3).

<sup>238</sup> See *supra* note 213 and accompanying text.

<sup>239</sup> 24 C.F.R. § 990.116(a) (1985).

<sup>240</sup> *Id.* Data informally collected by the Council of Large Public Housing Authorities for FY 1980 indicates that in 1980 many large PHAs across the nation did achieve improvements in conservation, corrected for weather data. See CLPHA, *supra* note 32, at 1.

<sup>241</sup> See 24 C.F.R. § 990.116 (1984).

<sup>242</sup> *Id.* § 990.116(b).

<sup>243</sup> *Id.* § 990.116(a). These funds are provided to financially troubled PHA projects, but are not used for energy or utility purposes. *Id.* § 990.116(d).

<sup>244</sup> CLPHA Survey, *supra* note 32, at 1.

with appliances.<sup>245</sup> Assuming that most major appliances have a lifespan of ten to fifteen years, every year PHAs must purchase approximately 100,000 refrigerators, as well as similar numbers of ranges, water heaters, and other major appliances.

The cost of replacing major appliances is an allowable expense and is included in the annual PFS budget estimate prepared by each PHA.<sup>246</sup> The fifty-two HUD area offices around the nation participate in a Consolidated Supply Program (CSP),<sup>247</sup> whereby HUD provides technical and procurement assistance to PHAs to purchase appliances on a consolidated basis and thereby take advantage of bulk purchase discounts.<sup>248</sup>

Under the CSP, HUD area offices are responsible for establishing procurement award criteria which conform to all regulatory requirements.<sup>249</sup> Competitive bids are solicited in response to formal invitations to bid.<sup>250</sup> HUD may award a supply contract to a responsible bidder whose bid is at or below the average price bid for the procurement item.<sup>251</sup> As a practical matter, the low-bid item normally receives the contract for supply.<sup>252</sup>

PHAs place orders directly with the supplier for individual items from the list of contract items available through the CSP.<sup>253</sup> Therefore, PHAs are restricted to those appliances which are offered (at lowest bid price) through the CSP. For energy-consuming appliances, often only the least-cost, least-efficient models are available through CSP.

Whether PHAs purchase efficient or inefficient appliances profoundly affects the PHAs' utility bills experiences. If all PHAs this year purchased the most cost-efficient model of refrigerator, rather than the least expensive on a first cost basis, they would save 780 million Kwh of electricity annually; save \$62 million in energy costs in the first year alone; and over a fifteen-year refrigerator lifetime, save more than \$936 million in

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<sup>245</sup> OTA, *supra* note 3, at 154.

<sup>246</sup> 24 C.F.R. § 965.601 (1984).

<sup>247</sup> *Id.* § 965.603.

<sup>248</sup> HUD procurement regulations are codified at 41 C.F.R. §§ 24-1.451-451-2(d) (1984), and 24 C.F.R. 965.601-.605 (1984).

<sup>249</sup> 24 C.F.R. § 965.603 (1984).

<sup>250</sup> *Id.* § 965.603(a)(1).

<sup>251</sup> *Id.* § 965.603(a)(2).

<sup>252</sup> *See id.* § 965.603(a)(2).

<sup>253</sup> *Id.* § 965.604(c).

energy costs (in current dollars).<sup>254</sup> These numbers represent just the efficiency savings for one major appliance. The added cost of procuring the most efficient models would be recouped in the first one to two years of operation. When extended to other major energy-consuming appliances, the total savings could be even more substantial.<sup>255</sup>

In 1980, after nationwide litigation challenged energy inefficiency in public housing,<sup>256</sup> HUD promulgated regulations directing every PHA, when replacing appliances, to either perform a life-cycle cost analysis and procure the major appliance which the analysis dictates is the most cost-efficient or to procure the most efficient appliance available.<sup>257</sup> The difference in efficiency between the outcome of these two options is minimal.<sup>258</sup>

This directive to procure efficient appliances has not worked well in practice, however. HUD made no visible effort to enforce this provision and as a result it is likely that very few PHAs have performed life-cycle cost analyses. Moreover, the administration withheld promulgation of a draft guide for the preparation of life cycle cost analyses.<sup>259</sup>

The dichotomy in responsibility for procurement, split as it is between HUD and the PHA, results in an abrogation of the PHAs' responsibility to procure efficient appliances. The result of this administrative failure is measured in tens of millions of dollars of federal energy expenditures annually which could be saved.

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<sup>254</sup> Frostfree refrigerator models of approximately 17 cubic feet in volume now manufactured in America by major companies require between 750 Kilowatthours (Kwh) per year and 1,400 Kwh per year depending upon the model. CALIFORNIA ENERGY COMMISSION NEWS & COMMENT, Spring 1985, at 1. This differential between the most efficient and least efficient models, in 1.2 million public housing units, comes to 780 million Kwh annually. At an average cost of \$0.08 per Kwh, this represents \$62 million in annual savings; \$936 million over the 15-year lifetime of an appliance.

<sup>255</sup> See *supra* notes 192-202.

<sup>256</sup> See *supra* text accompanying notes 124-33. As originally filed, the litigation contested the failure of HUD to pursue alternatives for greater efficiency as a violation of the National Environmental Policy Act. See *Mass. Union*, Complaint, *supra* note 126, at 12, 13.

<sup>257</sup> 24 C.F.R. § 965.308(d) (1984).

<sup>258</sup> A life-cycle cost analysis calculates the capital cost of purchasing the appliance, and the discounted present cost of purchasing energy to operate the appliance over its expected lifetime. See generally GSA, *supra* note 99. The result indicates the appliance with the lowest total acquisition and operating costs over its lifetime. While this model may not be the most efficient one available, depending on relative acquisition costs, the analysis will prefer at least one of the most efficient models.

<sup>259</sup> U.S. Dep't of Hous. & Urban Dev., A Guide for the Preparation of a Life-Cycle Cost Analysis for Heating and Cooling Systems and Energy Conserving Measures in Residential Buildings, Handbook 4075.17 (undated draft) (on file at HARV. J. ON LEGIS.).

## V. UTILITY ALLOWANCES: AT THE TURNING POINT

Just as the Performance Funding System passes utility operating funds from HUD to the PHA, utility allowances pass utility operating funds from PHAs to tenants.<sup>260</sup> Because utility allowances are the only direct payment or credit from the PHA to tenants,<sup>261</sup> they are a vital element in the implementation of present housing policy, as well as a critical transaction in the landlord-tenant relationship.

The importance of utility allowances grew during the last decade, as energy costs skyrocketed. Not only does the utility allowance determine the amount of federal utility funds which the PHA provides to tenants, but it also controls the distribution of utility costs between tenants and the government, the price incentives to tenants to conserve/consume utility services, and both a tenant's eligibility for federal Low Income Energy Assistance and the amount of his benefits under that program.<sup>262</sup> Tenant utility allowances represent a substantial cash outlay for the federal government, with estimated public housing energy costs of \$749 million (in 1980 dollars).<sup>263</sup> As utility costs escalated and federal financial support leveled off, the utility allowance became the focus of concerted attention. Today, the utility allowance is a regulatory mechanism at the turning point.

A. *The Utility Allowance as a Regulatory Device*

The Brooke Amendment<sup>264</sup> to the United States Housing Act<sup>265</sup> requires that the percentage of income which public housing tenants pay for "shelter" be no higher than a specified percentage of their adjusted family incomes.<sup>266</sup> Originally, the statutory ceiling was twenty-five percent of adjusted family

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<sup>260</sup> See 24 C.F.R. §§ 965.470-482 (1984).

<sup>261</sup> *Id.*

<sup>262</sup> See *infra* notes 337-95 and accompanying text.

<sup>263</sup> PERKINS & WILL, & THE EHRENKRANTZ GROUP, *supra* note 188, at 1-6. In 1986 dollars, this amount would approach \$1 billion. For utility allowances affecting Section 8 housing subsidized by HUD, see 24 C.F.R. § 882.110 (1984).

<sup>264</sup> Housing and Community Development Amendments of 1979, Pub. L. No. 96-153, 93 Stat. 1101 (codified at 42 U.S.C. § 1437a (1982)).

<sup>265</sup> Codified as amended at 42 U.S.C. § 1437 (1982).

<sup>266</sup> *Id.* § 1437a.

income.<sup>267</sup> Recently, the ceiling has been raised one percent annually which will continue until it reaches a maximum of thirty percent of adjusted family income in 1986.<sup>268</sup>

HUD has defined shelter to include a reasonable amount of utility service.<sup>269</sup> Controversy flared for most of the last decade over what constitutes a reasonable amount: at times, a reasonable amount of utility service was determined by the type of utility meter serving the units,<sup>270</sup> while at other times the key factor may have been whether the tenants were elderly households or low-income families.

Much as with the Minimum Property Standards for PHA project construction,<sup>271</sup> utility allowances evolved through several stages. In 1963, HUD incorporated tenant utility allowances in a Handbook, which was never promulgated in the form of binding regulations.<sup>272</sup> The Handbook specified that reasonable utility allowances be based on the past twenty-four billing periods for utilities in a given PHA project.<sup>273</sup>

If individual tenant units were submetered, HUD specified that tenants should be surcharged for consumption in excess of a reasonable quantity of utility service supplied free.<sup>274</sup> HUD suggested that this reasonable quantity be established at a value representing average consumption plus twenty percent.<sup>275</sup> The rationale for this standard was that it would ensure that at least five percent, but no more than twenty-five percent, of tenants would be surcharged.<sup>276</sup> The surcharges were to be retained by the PHA as part of its operating budget.<sup>277</sup> In master-metered units, HUD allowed a flat-rate surcharge for the possession of certain unauthorized appliances.<sup>278</sup> Allowances were revised

<sup>267</sup> Housing and Urban Development Act of 1969, Pub. L. No. 91-152, 83 Stat. 379 (codified as amended at 42 U.S.C. § 1437a (1982)). The amount paid by the tenant must be at least 10% of gross income. 24 C.F.R. § 960.404 (1984).

<sup>268</sup> 42 U.S.C. §§ 1437a(a), (f) (1982); 47 Fed. Reg. 19,120-24 (1982).

<sup>269</sup> 49 Fed. Reg. 31,400 (1984); see also U.S. PUB. HOUS. ADMIN., LOCAL PUBLIC HOUSING AUTHORITY MANAGEMENT HANDBOOK, pt. 2, § 9, at 14 (1963) [hereinafter cited as LOCAL PUBLIC HOUSING AUTHORITY HANDBOOK].

<sup>270</sup> Originally HUD installed master-meters in many units of public housing. See *supra* notes 85-88 and accompanying text.

<sup>271</sup> See *supra* text accompanying notes 34-53, 64-67.

<sup>272</sup> LOCAL PUBLIC HOUSING AUTHORITY HANDBOOK, *supra* note 269, at 14-16.

<sup>273</sup> *Id.* at 17-20. This procedure meant that projects which were billed for utility service on a monthly basis utilized two years of data, while projects billed on a quarterly basis utilized six years of data.

<sup>274</sup> *Id.* at 17.

<sup>275</sup> *Id.* at 14.

<sup>276</sup> *Id.* at 15.

<sup>277</sup> *Id.* at 17.

<sup>278</sup> *Id.* at 17-20.



“whenever any substantial changes [were] made in the rent schedule.”<sup>279</sup>

Basing utility allowances on actual consumption data for a particular housing project ensures that the allowance will at least reflect the relative costs associated with operating the heating system and appliances of that particular project. Data suggests, however, that PHAs seldom followed this directive of the HUD Handbook.<sup>280</sup> Instead, allowances typically were not based on actual data at each project and were often woefully inadequate.<sup>281</sup> In some cases, the utility allowance for several months did not reasonably compensate any of the tenants for utility costs.<sup>282</sup> Some utility allowances were not even sufficient to pay for the electricity needed to operate the refrigerator supplied to tenant units.<sup>283</sup>

Under pressure to fashion mandatory standards in order to ensure reasonable allowance levels in fact, HUD, in 1980, promulgated regulations which included utility allowance formulae for the first time.<sup>284</sup> Separate allowances were to be established for different types of structures<sup>285</sup> and for different sized units.<sup>286</sup> While PHAs were provided with the option to establish a distinct allowance category to reflect any unique thermal qualities of a particular unit, few did.<sup>287</sup>

The 1980 regulations made utility metering the dominant factor in the determination of allowances. The regulations differentiated allowances by the unit's type of metering system: master metering, individual metering, or submetering.

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<sup>279</sup> *Id.* at 21. Today, most public housing authorities no longer maintain rent schedules. Rather, they establish tenant rents at 30% of each individual tenant's adjusted income. See 42 U.S.C. § 1437a (1982).

<sup>280</sup> J. Stein, *supra* note 170, at § 4.60.

<sup>281</sup> *Id.*

<sup>282</sup> *Id.*

<sup>283</sup> *Id.*

<sup>284</sup> 45 Fed. Reg. 59,505 (1980) (to be codified at 24 C.F.R. § 865), later redesignated by 49 Fed. Reg. 6714 (1984) (to be codified at 24 C.F.R. § 965).

<sup>285</sup> “Separate allowances shall be established for each utility and for each category of dwelling units within structures which are reasonably comparable as to age and construction type, have the same utility combination and the same type of major equipment.” 24 C.F.R. § 965.474(a) (1984).

<sup>286</sup> *Id.* § 965.474(c).

<sup>287</sup> *Id.* For example, two identically sized units in the same building, whose inhabitants use energy in identical ways, may require heating energy in amounts varying by more than a factor of two in order to maintain identical temperatures. For example, a top-floor corner unit (with two walls and a ceiling exposed to the exterior) on the north side of the building will consume twice as much winter heating energy to maintain an identical temperature as the same size unit located on the south side, on a middle level of the building and not in the corner.

First, for master-metered tenants, these regulations did not substantially change the previously existing system.<sup>288</sup> Tenants paid thirty percent of adjusted income for rent and received all utility service without charge.<sup>289</sup> The PHA could charge tenants for the possession, but not the use, of household appliances that it deemed unauthorized.<sup>290</sup> An "unauthorized" appliance could be any energy consuming appliance not supplied by the PHA, even if its use was necessary.<sup>291</sup>

Second, for individually-metered tenants, the regulations did change the previously existing system. The tenant now paid the full amount of the utility bill and the contract rent payment was reduced by the cash dollar amount of the utility allowance.<sup>292</sup> The utility allowance was calculated at the fiftieth percentile, or average, of historic utility consumption for units in the project of similar size.<sup>293</sup> Individually-metered tenants were not reimbursed for any costs of utility consumption which exceeded the value of their utility allowances.<sup>294</sup> Any energy conservation resulted in direct cash savings to the tenant.<sup>295</sup>

Finally, submetered tenants now paid thirty percent of adjusted family income for rent and received a specified quantity of utility service as their utility allowance.<sup>296</sup> This quantity was established at the ninetieth percentile of actual consumption at each project for units of a given size in each dwelling unit category.<sup>297</sup> Up to the utility allowance amount, submetered tenants consumed energy at no additional cost to themselves, but no rebates were provided for conservative consumption.<sup>298</sup> If a household consumed more than the utility allowance amount, the PHA could surcharge it for the excess consumption; about ten percent of the dwelling units were to be surcharged for some consumption under this regulation.<sup>299</sup> The surcharge was computed at the average per unit cost of energy to the PHA

<sup>288</sup> See *supra* note 278 and accompanying text.

<sup>289</sup> See *supra* note 268 and accompanying text.

<sup>290</sup> See LOCAL PUBLIC HOUSING AUTHORITY HANDBOOK, *supra* note 269, at 20.

<sup>291</sup> *Id.*

<sup>292</sup> 24 C.F.R. § 965.475(b) (1984).

<sup>293</sup> *Id.* § 965.477.

<sup>294</sup> *Id.* § 965.478.

<sup>295</sup> *Id.*

<sup>296</sup> See *supra* note 268 and accompanying text.

<sup>297</sup> 24 C.F.R. § 965.477 (1984).

<sup>298</sup> *Id.* As originally proposed, the regulations would provide rebates for consumption 15% below the average consumption and surcharges would be assessed for consumption 15% in excess of average consumption. See 44 Fed. Reg. 1600-03 (1979).

<sup>299</sup> 24 C.F.R. § 965.477 (1984).

through its master meter.<sup>300</sup> The allowance had to be reviewed and adjusted upward, if appropriate, when more than twenty-five percent of the tenants were surcharged in any billing period.<sup>301</sup>

The regulatory mechanics for all three types of tenant metering required that allowances be computed from energy consumption data for the prior three-year rolling period.<sup>302</sup> If this data was not readily available, prior two-year or one-year periods were to be used.<sup>303</sup> For new housing, or for existing housing after a meter conversion or fuel source change, a new estimated utility allowance was established by reference to comparable housing in the locality.<sup>304</sup>

These standards provided tenants several affirmative protections. First, excess consumption due to a failure of management to make necessary repairs could not result in out-of-pocket costs or surcharges to tenants.<sup>305</sup> Second, the PHA was obliged to provide counseling, to modify dwellings to increase efficiency, or to provide corrective maintenance for any tenants who consumed excessively.<sup>306</sup> Finally, the cash value of utility allowances for individually-metered tenants was to be revised whenever rates cumulatively increased ten percent or more,<sup>307</sup> and additurs could be considered by the PHA on an individual basis whenever consumption exceeded the established allowance by twenty percent or more in any billing period.<sup>308</sup>

This regulatory system governed tenant utility allowances from September 1980 until April 1985. Since that time, local PHAs are no longer required to adhere to these HUD utility allowance standards.<sup>309</sup> The majority of PHAs, however, have not yet altered the allowances they established pursuant to these standards. Consequently, these standards still remain in effect for most public housing.

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<sup>300</sup> "The amount of the Surcharge for each block (of excess consumption) shall be computed by applying the Utility Supplier's average rate to the amount of the excess." 24 C.F.R. § 965.479 (1984)

<sup>301</sup> *Id.* § 965.480(b).

<sup>302</sup> *Id.* § 965.476(a). Each year must consist of 12 consecutive months to be used for purposes of determining utility allowances. *Id.*

<sup>303</sup> *Id.*

<sup>304</sup> *Id.* § 965.476(b)-(c).

<sup>305</sup> *Id.* § 965.481(a)(2).

<sup>306</sup> *Id.* § 965.481(c).

<sup>307</sup> *Id.* § 965.480(c)(1).

<sup>308</sup> *Id.* § 965.481(a)(3).

<sup>309</sup> 47 Fed. Reg. 35,251 (1982).

### B. *Deregulating the Utility Allowance*

Under regulations promulgated on August 7, 1984, and effective on April 2, 1985, PHAs were granted the authority to establish utility allowances independent of any federal standards.<sup>310</sup> The stated goal of these new regulations was threefold: to place all tenants on relatively equal footing, to remove the significance of metering type in the determination of allowances, and to provide tenants with incentives for energy conservation.<sup>311</sup> HUD explicitly stated that its motivation for deregulation was an attempt to leave the PHAs individually liable in legal suits for improper or inadequate allowances.<sup>312</sup>

These regulatory changes had a wide range of effects:

-PHAs become solely responsible for the data, methodologies, and calculations used to establish tenant utility allowances.<sup>313</sup>

-The previously existing standard of a "reasonable allowance" is changed to an allowance based on a "reasonable consumption of utilities by an energy-conservative household of modest circumstances."<sup>314</sup>

-Inconsistencies in federal provisions which resulted in smaller utility allowances for individually-metered tenants are eliminated.<sup>315</sup>

-Nine factors of dwelling or tenant circumstances are now to be considered in setting individual allowances.<sup>316</sup>

<sup>310</sup> 49 Fed. Reg. 31,399 (1984). This regulation was originally proposed at 47 Fed. Reg. 35,249 (1982).

<sup>311</sup> 47 Fed. Reg. 35,251 (1982).

<sup>312</sup> *Id.*

<sup>313</sup> See 49 Fed. Reg. 31,408-09 (1984) (to be codified at 24 C.F.R. § 965.473).

<sup>314</sup> *Id.* at 31,409 (to be codified at 24 C.F.R. § 965.476(a)). Comments on the proposed regulation argued that this provision was vague and unenforceable. See *id.* at 31,401-07.

<sup>315</sup> *Id.* at 31,401-02.

<sup>316</sup> *Id.* at 31,409 (to be codified at 24 C.F.R. § 965.476(d)). These factors include the equipment and function covered, climatic location, size of dwelling and number of occupants, type of construction and design, the energy efficiency of supplied appliances and equipment, the consumption of reasonable tenant-supplied appliances, the physical condition and energy efficiency of the unit, interior temperature requirements, and the standby temperature of hot water heating equipment. *Id.*

- Surcharges for excess consumption can be set with broad discretion at the local level.<sup>317</sup>
- PHAs must set allowances that reflect the physical and appliance efficiency characteristics of the dwellings.<sup>318</sup>
- The requirement that allowances be based on actual historic consumption data is eliminated, although PHAs still can use such data if they choose.<sup>319</sup>

Individual relief is still allowed for elderly, ill, or handicapped tenants on a case-by-case basis.<sup>320</sup> Allowances are reviewed annually by the PHA.<sup>321</sup> Only if rates change by ten percent or more would an interim re-evaluation of the allowances be required.<sup>322</sup> Notice to tenants, as well as an opportunity for them to comment on any re-evaluation, is required.<sup>323</sup>

In addition to the many detailed substantive changes made in the determinations of utility allowances, these alterations fundamentally reallocate the balance of power on utility matters from HUD to PHAs and effect a shift from federally-insured tenant protections to deregulated PHA discretion. The new 1985 regulations do not require PHAs to *do* anything. They may passively continue the existing federal utility allowance system through their local regulatory discretion.

Apart from any merit evidenced by the new system, HUD's rationale for the alterations is inconsistent with reason and precedent. In promulgating the new allowance regulations, HUD mischaracterized several studies which it claimed justified the

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<sup>317</sup> *Id.* at 31,410 (to be codified at 24 C.F.R. § 965.477).

<sup>318</sup> *Id.* at 31,409 (to be codified at 24 C.F.R. § 965.476(d)).

<sup>319</sup> *Id.* at 31,409 (to be codified at 24 C.F.R. § 965.476(c)(1)).

<sup>320</sup> *Id.* at 31,410 (to be codified at 24 C.F.R. § 965.479). Notice of special relief provisions and the criteria for its granting must be provided tenants in the notice provided pursuant to *id.* at 31,409 (to be codified at 24 C.F.R. § 965.473(c)).

<sup>321</sup> *Id.* at 31,410 (to be codified at 24 C.F.R. § 965.478(a)).

<sup>322</sup> *Id.* at 31,410 (to be codified at 24 C.F.R. § 965.478(b)). Any increase in allowances because of rate increases is now retroactive to the effective date of the rate increase. The proposed 20% increase trigger for allowance revision was rejected in favor of a 10% increase trigger. *See id.* at 31,406.

<sup>323</sup> *Id.* at 31,409 (to be codified at 24 C.F.R. § 965.473(c)). Notice must be given as provided for in tenant leases and at least 60 days prior to any change in allowances. The PHA must provide notice of what appliances are included in the calculation of the utility allowance. *Id.*

deregulation.<sup>324</sup> In response to criticism during the rulemaking procedure,<sup>325</sup> HUD denied the relevance of the generally accepted belief that low-income persons demonstrate a lower price elasticity of demand for household energy services, thereby rendering them less able to conserve energy in response to price incentives or lower allowances.<sup>326</sup>

Moreover, it is unlikely that the current regulations will allow HUD to achieve its stated objective of insulating itself from litigation challenging unreasonable utility allowances in public housing. Regardless of any attempts to avoid becoming a party defendant to litigation, HUD probably remains liable for improper utility allowances.<sup>327</sup> Tenants may be able to enforce their entitlements to adequate utility allowances against HUD, its officials, and the PHA as a violation of their civil rights,<sup>328</sup> as a violation of their common law rights as third-party beneficiaries to public housing contracts,<sup>329</sup> as a violation of their lease

<sup>324</sup> The HUD rulemaking confuses the statistical results pertaining to electricity with those pertaining to gas energy sources. For example, HUD cites the Booz, Allen & Hamilton study written for the U.S. Department of Energy, to support lesser consumption in individually-metered residences "in the 10-20 percent ranges although some findings place savings as high as 35%." *Id.* at 31,405. In fact, this study found heating energy savings of no more than 7%, with significant data indicating that in many cases individually-metered tenants consumed more than master-metered tenants. Booz, Allen & Hamilton, *supra* note 74, at 1.

HUD also mistakenly relied upon a much discredited Federal Energy Administration study "to support a 15% level of savings." 49 Fed. Reg. 31,405 (1984). In fact, in the *Mass. Union* litigation the district court found that the study provided no basis of support. *Mass. Union*, Summary Judgment, *supra* note 137, at 3-4.

<sup>325</sup> More than 200 comments were received in response to the proposed rule. 49 Fed. Reg. 31,401 (1984).

<sup>326</sup> *Id.* at 31,405; see E. Vine & S. Gold, *supra* note 12, at 26-27.

<sup>327</sup> HUD is ultimately responsible for the operation of the entire public housing program since any violation occurs under its direct supervision and responsibility. Moreover, if inadequate utility allowances result from insufficient operating subsidies provided by HUD to a PHA, HUD violates the statute, the regulations, and its annual contribution contract (ACC) with that PHA. 42 U.S.C. § 1437g (1982); see 24 C.F.R. § 990 (1984).

<sup>328</sup> 42 U.S.C. § 1983 (1982). PHA tenants have a civil right not to pay a larger percentage of income for rent and reasonable utilities than guaranteed by statute and regulation. 42 U.S.C. § 1437a(a) (1982); 24 C.F.R. §§ 965.476-478 (1984); 49 Fed. Reg. 31,399 (1984); see *Nelson v. Greater Gadsden Hous. Auth.*, No. 82-0857, slip op. at 27-28 (N.D. Ala. Mar. 12, 1985). Inadequate allowances are those that require tenants to pay more for shelter than provided for by the Brooke Amendment. This violation is actionable. See *e.g., id.*; *McGhee v. Housing Auth. of Lanett*, 543 F. Supp. 607 (N.D. Ala. 1982); *Hudson v. Concord Dep't of Hous.*, No. 83-284, slip opinion (M.D.N.C. Mar. 14, 1984).

<sup>329</sup> The D.C. and 7th Circuit Courts of Appeals have upheld a tenant's ability to assert claims as a third-party beneficiary of the ACC. See *Ashton v. Pierce*, 541 F. Supp. 635 (D.D.C. 1982), *aff'd* 716 F.2d 56 (D.C. Cir. 1983), *modified* 723 F.2d 70 (D.C. Cir. 1983); *Holbrook v. Pitt*, 643 F.2d 1261 (7th Cir. 1981). *But see Perry v. Housing Auth.*, 664 F.2d 1210 (4th Cir. 1981).

agreements,<sup>330</sup> or as a violation of the Administrative Procedure Act.<sup>331</sup>

Courts have been slow to find an implied right of action for tenants to enforce the Brooke Amendment and its implementing regulations against PHAs,<sup>332</sup> but have been somewhat less hesitant regarding HUD.<sup>333</sup> More than two dozen challenges to individual utility allowances have been brought: HUD and PHAs have settled most of the cases in favor of plaintiffs' claims prior to a decision on the merits,<sup>334</sup> and a few have proceeded to judgment in plaintiffs' favor.<sup>335</sup> Additional litigation to determine tenant rights under the new utility allowance structure is pending.<sup>336</sup>

### C. *The Disputed Entitlement: LIHEAPing Public Housing*

The largest single source of energy benefits for low income households is the Low Income Home Energy Assistance Pro-

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<sup>330</sup> HUD requires each PHA to enter into a formal lease with every tenant. 24 C.F.R. § 966 (1984). Each lease must contain a clause protecting the tenant's right to low-rent housing, as specified in the Brooke Amendment. 42 U.S.C. § 1437a (1982). An inadequate utility allowance results in a violation of this statutory percentage-of-income guarantee on the low-rent character of public housing. *Id.*

<sup>331</sup> See *Russell v. Landrieu*, 621 F.2d 1037 (9th Cir. 1980); *Munoz-Mendoza v. Pierce*, 711 F.2d 421 (1st Cir. 1983). If HUD approves a PHA allowance which is not rationally based, is contrary to HUD regulations, or is arbitrary, it can be enjoined under the Administrative Procedure Act. See 5 U.S.C. § 702 (1982).

<sup>332</sup> *Jackson v. Housing Auth. of Fort Myers*, No. 82-136, slip op. at 1 (M.D. Fla. Apr. 4, 1984); *Thompson v. Binghampton Hous. Auth.*, 546 F. Supp. 1158, 1182 (N.D.N.Y. 1982); see *Stone v. District of Columbia*, 572 F. Supp. 976, 980 (D.D.C. 1983); *McGhee*, 543 F. Supp. at 608.

<sup>333</sup> See, e.g., *Howard v. Pierce*, 738 F.2d 722, 730 (6th Cir. 1984). But see *Wright v. Roanoke Redev. and Hous. Auth.*, 605 F. Supp. 532 (W.D. Va. 1985), *aff'd*, No. 85-1068 (4th Cir. Aug. 26, 1985).

<sup>334</sup> See, e.g., *Dunn Residents Council v. Dunn Hous. Auth.*, No. 81-423 (E.D.N.C. July 11, 1983) (consent judgment requiring PHA to increase allowances to required levels); *Leslie v. Mann*, No. 77-49 (N.D. Ga. June 20, 1980) (consent judgment requiring PHA to make rebates to tenants and former tenants for improper utility allowances that resulted in rental overcharge); *O'Neal v. Lake Wales Hous. Auth.*, No. 80-1015 (M.D. Fla. July 29, 1982) (consent judgment requiring PHA to reimburse tenants for overcharges); *Norman v. Housing Auth. of Montgomery*, No. 83-6 (M.D. Ala. Nov. 1, 1983) (consent judgment providing for gas and electric utility allowances to be raised and for rebates to eligible tenants for past payments); *Foster v. Housing Auth. of Avon Park*, No. 80-8164 (S.D. Fla. Mar. 15, 1985) (consent judgment providing for rebates and raised allowances).

<sup>335</sup> See, e.g., *Nelson v. Greater Gadsden Hous. Auth.*, No. 82-0857 (N.D. Ala. Mar. 12, 1982) (decree granting permanent injunction raising gas and electric allowances, and providing rebates for current and former tenants).

<sup>336</sup> See, e.g., *Junior v. Housing Auth. of New Orleans*, No. 85-2172 (E.D. La. filed May 17, 1985); *Brown v. Housing Auth. of McRea*, No. 384-50 (S.D. Ga. 1984), *appeal docketed*, No. 85-8186 (11th Cir. Mar. 22, 1985); *Jackson v. Housing Authority of Fort Myers*, No. 82-136 (M.D. Fla. 1984), *appeal docketed*, No. 84-3343 (11th Cir. May 30, 1984).

gram (LIHEAP).<sup>337</sup> It provides approximately two billion dollars annually for low income families to pay energy bills.<sup>338</sup>

The LIHEAP program originated as an experimental program in the federal Community Services Administration.<sup>339</sup> With the deregulation of crude oil prices in 1979 and the attendant oil price increases, the program was given increased funding.<sup>340</sup> In FY 1981, it was transferred to the Department of Health and Human Services,<sup>341</sup> and since FY 1982 it has been administered entirely through block grants to the states.<sup>342</sup>

For public housing tenants, three aspects of the current program are particularly important: states are now required by statute to give priority to households with the lowest incomes

<sup>337</sup> See 42 U.S.C. §§ 8621-29 (1982).

<sup>338</sup> See *id.* § 8621(b).

<sup>339</sup> The now-defunct Community Services Administration (CSA) made small efforts to assist low income households with their energy bills from 1973 through 1976. From 1977 through 1979, CSA operated a \$200 million per year crisis-oriented emergency assistance program which was the genesis of LIHEAP. Supplemental Appropriations Act, Pub. L. No. 95-26, 91 Stat. 61, 78 (1977). This program was known as the Special Crisis Intervention Program (SCIP). U.S. CONGRESSIONAL BUDGET OFFICE, LOW-INCOME ENERGY ASSISTANCE: ISSUES AND OPTIONS 28, 45 (1981) [hereinafter cited as CBO]. Eligibility was restricted to households with incomes at or below 125% of federal poverty guidelines. S. REP. NO. 64, 95th Cong., 1st Sess. 101 (1977).

<sup>340</sup> With the phased decontrol of crude oil prices and the creation of a crude oil windfall profits tax, Crude Oil Windfall Profits Tax Act, Pub. L. No. 96-123, 94 Stat. 229 (1980) (codified in scattered sections of 17, 19, 26 & 42 U.S.C. (1982)), the FY 1980 program appropriated \$1.6 billion for Energy Assistance. 1980 Appropriations for the Department of the Interior and Related Agencies, Pub. L. No. 96-126, 93 Stat. 954, 978 (1980).

This program institutionalized dual Energy Assistance programs: a state block grant assistance program and a more locally-targeted energy crisis program. Through these programs, \$800 million was to be distributed by the states, \$400 million as locally-targeted Energy Crisis Assistance and \$400 million as "a special one-time energy allowance to recipients of Supplemental Security Income (SSI)." 1980 Appropriations for the Department of the Interior and Related Agencies, Pub. L. No. 96-126, 93 Stat. 954, 978 (1980).

<sup>341</sup> In FY 1981, the program shifted entirely to the Department of Health and Human Services (HHS) and was to distribute funds only in the form of block grants. Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, Title III, 94 Stat. 229 (1980), *repealed by* Omnibus Budget Reconciliation Act of 1981, Pub. L. No. 97-35, § 2611, 95 Stat. 902 (1981). The program operated under a \$1.85 billion appropriation, including \$89 million for a CSA crisis assistance program. Act of Oct. 1, 1980, Pub. L. 96-369, 94 Stat. 1351, 1354; Act of Dec. 16, 1980, Pub. L. No. 96-536, 94 Stat. 3166, 3168.

<sup>342</sup> In FY 1982, the program assumed its current form, being administered by HHS and operating entirely as block grants to the states. 42 U.S.C. §§ 8621-29 (1982). A supplemental appropriation of \$123 million was added to raise the FY 1982 appropriation to \$1.874 billion. Act of Feb. 15, 1982, Pub. L. 97-147, 96 Stat. 4. In FY 1983, the program operated under a continuing resolution providing funding of \$1.975 billion. Act of Dec. 21, 1982, Pub. L. 97-377, 96 Stat. 1830, 1891, 1918, 1922. The FY 1984 appropriation was \$1.85 billion. Act of Oct. 31, 1983, Pub. L. 98-139, 57 Stat. 871, 884. The FY 1985 appropriation is \$2.14 billion, Human Services Reauthorization Act, Pub. L. 98-558, 98 Stat. 2878, 2889 (1984), and \$2.275 billion has been appropriated for FY 1986. *Id.*



and the highest energy costs in relation to income, taking account of family size;<sup>343</sup> eligibility has been extended to a larger group of the poor by raising the income eligibility standard to either 150 percent of the Office of Management and Budget poverty guidelines or sixty percent of state median income;<sup>344</sup> and states are required by statute<sup>345</sup> to treat renters "equitably"<sup>346</sup> in the distribution of program benefits.<sup>347</sup>

The current LIHEAP program provides states with two options whereby they may reallocate portions of their Energy Assistance allotment: up to ten percent of any HHS block grant<sup>348</sup> can be transferred to other HHS block grants;<sup>349</sup> or up to twenty-five percent of the Energy Assistance block grant can be carried forward to the following fiscal year's Energy Assistance Program.<sup>350</sup> If both of these options were exercised at maximum percentage amounts, more than one-third of the Energy Assistance funds would disappear in any given fiscal year. Data assembled by the General Accounting Office (regarding FY 1982–1983 programs) indicates that of those states surveyed,

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<sup>343</sup> 42 U.S.C. § 8624(b)(5) (1984). HHS regulations provide that payment levels can vary at a state's election based on categories of households or individual circumstances. States are required to factor in the average home energy expenditure for households, the percentage burden of energy costs to income, variations in heating requirements by region, and other government assistance for energy costs. 45 C.F.R. § 260.154 (1984).

<sup>344</sup> Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, Title III, 94 Stat. 229. Until 1980, only those earning less than 125% of federal poverty guidelines were eligible. This group consisted of about 8.5 million households, of whom only about 1 million were served annually. Eligibility was expanded to include those below the Bureau of Labor Statistics' Lower Living Standard. This expansion added about 6.5 million households. CBO, *supra* note 339, at 27.

<sup>345</sup> 42 U.S.C. § 8624(b)(8) (1984).

<sup>346</sup> In 1980, equitable treatment was described by the Senate Labor and Human Resources Committee as the provision of "generally comparable relief from energy cost burdens to both classes of recipients." S. REP. No. 378, 96th Cong., 1st Sess. 18 (1979). The energy expenses of similarly situated direct purchasers of energy were to be used to approximate the energy expenses of indirect master-metered tenants when information on the actual energy costs of these tenants was not available. CBO, *supra* note 339, at 54.

<sup>347</sup> Originally, renters who did not pay directly for their home energy, but rather paid through their rent, were not eligible for benefits. CBO, *supra* note 339, at 45. The 1980 appropriation distributed half the appropriation through the states, directing "assistance for those who pay fuel bills indirectly as well as directly." Act of Nov. 27, 1979, Pub. L. No. 96-126, 93 Stat. 954, 979. This reference contemplated the inclusion of master-metered tenants. The Community Services Agency (CSA) also amended its regulations to make master-metered tenants, who pay for energy as part of their rental payments, eligible to receive the \$400 million of the FY 1980 appropriation reserved for crisis assistance. 45 C.F.R. §§ 1061.70–77(a)(3) (1984), 44 Fed. Reg. 58,877 (1979).

<sup>348</sup> 42 U.S.C. § 8623(f) (1982).

<sup>349</sup> Other HHS block grants eligible to transfer funds with LIHEAP are detailed in the regulations. 45 C.F.R. § 96.72 (1984); 46 Fed. Reg. 48,584 (1981).

<sup>350</sup> 42 U.S.C. § 826(b)(2)(A)–(B) (1982); 45 C.F.R. § 96.81 (1984).

most transferred close to the maximum amount (10%) from Energy Assistance into other social services block grants.<sup>351</sup> HHS estimates that \$92 million (or slightly less than 5% of the total funds appropriated for energy assistance) was transferred out of Energy Assistance in 1982.<sup>352</sup> In 1984, four percent of the appropriation was transferred to other block grant programs.<sup>353</sup>

Most states also exercised their options to carryover some of their FY 1982 and FY 1983 Energy Assistance funds to subsequent years. The General Accounting Office reports that of states surveyed, 9.2% of the FY 1982 grants and 7.4% of the FY 1983 grants were carried forward.<sup>354</sup> In FY 1984, 5.8% of the appropriation was carried over to the next fiscal year.<sup>355</sup> As these statistics suggest, the basic design and operation of LIHEAP permits states to defer or divert LIHEAP funds, and that can deny public housing tenants the benefits to which they are seemingly entitled.<sup>356</sup> This denial may be accomplished by three methods: direct denial of entitlement to LIHEAP benefits; diminution of LIHEAP benefits; and reduction of Food Stamp or other benefits as a consequence of receipt of LIHEAP assistance.

A controversy exists as to whether PHA and other HUD-assisted tenants are entitled to receive LIHEAP benefits. Several states have refused to include public housing tenants among those eligible for full LIHEAP participation.<sup>357</sup> Their argument

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<sup>351</sup> U.S. GEN. ACCOUNTING OFFICE, STATES FUND AN EXPANDED RANGE OF ACTIVITIES UNDER LOW-INCOME HOME ENERGY ASSISTANCE BLOCK GRANT ii (1984) [hereinafter cited as GAO].

<sup>352</sup> Alliance to Save Energy, *Federal Low-Income Energy Assistance: A Legislative History and State by State Perspective 20* (August 1982) (discussing results of 1982 HHS Telephone Survey on the Low-Income Home Energy Assistance Program) (on file at HARV. J. ON LEGIS.) [hereinafter cited as Alliance to Save Energy]. No state exercised its converse option to roll any funds out of other HHS block grants into the Energy Assistance block grant. *Id.*

<sup>353</sup> NATIONAL CONSUMER L. CENTER ENERGY UPDATE, Aug. 30, 1984, at 4.

<sup>354</sup> GAO, *supra* note 351, at 17. HHS reports that approximately \$166 million of the FY 1982 appropriation, representing about 9% of the total FY 1982 allocation, was applied to the next fiscal year. Alliance to Save Energy, *supra* note 352, at 20.

<sup>355</sup> NATIONAL CONSUMER L. CENTER ENERGY UPDATE, Aug. 30, 1984, at 4.

<sup>356</sup> For a full treatment of the LIHEAP program in all its incarnations, see generally Manaster, *Energy Equity for the Poor: The Search for Fairness in Federal Energy Assistance Policy*, 7 HARV. ENVTL. L. REV. 371 (1983).

<sup>357</sup> NATIONAL CONSUMER L. CENTER ENERGY UPDATE, Aug. 30, 1984, at 4. State treatment of households residing in subsidized housing varies widely. In some states, households residing in subsidized housing are treated as any other household in the LIHEAP program; in a number of states, such households are simply ineligible for LIHEAP; and many states treat those households as somewhere inbetween, providing full or restricted benefits if certain conditions are met. Generally speaking, households in subsidized housing must be able to show some "vulnerability" to energy costs, e.g., inadequate heating allowances. *Id.*

is that because public housing tenants receive subsidies for shelter expenses,<sup>358</sup> they are in less need of LIHEAP assistance than non-PHA tenants.

The LIHEAP statute is ambiguous on this point. PHA tenants and tenants of other publicly-assisted housing are not in any way explicitly excluded by the statute.<sup>359</sup> Moreover, the statute directs that states provide the greatest LIHEAP benefits to those with the highest energy costs relative to income, and to those with the lowest income relative to family size.<sup>360</sup> Public housing tenants have the lowest incomes of any class of persons eligible for HUD-assisted housing.<sup>361</sup> By virtue of the poor thermal quality of many PHA buildings and furnished appliances, PHA tenants experience some of the highest heating costs per square foot of living space.<sup>362</sup>

On the other hand, the statute and implementing regulations also direct states to consider the extent to which households are protected from rising costs of energy through other government programs.<sup>363</sup> PHA utility allowances provide some protection from rising energy expenses for PHA tenants,<sup>364</sup> which private-market tenants do not enjoy. Given that many states transfer LIHEAP funds to other programs or carry over program funds to subsequent years,<sup>365</sup> these exclusions of PHA tenants from LIHEAP provoked challenges from excluded tenants in HUD-subsidized housing.

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<sup>358</sup> Section 8 assisted housing tenants receive a utility subsidy established much like that for public housing tenants. 24 C.F.R. § 886.110 (1984).

<sup>359</sup> See 42 U.S.C. § 8624 (1981).

<sup>360</sup> 42 U.S.C. § 8624(b)(5) (1982).

<sup>361</sup> For PHA tenant income eligibility guidelines, see 24 C.F.R. § 960 (1984).

<sup>362</sup> Inattention to thermal characteristics in construction and appliance procurement render the public housing stock inefficient. See *supra* notes 34–67, 191–202 and accompanying text. The thermal quality of existing public housing stock varies greatly in its inefficiency. See *supra* text accompanying notes 170–72.

<sup>363</sup> 42 U.S.C. § 8624(b)(6)(A)–(B) (1982); 45 Fed. Reg. 66,694–95 (1980).

<sup>364</sup> See *supra* notes 260–336 and accompanying text.

<sup>365</sup> GAO, *supra* note 351, at 9–12. Thirteen states carried LIHEAP funds over from 1983 to 1984. *Id.* at 68, app. VIII.

On the other hand, eight cold-weather states supplement their federal LIHEAP benefits with state funds. For FY 1985, these states and the supplemental state appropriations are:

Colorado:	\$3.5 million plus tax credits
Connecticut:	\$1.6 million
Indiana:	\$12 million
Massachusetts:	\$17 million
Michigan:	\$65.2 million
New Jersey:	\$62 million
New Mexico:	\$1.5 million
Ohio:	\$39 million

In *Crawford v. Janklow*,<sup>366</sup> the District Court for South Dakota held that blanket exclusions of publicly-assisted housing tenants from entitlement to LIHEAP benefits violated the enabling statute.<sup>367</sup> The court based its holding on a needs/benefit calculus and the state's obligation to treat master-metered tenants equitably.<sup>368</sup>

Having found as a matter of law that the state must implement its LIHEAP program equitably by distributing benefits based on need,<sup>369</sup> there remained a factual inquiry into whether publicly-assisted tenants, in light of their receipt of HUD utility subsidies, qualified under the definition. The court concluded that even after deducting the utility subsidies, publicly-assisted housing tenants still experienced some of the largest heating costs as a percentage of income in the state.<sup>370</sup>

Even when states did not disqualify assisted tenants entirely from LIHEAP participation, many, like South Dakota, diminished the amount of benefit which the tenant could receive.<sup>371</sup> In *Clifford v. Janklow*,<sup>372</sup> however, the District Court for South Dakota enjoined such diminution of benefits.<sup>373</sup> The subtraction of the putative heating energy component of the utility subsidy from any LIHEAP entitlement of subsidized tenant households was declared violative of the "income disregard" provisions of the statute and the equal protection clause of the 14th Amendment.<sup>374</sup>

<sup>366</sup> 557 F. Supp. 1146 (D.S.D.), *aff'd* 710 F.2d 1321 (8th Cir. 1983).

<sup>367</sup> *Crawford*, 557 F. Supp. at 1149. Most of the LIHEAP litigation to date concerns section 8 and section 221(d)(3) publicly assisted tenants, rather than conventional public housing tenants. The former two programs are private market equivalents of the conventional public housing program. The income limits for conventional public housing tenancy, however, are lower than for the section 8 or section 221(d)(3) programs. Compare 24 C.F.R. § 960 (1984) with 24 C.F.R. §§ 886.117, .124 (1984).

<sup>368</sup> *Crawford*, 557 F. Supp. at 1149-50.

<sup>369</sup> *Id.* at 1149.

<sup>370</sup> *Id.* at 1150.

<sup>371</sup> See *infra* note 374 and accompanying text.

<sup>372</sup> *Clifford v. Janklow*, No. 83-3092, slip op. (D.S.D. Jan. 16, 1984), *aff'd* 733 F.2d 534 (8th Cir. 1984), *same case* 601 F. Supp. 16 (D.S.D.), *aff'd*, 747 F.2d 1231 (8th Cir. 1984).

<sup>373</sup> *Clifford*, slip op. at 16.

<sup>374</sup> *Id.* at 11, 14. The court pointed to other federal programs specifically enumerated in 42 U.S.C. § 8624(f) (1982), the benefits for which are established with reference to energy costs. *Clifford*, slip op. at 5. The court concluded that Congress clearly intended that these other benefits be ignored in computing eligibility for Energy Assistance. *Id.* at 6. Considering these other benefits would violate the requirement to disregard other sources of income, as well as the requirement that the greatest benefits go to those with the lowest income and with the greatest need relative to income. *Id.* at 7; see 42 U.S.C. § 8624(b)(5) (1982).

The *Clifford* court ordered the state to pay LIHEAP benefits to publicly-assisted tenants without regard to receipt of *any* utility subsidies.<sup>375</sup> The decision allows assisted tenants full LIHEAP benefits subject only to the limitation that the combination of LIHEAP benefits and utility subsidies not exceed actual utility costs.<sup>376</sup>

Litigation has successfully challenged other states' attempts to exclude PHA tenants from LIHEAP benefits. Maine's practice of excluding all publicly-assisted housing tenants from participation in the LIHEAP program was ended by a consent decree,<sup>377</sup> while Wisconsin's similar practice has been preliminarily enjoined on equal protection and statutory grounds.<sup>378</sup>

Some states have attempted to diminish the amount of LIHEAP benefits afforded individually-metered PHA tenants. In 1985, for example, New Hampshire categorically excluded individually-metered public housing tenants from receiving LIHEAP benefits;<sup>379</sup> whereas in 1984, New Hampshire excluded such tenants only if their rent and utility costs exceeded thirty-five percent of their incomes.<sup>380</sup> New Hampshire, under legal pressure,<sup>381</sup> recently adopted a middle ground: PHA tenants can now receive LIHEAP benefits equal to forty percent of the amount of their utility costs not covered by PHA utility allowances.<sup>382</sup>

The geographic pattern of litigation suggests that PHA tenant eligibility for LIHEAP is of paramount importance in cold weather states. For FY 1985, the reauthorization of the LIHEAP program redistributed federal funds from cold-weather states to

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<sup>375</sup> *Clifford*, slip op. at 16.

<sup>376</sup> *Id.*

<sup>377</sup> See *McAnany v. Maine Division of Community Services*, No. 83-21 (Me. Super. Ct. Aug. 12, 1983) (consent decree by which the state agreed to drop a blanket exclusion of publicly-assisted housing tenants from current and future LIHEAP programs).

<sup>378</sup> *Boles v. Earl*, 601 F. Supp. 737 (W.D. Wis. 1985). The court found an exclusion from participation based solely on status as a publicly-assisted housing tenant, when these tenants had a greater need for supplemental assistance than other recipients of LIHEAP benefits within the state, impermissible. *Id.* at 747.

<sup>379</sup> NATIONAL CONSUMER L. CENTER ENERGY UPDATE, Apr. 2, 1985, at 3.

<sup>380</sup> *Id.* Since public housing tenants in 1984 paid 28% of income for rent, if utility costs were equal to or greater than 7% of income, public housing tenants could receive LIHEAP benefits. This formula made receipt of LIHEAP benefits an all or nothing proposition.

<sup>381</sup> *Id.*

<sup>382</sup> *Id.* The rationale for this figure is that the average LIHEAP recipient in New Hampshire receives a LIHEAP payment which on average covers 60% of heating energy costs. Although 60% is an average figure, it is important to note that LIHEAP itself is not designed to cover a percentage of family utility costs.

warm-weather states.<sup>383</sup> Preliminary figures from HHS indicate that about half the states, those located in colder climates, will lose LIHEAP funds in absolute dollars.<sup>384</sup>

In addition, PHA tenants risk the loss of other forms of supplemental assistance when they receive LIHEAP benefits. For example, a bill to reduce Food Stamp benefits<sup>385</sup> for families which benefit from LIHEAP is pending in Congress.<sup>386</sup> This legislation would have a serious impact on many LIHEAP benefit recipients and drastically alter the present statutory scheme, because LIHEAP benefits are routinely distributed to households which receive Food Stamp benefits.<sup>387</sup>

The original LIHEAP statute explicitly provides that receipt of Energy Assistance benefits would supplement, not reduce, Food Stamp and other benefits:

Notwithstanding any other provisions of law, the amount of any home energy assistance payments or allowances provided to an eligible household under this subchapter shall not be considered income or resources of such household (or any member thereof) for any purpose under any Federal or State law, including any law relating to taxation, food stamps, public assistance or welfare programs.<sup>388</sup>

Despite this directive, the Department of Agriculture (USDA) attempted to reduce food stamp benefits for LIHEAP recipients.<sup>389</sup> USDA interpreted the statute to find that this so-called

<sup>383</sup> NATIONAL CONSUMER L. CENTER ENERGY UPDATE, June 20, 1985, at 5.

<sup>384</sup> *Id.*

<sup>385</sup> 7 U.S.C. §§ 2011-29 (1982).

<sup>386</sup> H.R. 2422, 99th Cong., 1st Sess., 131 CONG. REC. H3027 (daily ed. May 8, 1985). The bill would amend section 5(e) of the Food Stamp legislation, 7 U.S.C. § 2014(e) (1982), to limit the shelter deduction from income where vendor payments of LIHEAP benefits are paid on behalf of low-income households. Similar legislation was introduced in the Senate by Senator Helms (R-N.C.), S. 969, 99th Cong., 1st Sess., 131 CONG. REC. S4466 (daily ed. Apr. 22, 1985), and by Senator Dole (R-Kan.), S. 1142, 99th Cong., 1st Sess., 131 CONG. REC. S6261 (daily ed. May 15, 1985).

<sup>387</sup> The statute specifically provides that recipients of Food Stamps are automatically eligible for Energy Assistance. 42 U.S.C. § 8624(b)(2)(A)(iii) (1982); 45 C.F.R. § 260.154(f) (1980); 45 Fed. Reg. 66,694-95 (1980). This automatic distribution to Food Stamp recipients has been embodied in regulations since the FY 1980 authorization for the program. *See* 45 Fed. Reg. 69,037-38 (1980). If Congress and the agency specifically provided that those already receiving Food Stamps were automatically eligible for Energy Assistance benefits, it appears contrary to the clear intention of the statute to argue that receipt of Energy Assistance should disqualify one from certain benefits under the Food Stamp Program. *See infra* text accompanying note 388.

<sup>388</sup> Act of Aug. 13, 1981, Pub. L. No. 97-35, 95 Stat. 357, 899 (codified at 42 U.S.C. § 8624(f) (1982)).

<sup>389</sup> 7 C.F.R. § 273.10(d)(1)(i) (1985).

“income disregard” provision<sup>390</sup> applied only to those low-income households which received LIHEAP benefits directly in hand.<sup>391</sup> The vast majority of recipients—including master-metered and sub-metered public housing tenants—receive LIHEAP benefits indirectly as a credit against accounts payable to the recipient’s utility vendors.<sup>392</sup> For these households, the benefits were counted by USDA as income, pushing many recipients above the income ceiling, and making them ineligible to receive Food Stamps.<sup>393</sup> The courts have countermanded this administrative effort to deny benefits to tenants in a number of recent decisions.<sup>394</sup>

Many states still maintain a checkered policy on LIHEAP benefits for PHA tenants.<sup>395</sup> HHS has not attempted to enforce equitable treatment of PHA, or other master-metered, tenants. Diminished energy benefits for PHA tenants place greater burdens on PHAs to provide adequate utility allowances and the most efficient dwellings possible. As a result, innovative local strategies are required in an era of diminished real federal resources.

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<sup>390</sup> The statute provides: “Households . . . shall also be entitled . . . to . . . an excess shelter expense deduction [from income] to the extent that the monthly amount expended by a household for shelter exceeds an amount equal to 50 per centum of monthly household income after all other applicable deductions have been allowed.” 7 U.S.C. § 2014(e) (1982).

<sup>391</sup> 7 C.F.R. § 273.9(c)(1)(iii) (1985).

<sup>392</sup> See 42 U.S.C. § 8624(b)(7) (1982). Only eight states provide their LIHEAP benefits directly to individual recipients. The other states provide LIHEAP benefits either indirectly to utilities or as two-party checks which can only be cashed at the utility. Alliance to Save Energy, *supra* note 352, at 17.

<sup>393</sup> 7 C.F.R. § 273.10(e)(1)(i) (1985). Since the cost of rent plus utilities constitutes the “shelter expense,” nonrecognition of utility expenses incurred by a household lowers its shelter expense, which in turn lowers its deductions from income, thus raising its net income and perhaps disqualifying it from Food Stamp eligibility. When LIHEAP payments are paid to the utility directly on behalf of the recipient, the recipient’s utility costs are reduced. This reduction is used by USDA to reduce the net shelter expense for these families, but not for families which receive their LIHEAP payments directly in cash and then pay the utility supplier.

<sup>394</sup> See *Schmiege v. Secretary of Agriculture*, 693 F.2d 55 (8th Cir. 1982); *Idaho Dep’t of Health and Welfare v. Block*, No. 84-1106 (D. Idaho 1984) (memorandum opinion); *Harkins v. Block*, No. 84-124 (D. Mont. 1985) (memorandum opinion); *Seban v. Block*, No. 83-106 (S.D. Ind. 1985) (memorandum opinion).

<sup>395</sup> A different challenge to state attempts to limit receipt of full LIHEAP entitlements was decided against the state. See *State Communities Aid Association v. Regan*, 125 Misc. 2d 1083, 482 N.Y.S.2d 960 (Sup. Ct. 1984) (state’s attempt to transfer LIHEAP payments to cover utility expenses under state’s general assistance program overturned).

## VI. CREATING STRATEGIC OPPORTUNITIES TO EXPLOIT THE REGULATORY VOID

### A. *The Topography of Strategy: Cashflow, Savings, and Benefits for PHAs*

Under recent regulations, PHAs are now free to establish and administer their own utility allowance systems.<sup>396</sup> Four factors in the new utility allowance standard affect PHA discretion:

- Allowances can distinguish between the dwellings which have been made energy efficient and those which have not.<sup>397</sup>
- Allowances need no longer be based on historic utility usage data.<sup>398</sup>
- Significant differences in allowances based solely on the type of utility metering no longer are required.<sup>399</sup>
- Allowances can reflect tenants' energy conserving behavior.<sup>400</sup>

The new utility allowance discretion separates the determination of utility allowances from the determination of PFS funding. Although utility allowances are no longer based on actual consumption data or historic averaging periods, the PFS measure remains: determined exclusively by federal procedures; linked to a three-year calculation based on actual consumption experience; determined by a calculation period which always reflects an historic period at least one to five years in the past; and determined without any local PHA discretion.<sup>401</sup>

In fashioning these regulatory changes, HUD probably only intended to remove itself from the chain of litigation, and not to affect its cash flow to PHAs.<sup>402</sup> The separation of utility allowances from PFS, however, creates a regulatory void. In

<sup>396</sup> See *supra* note 310 and accompanying text.

<sup>397</sup> 49 Fed. Reg. 31,409 (1984) (to be codified at 24 C.F.R. § 965.476(d)(7)).

<sup>398</sup> *Id.* at 31,409 (to be codified at 24 C.F.R. § 965.476(c)(1)).

<sup>399</sup> *Id.* at 31,401-02 (to be codified at 24 C.F.R. § 865.476).

<sup>400</sup> *Id.* at 31,409 (to be codified at 24 C.F.R. §§ 965.473, .476(a)).

<sup>401</sup> 24 C.F.R. §§ 990.101-116 (1984). See also *supra* text accompanying notes 204-43.

<sup>402</sup> See 49 Fed. Reg. 31,399 (1984).



this void, a creative PHA can obtain greater cash subsidies from HUD and improve the energy efficiency of PHA dwellings and appliances at little or no cost to itself or its tenants. In an era of shrinking federal support for PHAs,<sup>403</sup> this regulatory void is the single greatest opportunity or pitfall confronting local public housing authorities.

Through careful planning and execution, a PHA can use HUD PFS cash flow to update the efficiency of PHA dwellings and appliances. The stages of this process are as follows:

(i) The PHA conducts an energy audit,<sup>404</sup> identifies cost-justified energy efficiency investments, and devises a master plan for their implementation.

(ii) The PHA obtains creative financing to cover the initial capital costs of the selected efficiency investments and installs these measures.<sup>405</sup>

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<sup>403</sup> Housing and Community Development Amendments of 1981, Pub. L. No. 97-35, 95 Stat. 384 (1981).

<sup>404</sup> Under the Residential Conservation Service Program, this audit can be performed at significant subsidy, with rate base resources, by the local utility supplier. 42 U.S.C. § 8235a(a)-(b) (1982).

<sup>405</sup> Financing is the key to implementing energy efficiency measures in public housing authorities. If a set of energy efficiency measures is cost-justified, the initial up-front financing is often the critical factor for implementing the measures. Once the measures are installed, the energy efficiency savings provide the means to repay any initial financing.

Since PHAs split any savings with HUD, *see supra* note 230 and accompanying text, a PHA may require preferential financing to realize sufficient economic incentives, until the PFS system eventually catches up with lower utility operating expenses. *See supra* notes 218-44 and accompanying text. There are a variety of creative financing techniques which can be used to finance public housing energy efficiency investments, a detailed explanation of which is beyond the scope of this Article. Briefly, there is a preferred hierarchy of funding for public housing energy efficiency financing which may be used to maximize the benefits to the PHA:

1. HUD Funds
2. Grant Funds
3. Third Party Financing
4. Preferential Financing.

A PHA can proceed down this list of options until it obtains adequate financing on the best terms. Within this hierarchy, several sources of financing can be combined to maximize the benefit to the PHA.

There are three primary sources of HUD-generated financing for the capital costs of public housing energy efficiency improvements: Comprehensive Improvement Assistance Program (CIAP) funds, development funds, and operating reserves. PHAs are eligible to receive CIAP grants from HUD to meet modernization and energy conservation standards to preserve "decent, safe and sanitary living conditions in public housing projects." 24 C.F.R. § 968.4(a) (1984). Development funds awarded by HUD are used by a PHA for comprehensive redevelopment of a project, which often includes a host of energy efficiency improvements. 24 C.F.R. § 941 (1984). In addition, PHAs can use their own operating reserves, to the extent that they exist, to fund energy efficiency capital improvements. Moreover, the *Mass. Union v. Pierce* litigation should lead to restitution of past utility overpayments by tenants in response to illegal meter conversions. *See supra* notes 150-53 and accompanying text. To the extent that some

(iii) Lower energy consumption resulting from the efficiency investments is not included in the PFS calculation for more than one (and as many as three) year(s) after the PHA begins realizing dollar savings from lower annual energy expenditures. When the lower annual consumption data is finally reflected in the PFS calculation, it is averaged with two other prior years' higher pre-improvement consumption data.<sup>406</sup>

(iv) PFS funding from HUD, after several years lag, gradually declines to reflect the immediately lower energy costs incurred

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overcharged tenants have moved and/or cannot be located, the application of their restitution to greater efficiency may be possible.

Grant financing is available from a number of federal programs. The Solar Energy and Energy Conservation Bank subsidizes the cost of financing energy efficiency measures and solar energy improvements and has recently been opened to public housing applications. See Ferrey, *Solar Banking*, *supra* note 1, at 483 (1981); 49 Fed. Reg. 9865 (1984). The Community Development Block Grant (CDBG), Pub. L. No. 93-383, Title I, 88 Stat. 633 (codified in scattered sections of 12, 31 & 42 U.S.C. (1982)) as amended by The Housing and Community Development Act of 1977, Pub. L. No. 95-128, 91 Stat. 1111 (codified in scattered sections of 12, 40 & 42 U.S.C. (1982)), and Urban Development Action Grant (UDAG), 42 U.S.C. § 5318 (1982) programs administered by HUD can be used to finance energy efficiency investments in public housing. The Housing and Community Development Act Amendments of 1980 specifically authorized the use of CDBG funds for loans to finance energy conservation improvements in rehabilitating housing. Housing and Community Development Act of 1974, Pub. L. No. 93-383, § 105(a)(4), 88 Stat. 641, as amended by The Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 104(c)-(e), 94 Stat. 1616-18. The Weatherization Assistance Program (WAP), created by the Energy Production and Conservation Act, 42 U.S.C. § 6861(b) (1982), can provide free basic weatherization to public housing units. See S. Ferrey, et al., *supra* note 17, at 43-44; Ferrey and Gordon, *Filling the Cracks in Federal Weatherization: The Implications of Conflicting Policy Objectives*, in ACEEE, 1982 *supra* note 178, at 8. The Low Income Home Energy Assistance program, 42 U.S.C. § 8621 (1982), can provide payments to tenants or utilities to promote energy efficiency and conservation. States can also set aside up to 15% of their Energy Assistance grants for weatherization activities. *Id.* § 8624(k). Several billion dollars of overcharged amounts for the purchase of crude oil and oil products is due to be returned through the states for energy efficiency financing. This payment will provide the largest single influx of cash for energy efficiency investments.

Third-party financing can be provided by energy service companies. See OTA, *supra* note 3, at 199. These organizations will finance, install, manage, and maintain energy efficiency improvements for a building. *Id.* They will pay the entire cost of installing energy efficiency measures and take a significant share of the energy savings over a period of years. *Id.* at 200-01. The PHA is not required to share the cost of installation. *Id.* Because 50% of energy savings must be returned to HUD, however, a PHA may find itself splitting any savings between HUD and the Energy Service company, with nothing much left for itself. Nevertheless, the PHA would incur no cost for installation of the efficiency measures.

In addition, several creatively structured preferential debt financing programs are specifically applicable to public housing. PHAs, as separately chartered municipal or county government agencies, may issue tax-exempt government bond financing. 26 U.S.C. § 103 (1982). In the last five years, a number of electric utilities have initiated various types of innovative utility-financed energy efficiency programs. See Moulton, *The Impact of Utility Sponsored Energy Conservation Loan Programs on Low-Income Households*, in ACEEE, 1984, *supra* note 168, at H-105. These programs supply ratepayer capital for investments in conservation, renewable energy equipment, or more efficient appliances. *Id.*

Finally, the payment in lieu of taxes (PILOT) made by PHAs to their local host communities could be deferred to finance energy efficiency investments. Whether or not this payment is actually made, HUD treats the payments as an allowable expense. 24 C.F.R. § 990.105(a) (1984). The deferred PILOT can be repaid out of subsequent energy savings.

<sup>406</sup> 24 C.F.R. § 990.107(c)(1) (1984).

by the PHA; the PFS system continues to overfund actual PHA energy operating expenses for a period of two to five years after the energy efficiency benefits begin.

(v) The PHA, pursuant to HUD regulations, keeps fifty percent of the difference between the PFS funding it receives and the lower actual energy consumption expenses for which it is billed.<sup>407</sup>

(vi) The PHA utilizes the full PFS funding during the fiscal year and earns interest on the entire overfunding until it is adjusted for actual costs at the end of the year.

The principles, operation, and results of this strategy are best illustrated by example. Using conservative assumptions based on data discussed above,<sup>408</sup> energy efficiency investments for the building shell, heating system, and major appliances in typical public housing projects should achieve average savings of thirty percent from the building shell and heating system<sup>409</sup> and twelve percent from greater appliance efficiency.<sup>410</sup> To achieve these savings from energy conservation, projected PHA investments of \$1000 per unit (exclusive of appliance procurement expenses covered by HUD) would be necessary in a multi-family project where economies of scale in efficiency improvements are possible.<sup>411</sup>

For purposes of illustration, assume a prototype PHA project with 200 units. The average PHA unit in 1980 accounted for \$673 in household energy expenses.<sup>412</sup> This figure represents approximately \$900 per unit in 1986 household energy costs. Total 1986 project energy costs are therefore estimated to be \$180,000 annually.<sup>413</sup> At an estimated cost of \$1000 per unit,<sup>414</sup>

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<sup>407</sup> *Id.* § 990.107(f).

<sup>408</sup> *See supra* notes 170–202 and accompanying text.

<sup>409</sup> Recall that for heating energy in public housing, HUD estimates that 30%–60% savings are possible from efficiency investments. *See supra* notes 188–89 and Table 6. The Massachusetts Executive Office of Communities and Development estimates that heating savings up to 35% are possible in Massachusetts' state-aided public housing. *See supra* note 189. The Roxbury and New Jersey data indicate that heating system savings approaching 50% are possible. *See supra* notes 179–80, 183–84. To make conservative assumptions and avoid overstating the conservation potential, I assume the minimum savings from this range: a savings of 30% from a combination of building shell and heating system efficiency improvements.

<sup>410</sup> Units equipped with efficient major appliances should save an additional 12%–30% of total energy consumption. *See supra* text accompanying notes 192–202.

<sup>411</sup> PERKINS & WILL, & THE EHRENKRANTZ GROUP, *supra* note 188, at 1–6.

<sup>412</sup> *Id.* at 1–5.

<sup>413</sup> This calculation assumes 200 units times \$900 per unit per year in energy expenses (reflecting an escalation in expenses for energy of 5.5% annually since the 1980 data).

<sup>414</sup> *See supra* note 411.

**Table 7**  
*Regulatory Strategy:*  
*Cashflow, Expenses and Retained Benefits*

(in \$1000s)					
(1)	(2)	(3)	(4)	(5)	(6)
Year	PFS Base Yrs Calculation	PFS Amt Recv'd	Utility Expenses	Savings (3)-(4)	50% Savings Kept by PHA
1985	1981-83	180.0	180.0	0	0
	Improvements Implemented				
1986	1982-84	180.0	104.4	75.6	37.8
1987	1983-85	180.0	104.4	75.6	37.8
1988	1984-86	154.8	104.4	50.4	25.2
1989	1985-87	129.6	104.4	25.2	12.6
1990	1986-88	104.4	104.4	0	0
Totals	1986-1990	748.8	522.0	226.8	113.4

heating efficiency improvements to all 200 units will cost \$200,000. Assume that the \$200,000 up-front cost of one-half of these improvements to the building shell and heating system is financed through a grant and the other half through zero-interest creative financing.<sup>415</sup> Since costs of more efficient appliances are financed entirely by HUD, and not by the PHA,<sup>416</sup> the PHA must repay half the up-front cost of the heating energy improvements, represented by the zero-interest loan. To summarize, the total cost of efficiency improvements equals \$200,000, the subsidy on acquisition at 50% equals \$100,000, and the net improvement cost to the PHA is \$100,000.

Assuming that the improvements are implemented in early 1986, Table 7 illustrates the cash flow impact of this strategy on the PHA.

In this example, three parties benefit: over four years the PHA retains \$113,400 received from HUD but not expended for utility costs; HUD also saves \$113,400; and tenants have more comfortable and efficient dwellings. The \$113,400 retained by the PHA more than repays the cost of the \$100,000 which the PHA owes. Using less conservative assumptions about cost of the investments, savings realized, or annual energy operating costs, even greater cash flow benefits to the PHA will be cre-

<sup>415</sup> This assumption is reasonable and conservative. See *infra* notes 422-27 and accompanying text.

<sup>416</sup> See *supra* text accompanying notes 247-48.

**Table 8**  
*Annual Dollar Energy Savings and Retained Savings by PHAs Under Various Percentage Efficiency Assumptions*

<i>Percentage Efficiency Savings</i>	<i>Total Nationwide Annual Dollar Energy Savings</i>	<i>PHA Annual Energy Savings (50% of Total)</i>
10%	\$108 million	\$ 54 million
20%	\$216 million	\$108 million
30%	\$324 million	\$162 million
40%	\$432 million	\$216 million
50%	\$540 million	\$270 million
60%	\$648 million	\$324 million

ated. Any cash flow beyond that needed to repay the initial financing can be used for rebates to conserving tenants, for a revolving fund to capitalize additional efficiency investments in other PHA buildings, or for other purposes. Table 8 illustrates the magnitude of various percentage efficiency savings when applied nationwide in 1.2 million PHA units.

Stated another way, in climates with significant winter heating requirements, energy operating expenses typically consume forty percent of the annual PHA operating budget;<sup>417</sup> in some projects, utility expenses can consume up to fifty percent or more of annual operating budgets.<sup>418</sup> If a typical PHA reduces its energy expenses by forty-two percent under this strategy, retaining half the savings for itself and its tenants, the PHA increases its non-utility operating budget by fourteen percent in the first year.<sup>419</sup> If the PHA cuts its energy expenses by fifty percent under this strategy, and if energy constitutes fifty percent of its annual operating budget, it increases its non-utility operating budget by twenty-five percent in the first year.<sup>420</sup>

<sup>417</sup> CLPHA Survey, *supra* note 32, at 1, app.

<sup>418</sup> *Id.*

<sup>419</sup> Assuming a 42% savings in energy expenses, in a PHA in which energy expenses constitute 40% of the operating budget, 17% of the total annual operating budget would thereby be saved. The PHA retains half of this saving, or 8.5%. As this money is no longer needed for utility operating expense purposes, it represents a  $8.5\%/60\% = 14\%$  increase in the 60% of the budget devoted to nonutility expenses. It can be used for energy efficiency or other investments.

<sup>420</sup> Using the same calculations as in note 419 *supra*, the savings in energy expenses represent a 25% increase in the 50% of the budget devoted to nonutility expense ( $12.5\%/50\% = 25\%$ ).

These savings constitute a substantial return on investment each year, while simultaneously improving the capital (housing) stock and increasing tenant welfare and comfort.

B. *Maximizing the Strategic Opportunity: Enhancements, Variations, and Embellishments*

A number of enhancements, variations, and embellishments on the basic strategy are available. Each of the following six proposals is designed to increase the benefit of the strategy for the PHA.

First, a PHA can invest the PFS overfunding and retain the interest earned for its own uses.<sup>421</sup>

Second, a PHA can have the fifty percent savings which it returns to HUD credited against its expected quarterly PFS payments for the next fiscal year.<sup>422</sup> Continued in successive years, this crediting system becomes a continuous short-term deferral and float.

Third, a PHA can increase the amount of PFS funding during the years in which this strategy is employed if a utility rate increase has been approved but is not yet effective or is in effect only on an interim basis. The PHA can elect to use the proposed higher rates in calculating its annual PFS allotment.<sup>423</sup> These higher amounts of funds are retained by the PHA and can be invested during the year.

Fourth, if the efficiency investments render its dwellings more attractive, a PHA could with reasonable justification estimate conservatively the vacancies it expects during the next fiscal year.<sup>424</sup> Justifiable conservative estimates will increase the amount of PFS funding received by the PHA.

Fifth, under the new regulations, the PHA can provide tenants with direct rebates for conserving behavior in master-metered or submetered units.<sup>425</sup> These rebates would provide incentives for conservation. When carefully designed, these incentive re-

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<sup>421</sup> The PFS formula anticipates that the PHA will earn at least the Treasury borrowing rate on any retained funds. 24 C.F.R. §§ 990.109(e), .110(e) (1984). If a PHA earns more or less than this, it keeps or loses the difference. *See id.* § 990.109(e).

<sup>422</sup> *Id.* § 990.110(c).

<sup>423</sup> *Id.* § 990.107(b).

<sup>424</sup> *Id.* § 990.107(a). The PFS operating subsidy is calculated on a per unit basis counting those units thought to be in service. *Id.*

<sup>425</sup> *See supra* note 310 and accompanying text.

bates constitute valid elements of tenant utility allowances and will be funded by HUD.<sup>426</sup>

Sixth, some PHAs may be disinclined to make efficiency investments which reduce aggregate consumption, because such investments will eventually reduce PFS funding to the housing authority (even though utility expenses decrease correspondingly). To counteract this reduction in consumption, PHAs can provide conservation incentives in the form of common area or common-use appliances in master-metered projects. These appliances can be paid for by the PHA from energy savings and be available for free or reduced cost tenant use.<sup>427</sup> By adding appliances, this strategy prevents the PFS consumption base from declining as much as it otherwise might in light of other energy efficiency savings.

### CONCLUSION

The conflict over energy policy in public housing is a microcosm of the national debate over energy policy in general. The tensions between owner and tenant accountability, between initial capital investment and operating costs, and between efficiency and cost-cutting, mirror the more widespread societal energy dilemma. And as with the general debate, no consensus has been achieved in the tension over public housing energy policy. The initial policy choices have been trimmed and ultimately reshaped by judicial intervention.

The events of the past three decades have pointed out numerous problems in federal and state public housing energy policy, as well as opportunities for improvement. What is past is prologue. The new federal regulatory changes offer creative public housing authorities an opportunity to recast the energy use structure in their favor. Just as the events of the past decades have shaped our current situation, initiatives taken today will set the stage for public housing's energy future.

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<sup>426</sup> *Id.* These rebates can be based either on savings over historic usage or savings relative to a prototype tenant unit. For tenants, rebates are the positive side of the surcharges which they have paid for years in submetered units. Constructing rebates so that they are funded by HUD rather than the PHA is not a simple maneuver and should be attempted only after careful regulatory and legal analysis.

<sup>427</sup> Examples might be coinless washers and dryers, extra security lighting, and similar items.





# ARTICLE

## ESOPs AND ECONOMIC DISTORTION

RICHARD L. DOERNBERG\*  
JONATHAN R. MACEY\*\*

*Since 1974, Congress has created numerous tax benefits favoring Employee Stock Ownership Plans (ESOPs). Congress significantly expanded those benefits with the Deficit Reduction Act of 1984, and as a result the use of ESOPs is likely to increase substantially in the future.*

*In this Article, Professors Doernberg and Macey argue that ESOPs do not deliver the non-tax benefits claimed for them by proponents and cause inefficient market distortions. After exploring the history and requirements of ESOPs, they discuss various market distortions caused by ESOPs, with particular emphasis on the market for corporate control. After reviewing the treatment ESOPs have received in recent tax reform proposals, Professors Doernberg and Macey conclude by suggesting that many of the beneficial goals ESOPs are alleged to serve could be better achieved by modifying the laws governing individual retirement accounts.*

We embark upon a critical journey through an area of tax-created incentives that have been widely praised, but narrowly understood. An Employee Stock Ownership Plan ("ESOP") is a deferred compensation plan where the employer's stock is held in trust for the benefit of employees. An employer can deduct the value of stock contributions to the trust while employees are permitted to postpone the recognition of income until they withdraw stock or other property from the trust.<sup>1</sup>

Senator Russell Long (D-La.), a leading advocate of ESOP legislation in Congress, sings the praises of ESOPs as follows:

Tomorrow's economic system will be born out of the decisions that we in this Chamber make today . . . We simply must enact incentives to insure that tomorrow's free enter-

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<sup>1</sup> See *infra* text accompanying notes 50-59 for a discussion of the tax benefits associated with ESOPs. For a comprehensive treatment of ESOPs, see Elinsky, *The Uses of ESOP's*, 1984 N.Y.U. TAX INST. ON ERISA, 7-1 to 7-41; Kaplan & Ludwig, *ESOPs*, TAX MGMT. (BNA) No. 3542d; Ronan, *Tax Incentives Encouraging Use of Employee Stock Ownership Plans As Corporate Finance and Anti-Takeover Devices*, 58 TEMP. L.Q. 115 (1985).

prise system is financed so as to be more broadly owned

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... By enacting such incentives, we can bring about a new sense of connection and participation. That, in turn, will help us to more fully enlist the drive, enthusiasm, and intelligence of the American public.<sup>2</sup>

There has been some criticism of the use of ESOPs. These critics have primarily argued that there are other tax-motivated transactions that offer corporations and plan participants the same strategic benefits as ESOPs at lower cost.<sup>3</sup> This Article suggests that the problems with ESOPs are more fundamental. The tax advantages of ESOPs do not provide the non-tax benefits to workers that proponents suggest, and they cause inefficiency and distortion in the market.

It is not the tax advantages of ESOPs that cause problems. Rather, the severe limitations and restrictions on corporate behavior imposed by ESOP legislation are the cause of the undesirable inefficiency and distortion. Actually, the favorable tax treatment of ESOPs is largely consistent with the principles underlying a consumption tax.<sup>4</sup> As discussed below, a con-

<sup>2</sup> 129 CONG. REC. S16,638 (daily ed. Nov. 17, 1983) (statement of Sen. Long).

<sup>3</sup> See, e.g., Baldwin, *The Myths of Employee Ownership*, FORBES, Apr. 23, 1984, at 108-10 (citing problems at worker-owned companies and suggesting successes may be due to factors other than ESOPs); Hoerr, *ESOPs: Revolution or Ripoff?*, BUS. WK., Apr. 15, 1985, at 94, 102-10 (potential for abuse as shown by recent ESOP leveraged buyouts raise serious questions of ESOP utility to workers and to society at large); Huene, *Beware the ESOP: A Cautionary Tale*, 1976 TAX ADVISOR 722 (leveraged ESOPs are more expensive to present shareholders than conventional financing and rarely provide unique benefits); Kaplan, *ESOP's Fable: A Tale of Tax Planning Pitfalls and Opportunities Associated with Employee Stock Ownership Plans Complete with a Choice of Morals*, 53 TAXES 898 (1975) (claimed benefits of ESOPs as a financing tool may be largely illusory; corporation better served by existing methods); Levin, *Are Leveraged Employee Buyouts Fatally Flawed?*, WALL ST. J., Apr. 4, 1985, at 30, col. 3 (use of ESOP for leveraged employee buyout damaging to firm because it results in over-indebtedness without any real gain); Ronan, *supra* note 1, at 117-18 (insufficient safeguards for plan participants); Sherman & Lewis, *The ESOP Fallacy*, 3 J. PENSION PLAN & COMPLIANCE 226 (1977) (touted benefits of ESOPs offset by drawbacks and available through conventional types of plans such as stock bonus and profit-sharing).

<sup>4</sup> As its name implies, a consumption tax subjects a taxpayer to a tax on income used for consumption purposes rather than on all income. In many consumption tax configurations, consumption is measured by totalling a taxpayer's income and then subtracting amounts saved or invested. The difference between income and savings (investments) is consumption. There is a rich literature on consumption taxes. See, e.g., Doernberg, *A Workable Flat Rate Consumption Tax*, 70 IOWA L. REV. 425 (1985) (discussing the proposal advanced by Robert E. Hall and Alvin Rabushka, senior fellows at the Hoover Institute); R. HALL & A. RABUSHKA, *LOW TAX, SIMPLE TAX, FLAT TAX* (1983); DEP'T OF TREASURY, *BLUEPRINTS FOR BASIC TAX REFORM* (1977); Bradford, *The Case for a Personal Consumption Tax*, in *WHAT SHOULD BE TAXED INCOME OR EXPENDITURE* 75 (J. Pechman ed. 1980); Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974).

sumption tax reverses the anti-saving, anti-investment bias of our income tax.<sup>5</sup> Thus, in one sense, ESOPs may represent a step in the right direction. While the movement to a consumption tax offers much promise, the ESOP experience illustrates that piecemeal changes toward such a tax only guarantee complexity and inefficiency.

The use of ESOPs is not widespread,<sup>6</sup> but the sharply enhanced tax benefits for ESOPs enacted as part of the Deficit Reduction Act of 1984<sup>7</sup> assure their rapid growth. While details of the 1984 changes are discussed below,<sup>8</sup> perhaps the most significant change is tax-subsidized borrowing made available to corporations with ESOPs, which will enable them to borrow at lower interest rates than other borrowers.<sup>9</sup> The availability of this preference will inevitably cause ESOP formation by firms that otherwise would not have considered the plans.

After a brief exploration of the history and requirements of ESOPs in Part I, this Article attempts to shed some light on the claims made by ESOP supporters in Part II. ESOPs are claimed to hold the key to curing much of what ails this country socially and economically.<sup>10</sup> These claims simply are not supportable. Moreover, regulation of employee compensation through tax incentives alters behavior in an inefficient manner. Part III focuses on an important illustration of such inefficiency—the market for corporate control. Part IV addresses the effects that comprehensive tax reform might have on ESOPs.

## I. HOW ESOPS WORK

While the notion of employee stock ownership traces back to the nineteenth century,<sup>11</sup> the modern era of ESOPs started in the 1950's when Louis Kelso first presented his thesis of own-

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<sup>5</sup> See *infra* text accompanying note 85-90.

<sup>6</sup> Accurate data on ESOPs is virtually impossible to obtain. One source has estimated 7000 ESOPs with nearly 10 million participants. Hoerr, *BUS. WK.*, *supra* note 3, at 94.

<sup>7</sup> Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (to be codified at 26 U.S.C. § 1).

<sup>8</sup> See *infra* text accompanying notes 55-59.

<sup>9</sup> See I.R.C. § 133(a) (West Supp. 1985); Sheppard, *ESOPs, Wealth Distribution, and Leveraged Buyouts*, 1984 TAX NOTES 1270, 1271 (suggesting that ESOPs will be able to borrow at rates one-third lower than the prime lending rate).

<sup>10</sup> See *infra* text accompanying note 83.

<sup>11</sup> The first formal plan on record in the United States was started by Rand, McNally and Co. in 1879. D. PECKMAN, *EMPLOYEE STOCK OWNERSHIP PLANS: A DECISION MAKER'S GUIDE* (Apr. 1983)(unpublished manuscript).

ership based on labor and capital.<sup>12</sup> Kelso reasoned that technology is the principal factor in increasing productivity, and that technology operates solely on capital.<sup>13</sup> Accordingly, Kelso viewed capital, not labor, as the primary source of wealth in an industrial society.<sup>14</sup> He saw no way of sharing the affluence of the United States unless capital ownership was made available to labor.<sup>15</sup> Neither he nor other ESOP advocates cogently explain why government regulation through tax incentives will lead to his goal of wealth redistribution throughout society.

According to Kelso, capitalist economies must artificially enlarge labor's share of income in order to avoid mass starvation and the concomitant social disorder. This wealth transfer supposedly is accomplished through unionization and the pursuit of inflationary full-employment policies that keep the demand for and the price of labor high. The excess income allocated to labor allegedly leads to a reduction in capital which leads in turn to inadequate development of new technology, stagnant productivity, and high rates of inflation. This wealth transfer also leads to a distortion in the allocation of income between labor and capital.<sup>16</sup>

Kelso's solution to the perceived problem was to restructure the economic system so that capital resources would be more widely dispersed.<sup>17</sup> This would allow capital to receive the rate of return Kelso believed it deserved without relegating laborers to poverty.

ESOPs were the mechanism for implementing Kelso's plan. He envisioned employee investment plans borrowing money (using the credit of the sponsoring employer) to finance corporate investment through the purchase of employer stock. The employer would then repay the original loan to the ESOP. As the loan was repaid, employees would become owners of large

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<sup>12</sup> L. KELSO & M. ADLER, *THE CAPITALIST MANIFESTO* (1958).

<sup>13</sup> *Id.* at 39.

<sup>14</sup> *Id.* at 171-72.

<sup>15</sup> Kelso more recently contended that workers do not invest in capital because very few of them earn enough in wages to allow them the luxury of purchasing stock. *Employee Stock Ownership Plans (ESOPs): Hearings Before the Joint Economic Committee, 94th Cong., 1st Sess. 134 (1975)* (statement of Louis O. Kelso, Managing Director, Kelso Bangert & Co.) [hereinafter cited as *Hearings*].

<sup>16</sup> Kelso estimated that labor's actual contribution to production is in the range of 10%, with capital contributing 90%. L. KELSO & M. ADLER, *supra* note 12, at 41. Economists dispute his figures, arriving at a 75% contribution by labor to capital's 25%. T. JOCHIM, *EMPLOYEE STOCK OWNERSHIP AND RELATED PLANS* 12 (1982) (quoting Paul Samuelson, Nobel laureate in economics).

<sup>17</sup> See L. KELSO & M. ADLER, *supra* note 12, at 28-29.

blocks of capital in the form of stock allocated to their individual accounts.

The first such "leveraged" employee stock ownership plan was adopted in 1957.<sup>18</sup> For reasons discussed extensively throughout this Article, the plans proved to be unpopular and few firms adopted them. All else equal, employees prefer compensation in the form of cash rather than stock in their employer's firm. Thus, from 1956 until 1974 Kelso's concept languished in obscurity.<sup>19</sup>

Beginning in 1974, however, with the passage of the Employee Retirement Income Security Act of 1974 ("ERISA"), which established ESOPs as separately defined forms of stock bonus plans, replete with special fiduciary and distribution requirements, ESOPs have steadily gained in popularity.<sup>20</sup> Congress has given employers massive regulatory incentives to create ESOPs, thus correcting the market's failure to do so on its own.<sup>21</sup> Before 1984, these incentives met with limited success;

<sup>18</sup> The first leveraged ESOP was started by Peninsula Newspapers, Inc. STAFF OF JOINT ECON. COMM., 94TH CONG., 2D SESS., BROADENING THE OWNERSHIP OF NEW CAPITAL: ESOPs AND OTHER ALTERNATIVES 58 (Comm. Print 1976) [hereinafter cited as JOINT ECON. COMM. STAFF].

Kelso is so much identified with the leveraged ESOP idea that this type of ESOP is often denominated as a "Kelso Plan." See, e.g., Henle & Gravell, *Employee Stock Ownership Plans: Current Status and Proposed Legislation*, Cong. Research Service Multilith No. 75-159E, at CRS-7 (July 9, 1975), reprinted in *Hearings, supra* note 15, at 9, 17.

<sup>19</sup> Estimates vary, but most authorities put the number of ESOPs in 1975 in the 200-300 range. See *Hearings, supra* note 15, at 93 (app. to statement of Charles Walker, Ass't Sec'y Tax Pol'y, U.S. Treas. Dep't). Of the 229 firms responding to a nonscientific survey conducted by the ESOP Association in 1983, only 37 (16%) had established their ESOPs before 1975. THE ESOP ASSOCIATION, ESOP SURVEY 1983, at 15. The relative paucity of ESOPs prompted a congressional staff studying them to state that they had not been "widely adopted." JOINT ECON. COMM. STAFF, *supra* note 18, at 59.

<sup>20</sup> See *infra* note 21. ESOPs, unlike other qualified plans, can transact with the employer or another party in interest or otherwise disqualified person, I.R.C. § 4975(d)(3) (1982), and benefits arising under an ESOP must, in most instances, be distributable in employer securities. *Id.* § 4975(e)(7) (requiring compliance with I.R.C. § 409(h) (West Supp. 1985)).

<sup>21</sup> Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001-1461 (1982) [hereinafter cited as *ERISA*]. The preferential treatment of ESOPs began with the ERISA provisions which allowed borrowing by an ESOP from the employer (an otherwise disqualified person) or under the employer's guarantee, I.R.C. § 4975(d)(3) (1982), and for deduction of contributions made to an ESOP for repayment of both principal and interest. I.R.C. § 404(a) (West Supp. 1985). As part of their design to "invest primarily in qualifying employer securities," I.R.C. § 4975(e)(7) (1982), ESOPs are excused from the diversification requirement imposed by *ERISA* § 404(a)(1), 29 U.S.C. § 1104(a)(1) (1982) upon most qualified retirement plans to the extent of the ESOP's investment in employer securities. *ERISA*, § 404(a)(2), 29 U.S.C. § 1104(a)(2) (1982).

The Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26, 36-40, created a new form of qualified plan, called a Tax Reduction Act Stock Ownership Plan (TRASOP),

although there were over 5000 ESOPs in existence by 1983 they still were not much of a factor in the compensation of workers.<sup>22</sup> But the Deficit Reduction Act of 1984 ushered in a new era for ESOPs.

### A. *The Structure of an ESOP*

An ESOP gives employers who pay some portion of an employee's compensation in the form of stock significant tax advantages.<sup>23</sup> The stock is held by a trust, unavailable to employ-

in which allowable contributions were tied to an employer's capital investment rather than to payroll. A participating employer received a one percent tax credit for transferring stock equal to one percent of qualified capital investment to an ESOP. *See* I.R.C. § 48(n) (1982), *repealed by* Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (for taxable years beginning after Dec. 31, 1983). Contribution to TRASOPs were increased by the Tax Reform Act of 1976. Pub. L. No. 94-455, 90 Stat. 1520, 1583-91.

To make ESOPs and TRASOPs more attractive to closely-held corporations, the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, 2787-96, allowed for distributions in cash rather than stock and implemented a put-option requirement for stock not readily marketable. *Id.* at 2789.

Congress destroyed TRASOPs with the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172, 289-96, by eliminating the tie-in of the contribution allowance to the investment tax credit, but continued the tax credit idea by allowing a credit, equal to up to one-half percent of payroll, for contributions to a "PAYSOP."

The Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, made ESOPs substantially more attractive, with its provisions for a rollover of gains from sale of stock to an ESOP, I.R.C. § 1042 (West Supp. 1985); for deduction of cash dividend payments, *id.* § 404(k); for exclusion by the lender of 50% of the interest earned on ESOP loans, *id.* § 133(a); and for assumption by an ESOP of estate tax liability in an amount equal to the value of stock held by the estate transferred to the ESOP. *Id.* § 2210.

Additionally, the federal government's bailout of Chrysler Corporation depended upon that company's creation of an ESOP. Chrysler Corporation Loan Guarantee Act of 1979 § 7, 15 U.S.C. §§ 1861-75, at § 1866 (1982).

<sup>22</sup> 129 CONG. REC. S5836 (daily ed. May 3, 1983) (statement of Sen. Long). For a 1985 estimate, see *supra* note 6.

<sup>23</sup> I.R.C. § 4975(e)(7) (1982) defines an ESOP as "a defined contribution plan: which is a qualified stock bonus plan, or a stock bonus and money purchase plan both of which are qualified under § 401(a), and which are designed to invest primarily in qualifying employer securities . . ." I.R.C. § 414(i) (1982).

In a "defined contribution plan" where allowable *contributions* to the plan are either fixed or limited, the benefits received by employees depend on the contribution levels. *Id.*

Treasury regulations describe a stock bonus plan essentially as a profit-sharing plan in which employer contributions are not necessarily tied to profits and distributions to plan participants are in the form of employer securities. Treas. Reg. § 1.401-1(b)(1)(iii) (1960). The stock bonus plan may provide a strict formula for yearly employer contributions or may leave the amount of yearly contributions to the employer's discretion. *Id.* § 1.401-1(a)(2)(iii).

A money purchase plan sets a definite formula or a specific amount for the yearly employer contribution. *See Id.* § 1.401-1(b)(1)(i); Rev. Rul. 57-312, 1957-2 C.B. 255.

The regimen for qualification under I.R.C. § 401 is multifaceted. For an in-depth consideration of the provisions see Ronan, *supra* note 1, at 119-33.

ees until retirement. The employer receives a tax deduction of the stock's fair market value at the time it is contributed to the trust,<sup>24</sup> and employees are not taxed on the stock until they withdraw it.<sup>25</sup> The plan must invest primarily in qualifying employer securities—generally common stock.<sup>26</sup> Although an ESOP must be “designed to invest primarily” in employer securities, the phrase is not defined,<sup>27</sup> nor are there any judicial or administrative rulings on the meaning of “primarily” or the percentage of trust assets that must be qualifying employer securities.<sup>28</sup> Instead of contributing stock itself, employers can make cash contributions to ESOPs that can be used by the ESOP to purchase stock from shareholders or from the employer.<sup>29</sup>

Contributions to ESOPs must not discriminate in favor of officers, shareholders, or other highly compensated employ-

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<sup>24</sup> I.R.C. § 402(a) (1982).

<sup>25</sup> *Id.* § 402(a). Many of the technicalities governing the treatment of ESOPs will be simplified or ignored for the purposes of this discussion where, in the author's opinion, they add nothing to the arguments.

<sup>26</sup> A qualifying employer security is common stock of the employer that either is readily tradable on an established market or has a combination of voting power and dividend rights equal to or in excess of the most favorable dividend rights and voting power of any other class of common stock. I.R.C. § 409(l) (West Supp. 1985). Non-callable preferred stock can be a qualifying employer security if it is convertible into qualified common stock at a reasonable price at any time. *Id.* Bonds, debentures, or other debt instruments do not constitute qualifying employer securities even if marketable. *Id.* Stock issued by corporations controlled by the employer can also satisfy the qualifying employer securities requirement. I.R.C. §§ 4975(e)(8) (1982), 409(l) (West Supp. 1985). See Ronan, *supra* note 1, at 125–26.

<sup>27</sup> A plan may invest in assets other than qualifying employer securities as long as it satisfies the “primarily” test. Treas. Reg. § 54.4975-11(b) (1977).

<sup>28</sup> One writer has suggested a 51% qualifying threshold. Elinsky, *supra* note 1, at § 7.03[2]. A survey conducted in 1983 by the ESOP Association found that approximately 80% of the respondent plans had at least 75% of their assets invested in employer stock, with the overall average investment level for the 229 plans responding being 87.7%. THE ESOP ASSOCIATION, *supra* note 19, at 28–29.

<sup>29</sup> A leveraged ESOP can be a highly desirable mechanism for buying out a principal shareholder, for both the company and the selling stockholder. If three conditions are met, the shareholder can avoid having to meet the requirements of I.R.C. § 302 (1982) in order to secure capital gains treatment on the sale. The three conditions, imposed by implication of Rev. Proc. 77-30, 1977-2 C.B. 539, are: (1) the selling shareholder and related persons cannot “own” more than 20% of the beneficial interest in the ESOP; (2) restrictions on distribution of the stock sold to the ESOP by the shareholder cannot be harsher than restrictions on a majority of stock held by other shareholders; and (3) the employer and the ESOP must expressly state that redemption of the stock from the ESOP is not contemplated. Moreover, the shareholder can defer taxation on the gain realized from the sale by reinvesting the proceeds in certain qualifying securities within a specified period of time. I.R.C. § 1042 (West Supp. 1985). For further analysis of the requirements for a leveraged ESOP buyout of a principal stockholder, see Ronan, *supra* note 1, at 145–49.

ees.<sup>30</sup> In addition, the ESOP must satisfy a medley of minimum participation and vesting standards, imposed to shore up the nondiscriminatory aims of preferential pension legislation.<sup>31</sup> An ESOP must cover either seventy percent or more of all employees, or eighty percent of all eligible employees as long as seventy percent or more of the employees are eligible, or satisfy the Secretary of Labor that the classification used is not discriminatory.<sup>32</sup> The benefits that accrue to a participant's account from the corporation's contributions must vest according to a choice of vesting schedules ranging from no vesting during the first ten years of service, but 100% vesting upon completion of year ten, to gradual vesting from the end of five years of service

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<sup>30</sup> I.R.C. § 401(a)(4) (1982). Benefits and contributions may be proportional to compensation without being deemed discriminatory. *Id.* § 401(a)(5).

If a plan is found to be "top-heavy," i.e., if "key employees" (officers, those earning more than the current \$30,000 limit in § 415(c)(1)(A), and "owners"), I.R.C. § 116(c)(1)(A) (West Supp. 1985), have account balances which, combined, exceed 60% of the sum of the account balances of all employees under the plan, I.R.C. § 416(g)(1) (1982), the plan is subject to the more stringent contribution and vesting rules of I.R.C. §§ 416(b), (c), and (h) (1982). An employee is an "owner" for purposes of the "key employee" definition if he is one of the 10 largest shareholders of the employer, owns more than one-half of one percent of the outstanding employer securities and earns more than the limit set by I.R.C. § 415(c)(1)(A) (1982); or if he owns five percent of the outstanding securities issued by the employer; or earns over \$150,000 per year from the employer and owns at least a one percent interest in the employer. Treas. Reg. § 1.416-1 (1984).

<sup>31</sup> See generally I.R.C. §§ 401 (1982) (discrimination in favor of "prohibited group" of officers, shareholders or highly paid employees disallowed), 410 (establishing minimum participation standards), 411 (setting forth three minimum vesting schemes and blanket prohibition of "pattern of abuse") and 416 (setting forth procedure for determining if plan is top-heavy and penalty for top-heavy plans). See Kaplan & Ludwig, *supra* note 1, at A-7 to A-9, for an excellent and concise explanation of the participation and vesting requirements.

<sup>32</sup> I.R.C. § 410(b)(1) (1982). The latter test allows more flexibility. I.R.C. § 401(a)(5) (1982) permits an ESOP scheme to limit eligibility to salaried or clerical workers, subject to the general prohibition of discrimination in favor of the "prohibited group" of officers, owners and highly-paid employees contained in I.R.C. § 401(a)(4) (1982). See *supra* note 30. Some courts have developed a "fair cross-section" test which examines the cross-section of employees covered by the plan according to compensation level. See *John Duguid & Sons, Inc. v. United States*, 278 F. Supp. 101, 105 (N.D.N.Y. 1967). See also *Fujinom Optical, Inc. v. Commissioner*, 76 T.C. 499, 508 (1981); *Pulver Roofing Co. v. Commissioner*, 70 T.C. 1001, 1013-14 (1978).

Universal participation is not mandated. The plan may include a minimum age for participation not exceeding 21 years, I.R.C. § 410(a)(1)(A)(i) (1982), a minimum length of employment, *id.* § 410(a)(1)(A)(ii), and minimum continuous service requirements, *id.* § 410(a)(1)(B) (West Supp. 1985), but may not place a limit on a participant's maximum age, *id.* § 410(a)(2) (1982). Employees may be temporarily excluded from participation in employer contributions and reallocation of forfeitures for years in which they complete less than 1000 hours of service, *id.* § 411(b)(3)(C), or for periods in which they fail to make mandatory contributions to the plan, *id.* § 411(a)(4)(B). Employees temporarily excluded must nonetheless continue to share in profits and losses of the plan. *Id.* § 411(b)(3).



through fifteen years of service.<sup>33</sup> Whatever vesting schedule is chosen, I.R.C. § 411(d)(1)<sup>34</sup> prohibits any pattern of abuse, such as dismissal, which may tend to discriminate in favor of employees who are officers, shareholders, or highly compensated.

All ESOP assets must be held in trust and be managed by a trustee.<sup>35</sup> With some exceptions,<sup>36</sup> the trustee is named by the sponsor corporation's board of directors or a committee appointed by the board and is subject to the direction and authority of the appointing group.<sup>37</sup> The trustee is subject to the general fiduciary rules of ERISA requiring him or her to act with prudence exclusively for the purpose of providing benefits to participants.<sup>38</sup> However, other basic fiduciary requirements applicable to pension plans are relaxed to account for the special purpose of ESOPs. ESOPs are exempt from the diversification requirements normally imposed on pension plan trustees since ESOPs are designed to invest in employer's stock.<sup>39</sup> ESOPs can also purchase stock from an employer or from other parties in interest (major shareholders, officers, and directors) even though I.R.C. § 4975 prohibits such transactions for most pension plans.<sup>40</sup> In addition, I.R.C. § 4975(d)(3) and ERISA § 408(b)(3) permit an ESOP to borrow money from a party in interest, such as the employer, for the acquisition of employer stock.<sup>41</sup>

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<sup>33</sup> *Id.* § 411(a). The vesting schedules concern only those allocations or contributions to an employee's account that are attributable to the employer. An employee must always be 100% vested in his own contributions. *Id.* § 411(a)(1).

<sup>34</sup> *Id.* § 411(d)(1).

<sup>35</sup> ERISA, *supra* note 21, at §§ 402(a)(1) and 403(a), 29 U.S.C. §§ 1102(a)(1) and 1103(a).

<sup>36</sup> *See id.* § 403(a)(2), 29 U.S.C. § 1103(a)(2).

<sup>37</sup> *Id.* at § 403(a)(1), 29 U.S.C. § 1103(a)(1).

<sup>38</sup> *Id.* at § 404(a)(1), 29 U.S.C. § 1104(a)(1).

<sup>39</sup> *Id.* at § 404(a)(2), 29 U.S.C. § 1104(a)(2). To the extent that an ESOP invests in assets other than the employer's stock, ERISA's diversification requirements apply. *Id.* at § 404(a)(1), 29 U.S.C. § 1104(a)(1).

<sup>40</sup> *Id.* at § 408(e), 29 U.S.C. § 1108(e). The exemption applies only if the price paid for the stock constitutes "adequate consideration." *Id.*

<sup>41</sup> *Id.* at § 408(e), 29 U.S.C. § 1108(e); I.R.C. § 4975(d)(3) (1982). This exception to normal fiduciary restrictions covers direct loans, loan guarantees and installment sales, and assumes compliance with restrictions, including a reasonable interest rate, collateral restricted to employer securities, and primary benefit to employees. The Departments of Labor and Treasury have placed restrictions on ESOP "interested party" loans. 29 C.F.R. § 2550.408b-3(c) (1984); Treas. Reg. § 54.4975-7(b)(3) (1977). These posit an "arms-length transaction" standard to test the fairness of the loan terms and prohibit transactions which would siphon off the plan assets. In addition to limiting collateral to the employer securities being purchased with loan proceeds, 29 C.F.R. § 2550.408b-3(e) (1984) and Treas. Reg. § 54.4975-7(b)(5) (1977) mandate a "no recourse" clause in the loan provisions and restrict the plan's liability for repayment to employer contributions

ESOP participants must be entitled to vote the stock held in their accounts.<sup>42</sup> If the issuing corporation has no outstanding stock that must be registered, no voting rights pass-through is required except where, according to the corporate charter or applicable law, a matter must be decided by more than a majority vote of the outstanding common shares voted.<sup>43</sup>

If a participant in an ESOP is entitled to a distribution, he must have the right to demand that his benefits be distributed in the form of employer securities.<sup>44</sup> If no demand is made, the employer can make cash distributions.<sup>45</sup> Unless the securities received can be readily traded on an established market, a participant must have the right to require the employer (not the ESOP) to repurchase the securities for their fair market value.<sup>46</sup>

The annual contribution and other additions for an ESOP participant cannot exceed the lesser of thirty thousand dollars or twenty-five percent of annual compensation.<sup>47</sup> Similarly sit-

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other than stock, earnings on such contributions, and cash dividends on employer stock. Under 29 C.F.R. § 2550.408b-3(e) (1984) and Treas. Reg. § 54.4975-7(b)(8) (1977), the encumbered shares of employer stock must be released to participants' accounts as the loan is repaid. Demand loans are not permitted and a definite term must be set. 29 C.F.R. § 2550.408b-3(f) (1984); Treas. Reg. § 54.4975-7(b)(7) (1977).

If an ESOP interested party loan fails to satisfy any of the conditions described above, the loan may be declared a prohibited transaction under I.R.C. § 4975 and the transgressing interested party may incur a five percent excise tax penalty, which can be increased to 100% if the transaction is not sanitized. I.R.C. §§ 4975(a) and (c) (1982).

<sup>42</sup> *Id.* § 4975(e)(7).

<sup>43</sup> *Id.* §§ 409(e)(3) (West Supp. 1985) and 401(a)(22) (1982). The minimal voting rights requirement seems inadequate in view of the stated purpose of ESOPs; to give the employee some ownership interest in his employer. See generally *ERISA*, *supra* note 21, at § 402, 29 U.S.C. § 1102. As pointed out by Ronan, *supra* note 1, at 128-30, stock is allocated to the accounts of participants in a leveraged ESOP only as the loan taken out to purchase the stock is paid off. See Treas. Reg. §§ 54.4975-11(c),(d); 54.4975-7(b)(8)(15) (1977). Employees have no voting control at all until stock is allocated to their individual accounts. See I.R.C. §§ 4975(e) (1982), 409(e) (West Supp. 1985). Even after allocation, employees of companies with no securities required to be registered may vote only on a few relatively rare corporate transactions. This provision is particularly disturbing because many companies with ESOPs are small, closely-held corporations which are unlikely to have registered securities. See *infra* text accompanying notes 102-03. Thus, participants are often effectively excluded from the control normally incident to corporate ownership.

<sup>44</sup> I.R.C. § 409(h)(1)(A) (West Supp. 1985).

<sup>45</sup> *Id.* § 409(b)(2).

<sup>46</sup> *Id.* § 409(h)(1)(B).

<sup>47</sup> *Id.* § 415(c)(1) (1982). For purposes of the annual addition limitation, an employee's "compensation" includes, in addition to his or her salary and other usual components, employer contributions to defined contribution plans, forfeitures allocated to the employee's account and the lesser of one-half of employee contributions or all employee contributions over six percent of compensation. See *id.* § 415(c)(2).

Starting in 1986, the \$30,000 limitation will be adjusted for cost-of-living increases. If an ESOP allocates one third or less of employer contributions to officers, ten-percent shareholders, or highly compensated employees, the annual addition limitation can be

uated employees must be treated in a nondiscriminatory manner under the plan.<sup>48</sup> In determining the amounts allocated to the accounts of participants, forfeitures from unvested accounts do not increase the allocable amounts, but instead reduce the employer's allowable tax-deductible contribution.<sup>49</sup>

### B. *The Tax Treatment of an ESOP*

Traditionally, there have been three primary tax benefits to ESOPs. First, employers can deduct contributions to an ESOP in an amount up to twenty-five percent of the compensation of all participants.<sup>50</sup> No ceiling exists where the employer's contributions are used by the plan to pay interest on a loan incurred to buy employer securities.<sup>51</sup> Second, income earned by the trust is exempt from taxation until distributed.<sup>52</sup> Third, employees are taxed on distributions when made, but can use certain averaging and rollover provisions not ordinarily available to non-pension plan compensation.<sup>53</sup> While all qualified pension plans enjoy tax incentives as compared with direct compensation, the liberal deduction limitations for employer contributions to an ESOP along with the borrowing opportunities available through an ESOP offer significant advantages which other types of pension plans cannot match.

Four new provisions enacted as part of the Deficit Reduction Act of 1984<sup>54</sup> give ESOPs even greater tax advantages over other forms of compensation. First, any shareholder who sells quali-

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doubled to the extent that the additional allocation is used for employer securities either contributed to or purchased by the plan. *Id.* § 415(e)(6).

<sup>48</sup> See *supra* notes 30-32.

<sup>49</sup> I.R.C. § 415(c)(2) (1982). See *supra* note 47.

<sup>50</sup> I.R.C. § 404 (West Supp. 1985). For an ESOP consisting only of a stock bonus plan, the employer may deduct contributions up to 15% of total compensation of participants and carry over into future years any unused portion of the ceiling. See *id.* § 404(a)(3)(A). Where an employer maintains a stock bonus plan in conjunction with some other type of pension plan, there is a ceiling on total deductible contributions equal to 25% of total compensation. *Id.* § 404(a)(7).

<sup>51</sup> *Id.* § 404(a)(9)(B). Employer contributions to an ESOP to permit the ESOP's repayment of loan principal are deductible up to 25% of the compensation of participating employees without regard to employer contributions to other plans. See *id.* § 404(a)(9)(A). Note that the limits on deductibility may in some cases be more stringent than the individual allocation limits. An employer is free to make nondeductible contributions in excess of the deduction limitation so long as the individual allocation limits are not exceeded. *Id.*

<sup>52</sup> *Id.* §§ 501(a), (c), (d) (1982).

<sup>53</sup> *Id.* §§ 402(a), (e). See *infra* note 55.

<sup>54</sup> Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494.

fied stock to an ESOP can elect to defer any taxable gain if: (1) the proceeds are reinvested within a year in securities of a domestic corporation; and (2) after the sale, the ESOP owns thirty percent of the value of all employer stock.<sup>55</sup> This provision creates a strong tax incentive for shareholders to sell their stock to an ESOP rather than to other purchasers because sales to non-ESOP purchasers do not permit any deferral of gain, regardless of timely reinvestment.

Second, the employer corporation is permitted a deduction for cash dividends paid on stock held by an ESOP if the dividends are distributed to ESOP participants.<sup>56</sup> Distributing corporations generally do not receive deductions for dividends paid.

Third, I.R.C. § 2210 allows an ESOP to assume a decedent's estate tax liability in exchange for employer securities of equal value.<sup>57</sup> This provision allows large shareholders to cope with liquidity problems in connection with estate tax obligations.

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<sup>55</sup> I.R.C. § 1042 (West Supp. 1985). Rollover treatment is afforded only to shareholders of a corporation lacking any ready, established market for its securities. *Id.* § 1042(c)(1)(A). To qualify for this special nonrecognition provision, the taxpayer must have held the securities for at least one year, and they cannot have been acquired either through a qualified plan or stock option arrangement. *Id.* §§ 1042(c)(1)(B), 1042(c)(1)(C). Nonrecognition treatment is unavailable if the ESOP allocates the purchased securities for the benefit of the selling shareholder, family members, or any other person who owns more than 25% of the employer's stock. *Id.* § 1042(b)(3)(C).

The selling shareholder is entitled to exclude from income any gain from the sale which is reinvested in "qualified replacement property," defined as securities issued by any domestic corporation with passive investment income (e.g., dividends, rents, royalties) not exceeding 25% of gross receipts. *Id.* §§ 1042(a), 1042(c)(4). The qualified replacement property must be purchased at any time from three months prior to and 12 months after the sale. Any gain in excess of the cost of the qualified replacement property is recognized as income. *See id.* § 1042(c)(4). The "rollover" characteristic of these transactions is attributable to the reduction of the shareholder's basis in the replacement property by the amount of the gain not recognized by virtue of the ESOP-favored treatment. *See* I.R.C. § 1042(d) (West Supp. 1985).

The Code authorizes the imposition of an excise tax on the employer—hence, the requirement of employer consent to a shareholder's nonrecognition election—where the stock acquired by the ESOP is disposed of within three years, and such disposal decreases the total number of ESOP-owned shares or causes the ESOP to own less than 30% of the employer's securities. *See generally id.* § 4978.

<sup>56</sup> *Id.* § 404(k). The dividend must be paid in cash and be distributed to plan participants within 90 days of the close of the plan year. *Id.* § 404(k)(2). As stated in Ronan, *supra* note 1, at 141–42, since participants' interest in stock bought with the proceeds of an ESOP loan is minimal until the loan principal begins to be paid off, the dividend deduction is of little value to a corporation in the early years of a leveraged ESOP because the participants lack sufficient beneficial ownership in the stock to entitle them to dividends.

<sup>57</sup> I.R.C. § 2210 (West Supp. 1985) also provides generous deferral provisions for the ESOP's payment of the estate taxes. If the ESOP and the estate qualify, the ESOP may defer payment of the assumed tax liability for up to five years and nine months and may take up to 10 years following the first installment to pay off the entire liability. *Id.*

The fourth change will likely be the most significant in encouraging a dramatic increase in the use of ESOPs. An institutional lender who extends a loan to an ESOP for the purpose of enabling the plan to acquire employer securities can exclude from income fifty percent of the interest received on the loans.<sup>58</sup> The partial exemption will result in lower interest rates to ESOP-borrowers and ultimately will lower the cost of financing projects to corporate sponsors who sell employer securities to the ESOP.<sup>59</sup>

### C. *The Dynamics of ESOP Use*

If no preferential tax treatment were given to ESOPs, other pension plans, or other forms of compensation, employees generally would elect to receive all compensation in the form of cash. This is because cash offers employees the greatest flexibility for making expenditure choices among competing alternatives. Corporations desiring capital for projects would have to compete for funds from investors and lenders. There would be no particular reason why employee-investors would be any more disposed to purchase their employer's stock than outside investors. Perhaps some investors would invest or lend money to their employer; others would not.

The tax advantages accorded various forms of compensation changes their relative desirability and their use by employees. Compare compensation through an ESOP with direct cash payment. Suppose employee ("EE") and his employer ("ER") determine that EE's services are worth \$50,000 per year. Suppose further that the compensation alternatives are either \$50,000 in cash or \$40,000 in cash and a \$10,000 contribution to an ESOP to be allocated to EE's account.<sup>60</sup> If EE receives all cash, ER receives a \$50,000 deduction and EE is taxed on the compensation received.<sup>61</sup> At this point, whatever expenditure choice

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§ 6166(a) (1982). The installment payment method requires only four percent interest payments, and employer contributions to pay the interest are deductible. *Id.* §§ 2210(c)(2), 404(a)(9)(B) (West Supp. 1985).

<sup>58</sup> *Id.* § 133(a).

<sup>59</sup> See *infra* text accompanying notes 66-72.

<sup>60</sup> As indicated below, it is likely that the tax benefits associated with an ESOP will be divided between the employer (i.e. shareholders) and employees depending on the elasticities of the demand and supply curves for labor. See *infra* text accompanying note 72.

<sup>61</sup> I.R.C. § 162(a)(1) (1982).

EE makes (for example, to purchase ER's stock), the expenditure will be made with after-tax dollars.

If EE receives \$40,000 in cash and a \$10,000 contribution to EE's account in an ESOP, the treatment of the cash compensation does not change. From ER's perspective, the contribution to the ESOP, like a \$10,000 cash payment, will generate a \$10,000 deduction.<sup>62</sup> Moreover, the existence of an ESOP will permit ER to raise capital at less expense.<sup>63</sup> For EE the contribution to an ESOP means that \$10,000 is unavailable for expenditure on alternative investments or consumption. Stated differently, EE is induced by the tax system to invest a portion of his compensation in ER's stock. In exchange for the limitation on EE's expenditure choice, EE is not taxed on the contribution to the ESOP nor on any income earned by the ESOP until it is distributed. The ability to invest pre-tax dollars in ER's stock and to escape immediate taxation on the earnings of the stock will influence EEs on the margin to prefer the ESOP contribution to a cash payment.

ESOPs represent only one of several deferred compensation arrangements, all of which share certain basic tax benefits, including immediate deduction for the employer and deferral of taxation for the employee on both the initial contribution and any income it generates.<sup>64</sup> The total amount of compensation that an employer can contribute to all types of pension plans that an employer might maintain is limited by statute.<sup>65</sup> In light of these limitations, it is worthwhile to consider why an ESOP may offer advantages over other pension plans.

The general fiduciary rules that govern the management of pension trusts prohibit most sale and loan transactions between a pension plan and a party in interest, including the employer, major shareholders, directors, and officers.<sup>66</sup> This restriction

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<sup>62</sup> *Id.* § 404(a) (West Supp. 1985).

<sup>63</sup> Because the employer is only "bargaining" with the ESOP in a "leveraged" ESOP transaction (see *infra* text accompanying notes 63-66), rather than with many buyers in the open market, the transaction costs of raising capital through an ESOP are lower. An ESOP transaction may also avoid the cost of underwriting and registering a new stock issue. See Elinsky, *supra* note 1, at § 7.04[2][c].

<sup>64</sup> I.R.C. § 404 (West Supp. 1985). This section along with §§ 402(a) and 403(a) are part of the sweeping reforms brought about by the enactment of *ERISA*, *supra* note 21.

<sup>65</sup> Contributions to profit-sharing and stock-bonus plans are aggregated for purposes of the § 404 limitations. See I.R.C. § 404(a)(3)(A) (West Supp. 1985).

<sup>66</sup> *Id.* § 4975 (1982). The "prohibited transaction" rules do not completely deny plans the right to do business with interested persons. Defined benefit plans generally may

makes most pension plans unsuitable as a means of raising capital. ESOPs, on the other hand, offer ready financing for employers because these restrictions do not apply. In the example above, ER can retain \$10,000 in cash that would otherwise be paid to EE by contributing stock worth \$10,000 to an ESOP. An ESOP also can borrow at subsidized rates to purchase stock of the employer,<sup>67</sup> providing another method of financing projects. If an ESOP borrows money from a bank and uses the proceeds to purchase stock from the employer, it is as though the employer has borrowed money directly from the bank. The loan is repaid through annual employer contributions to the ESOP which in turn repays the lender. Use of an ESOP to fund corporate projects in this manner is referred to as leveraging.<sup>68</sup>

To illustrate how a leveraged ESOP might work, suppose that X Corporation ("X Corp.") wishes to borrow one million dollars for a building project that is expected to produce \$554,820 a year for five years. The project will require a present value of one million dollars in labor costs payable over the five-year period in annual installments of \$277,410. Assume that the loan is repayable over the same five-year period with annual payments equal to \$277,410. At the market discount rate of twelve percent built into the loan repayment schedule, X Corp. will be indifferent about undertaking the project.<sup>69</sup>

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invest up to 10% of assets in the employer corporation without need of providing any voting rights pass-through to participants or of making distributions in employer stock. *ERISA*, *supra* note 21, at § 407(a), 29 U.S.C. § 1107(a), I.R.C. §§ 401(a)(22), (23) (1982). Profit-sharing and stock-bonus plans may invest over 10% of plan assets in the employer by including a clause allowing greater investment in the trust agreement itself. *ERISA*, *supra* note 21, at § 407(d)(3), 29 U.S.C. § 1107(d)(3).

<sup>67</sup> See *supra* text accompanying notes 9, 58-59.

<sup>68</sup> See *supra* note 3.

<sup>69</sup> If the project produces one penny more, X Corp. would undertake the project.

Besides the 12% market discount rate, this example assumes: (1) a 50% flat tax rate for all taxpayers; (2) a sinking fund depreciation schedule, see M. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 133-35 (1985); and (3) the absence of inflation.

With sinking fund depreciation, the one million dollar cost of the building would be recovered as follows:

Year 1: \$157,410  
Year 2: \$176,299  
Year 3: \$197,455  
Year 4: \$221,149  
Year 5: \$247,687

The loan principal would be amortized on the same schedule, thereby producing the

Prior to the Deficit Reduction Act of 1984, if X Corp. investigated financing the project through an ESOP, it would decide to proceed. Typically, the ESOP would borrow \$1,000,000 from a bank. As part of the loan, the employer would guarantee the loan and promise to contribute enough money to the ESOP to permit the plan to make annual repayments. The ESOP would use the proceeds to purchase one million dollars worth of stock from X Corp. Every year X Corp. would contribute \$277,410 to the ESOP, enough to pay loan principal and interest. Compared with direct financing, use of the ESOP leaves X Corp. with \$277,410 in cash (minus taxes) each year during the five-year period because stock was used for compensation purposes rather than cash.<sup>70</sup>

The Deficit Reduction Act of 1984 made financing through an ESOP even more advantageous. Because the bank can exclude interest payments received from the ESOP, the interest rate charged will inevitably be lower.<sup>71</sup> For example, if the bank charges nine percent interest instead of twelve percent, X

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following interest deductions computed by subtracting the loan principal amortization from the annual \$277,410 loan repayment:

Year 1: \$120,000

Year 2: \$101,111

Year 3: \$ 79,955

Year 4: \$ 56,261

Year 5: \$ 29,723

With this in mind, consider Year 1. X Corp. receives \$554,820 but must pay \$277,410 in labor costs and \$277,410 to the bank. If there is any tax liability, X Corp. would not undertake the project. However, the \$554,820 in income is offset by the \$277,410 deduction for compensation under I.R.C. § 162(a)(1) (1982), the \$120,000 interest deduction under I.R.C. § 163 and the \$157,410 depreciation deduction under I.R.C. § 168. Similarly, there will be no tax liability in Years 2-5 since the interest and depreciation deductions will always total \$277,410.

If X Corp. distributed its own stock rather than cash to its employees: (1) the tax treatment of both the employer and employees would remain the same except that the employees would have a tax liability on the fair market value of the \$277,410 received annually without having the cash to pay the taxes; and (2) X Corp. would retain \$277,410 each year since compensation was paid in stock.

<sup>70</sup> Using the tables set forth in *supra* note 69, in Year 1, X Corp. would have income of \$554,820 offset by a depreciation deduction of \$157,410 and a deduction for the contribution to the ESOP in the amount of \$277,410. See I.R.C. § 404(a)(9) (West Supp. 1985). If it is in a 50% tax bracket X Corp. would pay \$60,000 of taxes on the \$120,000 of taxable income. The employees would not be taxed on the employer's contributions to the employee stock ownership trust. See I.R.C. § 402(a)(1) (1982). Thus, comparing this configuration with the nonqualified use of stock, *supra* note 69, in both cases X Corp. has the use of \$277,410 annually. Using nonqualified stock outside of the ESOP context leads to a large tax on employees. Use of stock through an ESOP leads to a smaller tax on the employer. Since the overall tax bite is smaller in the ESOP context, X Corp. and its employees can be expected to divide the tax savings in a pareto optimal manner. See *infra* note 72.

<sup>71</sup> See Sheppard, *supra* note 9, see also text accompanying note 52.

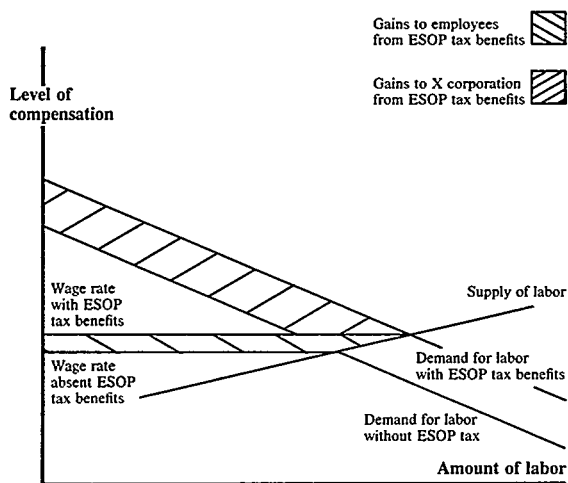


Corp.'s annual payments will be \$257,093, a \$20,317 savings each year over the five-year period. The present value of the savings at the commencement of the project is \$73,239 before taxes, or \$36,620, assuming a fifty percent tax rate.

How these tax savings will be shared between employer and employee is an empirical question depending on the elasticities of the labor supply and demand curves facing a firm. If the firm faces a firm-specific inelastic supply curve for labor, perhaps because of specialized training or high relocation costs, the firm rather than its employees will capture the lion's share of ESOP tax benefits. If it is costly for employees to collect information about and to move to other job opportunities even within the same industry, a firm will not have to use its tax benefits to retain employees and will be unable to use its tax benefits to attract new employees.<sup>72</sup>

<sup>72</sup> To take the extreme example, suppose that a firm faces a totally inelastic supply curve for labor. The wage rate will be set at the minimum point on the inelastic curve. Payment of a penny less will drive all workers to other pursuits. Payment of a penny more is wasteful for the firm since no new workers will be attracted. If ESOP tax benefits are introduced, X Corp. can attract the same number of workers by paying less—the government makes up the difference. Consequently, X Corp. rather than the employees would benefit from the ESOP tax benefits.

If a firm does not face a firm-specific inelastic labor supply curve, then the division of the tax benefits will depend on the elasticity of the industry-wide labor supply curve. If the supply of labor is very elastic so that a small rise in wage levels will result in a substantial increase in the supply of workers, we can represent the market for labor as follows:

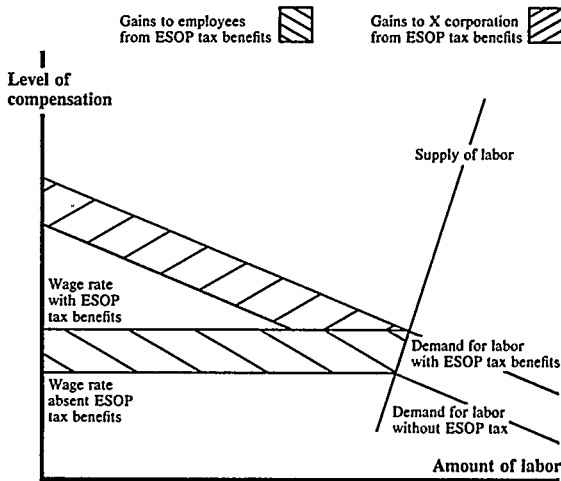


If tax benefits are introduced, X corp. can now get more labor for the same amount

The use of a leveraged ESOP to fund projects less expensively than through conventional financing leads to a variety of distortions.<sup>73</sup> The savings to a corporation or its employees from borrowing through an ESOP are not wealth-created savings. Rather the savings simply represent a tax transfer from all taxpayers to the corporation and those enrolled in ESOPs.

In addition to serving as a financing tool, an ESOP can provide a market for the employer's securities in the close corporation setting, thereby enabling shareholders to lessen the tax burden of cashing in on the corporation's earnings. Suppose X Corp. is managed by five key employees who own seventy-five percent of its outstanding stock. If X Corp. performs well, and the shareholders want to distribute the earnings to themselves, the key employee-shareholders will be unable to obtain the earnings without being taxed at ordinary income rates.<sup>74</sup> If a distribution is made or if there is a pro rata redemption, ordinary income

of money. Under such circumstances, X Corp. can attract new employees and still capture a large share of the tax benefits.



If the labor supply for the industry is very inelastic, however, such that changes in wage level do not materially affect the supply of workers, X Corp. will have to give most of the tax benefits to labor. This is because wages must be raised substantially before new workers are attracted. If a firm does not increase wages, competitors will bid away the firm's employees.

If a firm faces a firm-specific inelastic labor supply curve, however, as noted in the text, then regardless of the elasticity of the labor supply for the industry, the firm will capture most of the ESOP tax benefits.

<sup>73</sup> See *infra* text accompanying notes 92-94.

<sup>74</sup> See I.R.C. § 1202 (1982) for the capital gains deduction.

treatment will ensue.<sup>75</sup> If the employee-shareholders sell their stock to an independent third party, capital gains treatment may apply.<sup>76</sup> There may be no market for stock of a closely held corporation, however, and even if there is, the key managers may be wary of giving up control. If they try to sell to a controlled third party, like a newly formed controlled corporation, again ordinary income treatment results.<sup>77</sup>

But, if X Corp. sets up an ESOP, the plan can purchase stock, giving the sellers the benefit of capital gains treatment without having to sell to a fully independent third party and providing X Corp. with a deduction for earnings contributed to the ESOP.<sup>78</sup> Typically, the ESOP would borrow funds from a bank at a tax subsidized interest rate. The funds would be used to purchase the stock from the key managers. On an annual basis X Corp. would make tax deductible contributions to the ESOP which would be used to repay the loan with interest. While the sale of stock to an ESOP would reduce the ownership interest of the key managers, the reduction would be mitigated to the extent that the managers were also ESOP participants. The Internal Revenue Service will issue an advance ruling that a proposed sale to an ESOP will qualify for capital gains treatment if: (1) the beneficial interest of the selling shareholders in the ESOP does not exceed twenty percent; (2) the stock is no more restricted than other employer stock; and (3) the employer does not intend to redeem stock from the plan.<sup>79</sup>

Participants not only may receive capital gains treatment on a sales to an ESOP, but also may reinvest the proceeds in a timely and appropriate fashion, so as to postpone recognition of any gain on the sale.<sup>80</sup> Therefore a seller may postpone recognition of gain on a sale to the ESOP while recognizing any loss on a similar sale where the proceeds are not reinvested.<sup>81</sup>

## II. THE SUPPOSED BENEFITS OF ESOPs

Ironically, the most vocal proponents of ESOPs have based their support for the regulatory incentives encouraging ESOPs

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<sup>75</sup> See *id.* § 301.

<sup>76</sup> See *id.* § 302(c)(2)(C).

<sup>77</sup> See *id.* § 304.

<sup>78</sup> The ESOP will be considered the alter ego of the employer for purposes of evaluating the tax consequences of a redemption unless three conditions are met. See *supra* note 29.

<sup>79</sup> Rev. Proc. 77-30, 1977-2. C.B. 539-40.

<sup>80</sup> The "rollover" provision is outlined at *supra* note 55.

<sup>81</sup> I.R.C. § 1042 (West Supp. 1985).

on a commitment to a private property, free enterprise philosophy.<sup>82</sup> The notion seems to be that employee stock ownership is a good idea because it will transform workers into budding capitalists, thereby improving productivity and broadening the capital base.

The proponents of ESOP legislation extol its virtues in a manner similar to those who peddle Ponzi schemes. Everyone wins and no one loses. Employees supposedly benefit because they are able to share in the financial success of the firm. Other shareholders are supposed to benefit because the firm as a whole is more valuable due to increased worker productivity. Society is allegedly better off because current inequalities in the distribution of wealth are ameliorated and the level of savings and investment increases.<sup>83</sup>

If ESOPs are such an efficient method of employee compensation, one wonders why firms need such strong tax incentives to establish them. If ESOPs are truly "wealth creating" and efficient in the sense that they make workers better off without making anyone else worse off, there would be no need for regulatory coaxing to induce firms to implement them. If these plans provided benefits resembling those envisioned by their proponents, marginal firms that did not develop ESOPs probably could not survive in a competitive environment in which rival firms offered such plans. Yet the market system did not develop ESOPs voluntarily. These plans came into existence solely as a result of regulatory prodding.<sup>84</sup> This alone raises an initial question about the efficiency claims made by ESOP proponents.

This Part examines more closely the claimed virtues of ESOPs and suggests that the supposed benefits are illusory. Where

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<sup>82</sup> See, e.g., R. FRISCH, ESOP FOR THE '80s 10 (1982) ("ESOPs are already creating millions of new capitalists without taking anything from those who now own capital. As ESOPs proliferate, they may become the major hope for preserving our capitalistic system and perhaps ultimately, our democratic way of life"); Johnson, *Employee Stock Ownership*, RIFON Q., Summer 1975, at 34 ("[s]hall we revitalize the private enterprise system with employee stock ownership and real social security that owners of private capital can provide?"); 129 CONG. REC. S16,629-30 (daily ed. Nov. 17, 1983) (statement of Sen. Long) ("[i]f we want this private property system of ours to succeed, we simply must insure that as many Americans as possible have an opportunity to earn an ownership stake in that system").

<sup>83</sup> See, e.g., Sheppard, *supra* note 9, at 1270-71; see also R. FRISCH, *supra* note 82, at 8-10 for an optimistic view of ESOPs as the first step in a comprehensive plan to broaden the ownership of capital and thereby cure a litany of perceived economic woes, including inflation, low productivity, employee disgruntlement, foreign competition, high interest rates, disregard of the arts, and unionization.

<sup>84</sup> See *supra* note 21 and accompanying text.

ESOPs do provide workers with true benefits, they are purchased by all taxpayers through foregone revenue, and thus do not provide the kind of income redistribution that is generally claimed. Moreover, the tax incentives cause distortions in the economy that may lead to inefficient behavior.

#### A. *ESOPs Lead to Increased Savings and Investment*

Some supporters praise ESOPs because they lead to increased savings and investment.<sup>85</sup> While it is true that ESOP legislation will increase savings tendencies among participants, it does so only in a manner that creates a number of undesirable tax-induced distortions in the behavior of firms.

To see how ESOP legislation fosters increased saving, consider the behavior of a worker ("W") in the absence of taxes. Suppose W, who has earned \$100, is indifferent towards consuming now or at the end of time period one when his \$100 will have earned a ten percent rate of return, or ten dollars. An income tax may distort W's marginal decision in favor of immediate consumption.<sup>86</sup> If W is subject to a fifty percent tax rate, it will take \$200 to cover W's consumption needs, but \$200 is insufficient to produce \$110 at the end of time period one, because a tax is imposed on both the earning of the \$200 and the periodic payments accruing to the \$100 saved or invested. This payment of \$200 to W will allow him to have only \$105 at the end of time period one. If he was indifferent before taxes, W will now choose immediate consumption. Multiplying this distortion by millions of taxpayers leads to less savings than is optimal.

If W receives his compensation in the form of a contribution to an ESOP of \$200 worth of employer securities, W will owe no taxes now, but will be fully taxed upon withdrawal at the end of time period one. At a ten percent rate of growth and a fifty percent tax rate, W will be taxed on \$220 and will end up with \$110 for consumption purposes. Therefore, W will remain indifferent between consumption now or consumption later. The taxation of contributions to ESOPs is perfectly consonant with

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<sup>85</sup> See *supra* text accompanying notes 4-6.

<sup>86</sup> This static equilibrium model assumes that the imposition of a tax does not affect interest rates. Changes in interest rates due to taxes can affect the amount of distortion.

the basic principle of a consumption tax—to eliminate distortions discouraging savings and investment.<sup>87</sup>

To the extent that the treatment of ESOPs moves the tax system towards a consumption tax, it is likely to encourage savings and investment. Indeed the Internal Revenue Code now contains a welter of provisions that depart from strict income tax principles. The deferred compensation provisions,<sup>88</sup> the provision authorizing Individual Retirement Accounts,<sup>89</sup> and the accelerated depreciation provisions<sup>90</sup> all head the current system towards a consumption tax. The problem with this piecemeal march towards a consumption tax is that, while the legislation may redress some distortions, it creates others.<sup>91</sup>

Because ESOP legislation provides tax incentives when compared with cash compensation and other pension plans, on the margin we will observe firms setting up ESOPs where, in the absence of tax incentives, compensation would not have been paid with the employer's stock. In light of the Congressional mandate for a variety of restrictions and rules before an ESOP can qualify for preferential tax treatment, firms may alter their behavior in order to comply.

ESOP provisions are only available to certain corporations.<sup>92</sup> Businesses operated as partnerships or sole proprietorships cannot avail themselves of the tax subsidized loan privileges available to an ESOP or the rollover privilege available to shareholders on the sale of the employer's stock to an ESOP.<sup>93</sup> Marginal firms that favored a noncorporate form of operation before ESOP legislation may now favor incorporation even though the corporate form may result in some deadweight loss

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<sup>87</sup> See, e.g., I.R.C. § 401 (1982); see also *supra* note 21.

<sup>88</sup> See, e.g., I.R.C. § 219 (1982).

<sup>89</sup> See, e.g., *id.* § 168.

<sup>90</sup> See, e.g., *id.* § 167.

<sup>91</sup> Commentators looking at our tax system inevitably find themselves confronting the theory of "second best." Crudely summarized, the theory holds that since our tax system is full of provisions that promote inefficiencies, it is impossible to prove that a particular tax change that would be more efficient in a vacuum will lead to greater efficiency in our actual crazy-quilted system. See Lipsey & Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11, 12 (1956).

<sup>92</sup> Because an ESOP by definition must invest in employer stock, only corporations may establish ESOPs. See I.R.C. § 4975(e)(7) (1982). Even some corporations may be precluded from creating an ESOP. For example, a subchapter S corporation will lose its status if invested in by a trust. *Id.* § 1361(b)(1)(B). Professional corporations in most states will be denied the ESOP route because of state laws prohibiting investment in the corporation by nonprofessionals. See Kaplan & Ludwig, *supra* note 1, at A-10 to A-11.

<sup>93</sup> I.R.C. § 4875(e)(2) (West Supp. 1985).

to society.<sup>94</sup> If this was the worst distortion caused by ESOP legislation, the benefits of shifting towards a consumption tax might outweigh any disadvantages. ESOP funding limitations, however, cause more fundamental distortions.

The ceiling on contributions to an ESOP is measured by employee compensation levels. An employer may deduct a maximum of twenty-five percent of an employee's annual compensation.<sup>95</sup> If the amount allocated to the account of a participant exceeds the lesser of twenty-five percent annual compensation or \$30,000, the plan will be disqualified and will not be eligible for favored tax treatment.<sup>96</sup> Consider two firms, X Corp. and Y Corp., each producing the same product, and facing identical costs and prices in the market. They are identical in size and in every other respect except that X Corp.'s production is labor intensive while Y Corp. is capital-intensive.<sup>97</sup> The tax advantages associated with ESOPs, including the ability to borrow at tax subsidized interest rates, will give the labor-intensive X Corp. a decided advantage in the market.<sup>98</sup>

The distortion of ESOP legislation in favor of labor-intensive firms results in the inefficient allocation of investments throughout the economy. To the extent that larger firms achieve efficiencies by using capital to reduce labor costs, ESOP legislation subsidizes smaller, less efficient firms, thus causing overproduction by labor-intensive firms and underproduction by capital-intensive firms.<sup>99</sup>

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<sup>94</sup> See generally P. SAMUELSON, *ECONOMICS* 757-58 (1980). Deadweight loss is the lost output created by not operating at laissez faire optimality due to taxation or some other redistributive scheme.

<sup>95</sup> See *supra* note 50.

<sup>96</sup> I.R.C. § 415(c)(1) (1982). See *supra* note 47 and accompanying text.

<sup>97</sup> To make the comparison complete, we should assume that Y Corp. uses capital that has a one-year useful life and is therefore fully deductible in the same way as compensation or that depreciation deductions accurately measure the decrease in value of an asset with a life in excess of one year. *But see* Lipsey & Lancaster, *supra* note 91, at 12 (discussing the problem of second best).

<sup>98</sup> Again there may be a problem of second best if current tax rules through accelerated depreciation favor capital over labor. See *id.*

<sup>99</sup> Congress was not totally oblivious to the distortions created by ESOP legislation in favor of labor over capital. As part of the Tax Reduction Act of 1975, Congress authorized an additional one percent investment tax credit if the company used its tax savings to fund a specially defined type of ESOP known as a Tax Reduction Act Stock Ownership Plan or TRASOP. See Tax Reduction Act of 1975, Pub. L. No. 94-12, § 301, 89 Stat. 26, 36-45. Congress destroyed TRASOPs in 1981. See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 331, 95 Stat. 172, 289-96. Strong lobbying from labor interests convinced Congress that TRASOPs wrongly favored capital intensive companies. TRASOPs were replaced with PAYSOPs which offer a tax credit based on the percentage of participants' compensation contributed to the plan. *Id.*

Congress's abdication of equal treatment for capital intensive firms may be temporary

There is not much systematic, empirical evidence available on ESOPs.<sup>100</sup> Furthermore, the dramatic tax advantages created by the Deficit Reduction Act of 1984<sup>101</sup> may significantly alter the composition of firms availing themselves of ESOPs. What evidence is available confirms our expectations. Based on 1977 tax returns, over two-thirds of the ESOPs in existence were in the trade/service and manufacturing sectors.<sup>102</sup> The evidence suggests that the companies adopting ESOPs were small, labor-intensive operations. Over eighty-three percent of the ESOPs in 1977 had fewer than 250 employees, and over ninety percent had fewer than 500 employees.<sup>103</sup> By comparison, of the 301 TRASOPs in existence in 1977, all had more than one hundred participants and over sixty percent had one thousand or more participants.<sup>104</sup> In contrast to ESOPs, over forty percent of the TRASOPs were in the transportation/utilities industries with an additional thirty-four percent in manufacturing.<sup>105</sup> These capital-intensive industries benefited from TRASOP legislation, which determined tax benefits on the basis of investment rather than payroll.<sup>106</sup>

Similar conclusions can be drawn from a 1983 study of ESOPs conducted by an ESOP trade association.<sup>107</sup> The median number of ESOP participants per firm responding to one survey was 182.<sup>108</sup> Eighty-four percent of the firms responding were closely held.<sup>109</sup> Light manufacturing firms constituted the largest single

if Senator Long has his way. "It is my hope that at some future date the Congress will reexamine the investment tax credit area in light of our experience with ESOPs." 129 CONG. REC. S16,629-38 (daily ed. Nov. 17, 1983) (statement of Sen. Long).

<sup>100</sup> Hoerr, *supra* note 3, at 94, 102-10.

<sup>101</sup> See Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494. See *supra* notes 7, 9.

<sup>102</sup> The empirical information that follows is taken from D. PECKMAN, *supra* note 11, at 11-17. The statistics that follow are based on those plans with more than 100 participants.

<sup>103</sup> *Id.* at 17. These figures reflect the 600 ESOPs with more than 100 participants, and also the 1142 ESOPs with fewer than 100 participants. Interestingly, over 81% of ESOP plans with more than 100 participants actually had over 2500 participants. This is because a few very large corporations have adopted ESOPs. *Id.* at 18.

<sup>104</sup> *Id.* at 16-17. Ninety percent of all TRASOP participants were in plans with more than 2500 participants. *Id.* at 17.

<sup>105</sup> *Id.* It is likely that TRASOPs were used by heavy manufacturers in view of the larger number of participants per TRASOP as compared with ESOPs. *Id.*

<sup>106</sup> See I.R.C. § 48(n) (1982), *repealed by* Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (for taxable years beginning after Dec. 31, 1983). See *supra* note 99.

<sup>107</sup> ESOP SURVEY 1983, *supra* note 19.

<sup>108</sup> *Id.* at 8.

<sup>109</sup> *Id.* at 11.



line of business for firms with ESOPs.<sup>110</sup> Moreover, the highest percentages of employee ownership were present in light manufacturing and construction, typically labor-intensive activities.<sup>111</sup> Heavy manufacturers with ESOPs tended to have smaller proportions of employee ownership,<sup>112</sup> perhaps reflecting their capital intensive nature.

### B. *ESOPs Enhance Employee Productivity*

It is clear that employee productivity significantly influences a firm's profitability.<sup>113</sup> If worker productivity in a particular firm goes up, then, all else being equal, the value of that firm will rise relative to the value of other firms. Seen in this way, the issue of whether ESOPs increase worker motivation and productivity is essentially an empirical question.<sup>114</sup>

The theoretical justification for the notion that ESOPs increase employee productivity is straightforward—stockholders want the value of the firms in which they own stock to go up. As stockholders, employees of firms with ESOPs in theory will work harder so the value of their investment will increase.<sup>115</sup>

A number of empirical studies have attempted to measure the effects of ESOPs on employee productivity.<sup>116</sup> While ESOP pro-

<sup>110</sup> Light manufacturing businesses comprised 28% of the 229 respondents. *Id.* at 7.

<sup>111</sup> *Id.* at 6. The survey measured only ownership by the ESOP. The findings do not reflect ownership by employees investing in the firm on their own. *Id.*

<sup>112</sup> *Id.*

<sup>113</sup> See Hennessee, *Employee Stock Ownership Plans and the Publicly Held Corporation*, 27 OIL & GAS TAX Q. 167, 184 (1978).

<sup>114</sup> It is well established that the best way to measure the effects of a particular event on a firm is to compare the firm's stock performance before and after the particular event. See, e.g., R. BREALEY & J. MEYERS, *PRINCIPLES OF CORPORATE FINANCE* 266–81 (1984). If ESOPs increase worker motivation and productivity, then the implementation of ESOPs should have a positive effect on the share prices of firms implementing such plans, all else equal. Empirical studies of the stock prices of firms that have adopted ESOPs are likely to be unreliable, however, because any increase in share value may be attributable to the tax advantages given to such plans rather than to the effect on worker productivity. As a result, the empirical studies on the effects of ESOPs on worker productivity have by necessity used empirical standards inferior to stock performance. In these studies, the effect of ESOPs on such factors as the firms' earnings, cash flow and book value have been examined. But because of differences in accounting techniques among firms, studies based on such accounting data are inherently unreliable.

<sup>115</sup> See 129 CONG. REC. S16,629, S16,630–31 (daily ed. Nov. 17, 1983) (statement of Sen. Long) (describing the purported gains in productivity and work force morale that allegedly flow from the implementation of ESOPs).

<sup>116</sup> See, e.g., COMPTROLLER GENERAL OF THE U. S., *REPORT TO THE SENATE COMM. ON FINANCE: EMPLOYEE STOCK OWNERSHIP PLANS: WHO BENEFITS MOST IN CLOSELY HELD COMPANIES?* (1980) [hereinafter cited as COMPTROLLER GENERAL OF THE U. S.];

ponents have pointed to some of this research as providing compelling evidence that ESOPs are a proven success at raising worker morale, motivation, and output,<sup>117</sup> a more balanced view recognizes that "there has been no conclusive evidence . . . indicating that ESOPs serve as powerful employee motivators or effective productivity enhancers."<sup>118</sup> In evaluating the empirical work in this area, it is important to note both the tentative nature of the research<sup>119</sup> as well as the directly opposing con-

SURVEY RESEARCH CENTER, INSTITUTE FOR SOCIAL RESEARCH, UNIVERSITY OF MICHIGAN, *EMPLOYEE OWNERSHIP: A REPORT TO THE ECONOMIC DEVELOPMENT ADMINISTRATION (1978)*, reprinted in *The Small Business Employee Ownership Act: Hearings on S. 388 Before the Senate Select Comm. on Small Business*, 96th Cong., 1st Sess. 152, 218 (1979) [hereinafter cited as SURVEY RESEARCH CENTER]; THE U. S. RAILWAY ASS'N, *AN EVALUATION OF THE EMPLOYEE STOCK OWNERSHIP PLAN AS APPLIED TO CONRAIL (1975)*, reprinted in *Hearings*, *supra* note 15, at 653, 712; Conte & Tannenbaum, *Employee Owned Companies: Is the Difference Measurable?*, M. L. R., July 1978, at 23, 27; Livingston & Henry, *The Effect of Employee Stock Ownership Plans on Corporate Profits*, 47 J. RISK & INS. 491, 501 (1980); Marsh & McAllister, *ESOPs Tables: A Survey of Companies with Employee Stock Ownership Plans*, 6 J. CORP. L. 551, 620 (1981); Swad, *Some Empirical Evidence on the Impact of ESOPs on Company Operating Performance*, 29 OIL & GAS TAX Q. 751, 757 (1981).

<sup>117</sup> See, for example, Sen. Long's glowing account of productivity gains in companies that have adopted ESOPs: "On the basis of the research to date, it is clear that companies with employee ownership are likely to be more productive and more profitable than those without, and the more ownership held by employees, the better the performance of the company." 129 CONG. REC. S16,629, S16,631 (daily ed. Nov. 17, 1983) (statement of Sen. Long).

<sup>118</sup> D. PECKMAN, *supra* note 11, at 43.

<sup>119</sup> Thus one study seemed to make a highly favorable assessment of a particular ESOP, only to conclude that:

[i]t is not possible in this preliminary analysis, however, to provide a definitive explanation of this [company's] recovery or to attach specific weight to the ownership plan itself. Some of the data do indicate that the plan is having positive effects, both direct and indirect. Yet the company has operated during earlier periods (prior to 1969) at levels of profitability as high if not higher than current levels. Furthermore, we cannot say on the basis of this limited analysis that the company is performing better (or worse) than other traditionally owned companies in its industry.

SURVEY RESEARCH CENTER, *supra* note 116, at 218-19. Regarding its "finding" that ESOPs are associated with higher productivity, this study noted that: "[t]he firms for which we have measures of profit may be select and our analyses are based on correlations that illustrate associations among variables; they do not prove causation." *Id.* at 218-19. This study has, nonetheless, been cited as providing firm empirical support for the ESOP cause. See 129 CONG. REC. S16,629, S16,631 (daily ed. Nov. 17, 1983) (statement of Sen. Long).

Research data for several purportedly supportive studies was compiled by mailed questionnaires. Conte & Tannenbaum, *supra* note 116, at 27; Marsh & McAllister, *supra* note 116, at 588; Swad, *supra* note 116, at 753. Firms of course were free to respond or not as they chose. This raises the possibility of a 'nonresponse bias' if the respondents are not representative of the group as a whole. See Swad, *supra* note 116, at 756. It stands to reason that those firms which were more hopeful and enthusiastic about achieving productivity gains through an ESOP would be more likely to respond to such a survey, since, in all probability, only those firms would have attempted to monitor any resulting fluctuations in worker output. Furthermore, "as of the end of 1980, no complete listing (governmental or otherwise) of all companies that have adopted an

clusions arrived at by different studies.<sup>120</sup> To the extent that validity *can* be granted to their findings, several studies show a wide variation in the suitability of ESOPs for different industries.<sup>121</sup> This makes the wisdom of using tax incentives to encourage all firms to set up ESOPs—regardless of their line of business—seem dubious at best.

Although ESOPs might appear to raise productivity in certain firms or industries according to some studies, this does not establish that ESOPs are a more efficient method of motivating employees than other worker incentive plans. On the face of it, the argument that an ESOP will necessarily enhance worker productivity is flawed. In firms with ESOPs, the benefit to be derived from an employee's increased productivity does not flow directly to the employee. Any marginal increase in the value of the firm's stock must be shared equally by all of the firm's shareholders. Furthermore, the allocation of stock contributed to an ESOP is not adequately linked to the specific effort of an employee. In a typical ESOP, this allocation is based on employee compensation—a factor that does not accurately reflect individual productivity. In such a plan, stock is allocated to employees *ex ante* on the basis of their base salary, and not on the basis of their relative contribution to the firm *ex post*. As such, any incentive effect of the ESOP is minimized. By working harder, an individual employee:

will get only a minute share of the gain from this action. The very fact that the objective or interest is common to or

ESOP had been compiled. Without such a listing it is nearly impossible to identify an unbiased survey sample." Marsh & McAllister, *supra* note 116, at 588.

<sup>120</sup> A study conducted by the Institute for Social Research at the University of Michigan found that companies with ESOPs were more profitable than those without. SURVEY RESEARCH CENTER, *supra* note 116, at 156-57. However, this finding has been flatly contradicted by more recent research. A survey of 102 firms found that ESOP companies were less profitable than non-ESOP companies. See Livingston & Henry, *supra* note 116, at 501 - 02. Compare Marsh & McAllister, *supra* note 116, at 619 (increase in productivity) with COMPTROLLER GENERAL OF THE U.S., *supra* note 116, at 37 (no meaningful evidence of increased productivity). Moreover, a company might show higher profits after adopting an ESOP because of the tax advantages associated with the plan rather than as a consequence of enhanced worker productivity.

<sup>121</sup> Thus, one study noted that both utilities as well as companies and firms engaged in wholesale trade that had adopted ESOPs showed substantially higher increases in productivity than did those firms in the same line of business that had not done so. However, firms with ESOPs in the services, mining and construction industries showed substantially greater *decreases* in productivity than did their counterparts without ESOPs. Marsh & McAllister, *supra* note 116, at 615. Another study concluded that "the statistics (on company operating performance) are encouraging for manufacturers and processors. They offer no encouragement for other types of firms." Swad, *supra* note 116, at 757.

shared by the group entails that the gain from any sacrifice an individual makes to serve this common purpose is shared with everyone in the group. . . . [T]he individual in any large group with a common interest will reap only a minute share of the gains from whatever sacrifices the individual makes to achieve this common interest.<sup>122</sup>

This phenomenon is known to economists as the free rider problem.<sup>123</sup> Because any gain from an individual employee's increased efforts goes to everyone in the group, those who do not work any harder after an ESOP is imposed will benefit from any productivity increases just as much as those who do change their work habits. If ESOP contributions could be structured so as to favor particularly productive employees, these free rider problems would be eliminated. Unfortunately, the anti-discrimination philosophy that pervades the pension and profit-sharing area prevent this. Eligibility must be broad,<sup>124</sup> and allocations of employer contributions to plan participants must be on the basis of a pre-determined formula.<sup>125</sup>

Employers who wish to increase productivity by providing individualized incentives for productive workers must use a compensation device other than an ESOP, because attempting to reward particularly productive workers through an ESOP will jeopardize the plan's tax favored status.<sup>126</sup> Thus, firms that adopt ESOPs may not do so to promote productivity, but rather to capture the tax benefits.<sup>127</sup> If ESOPs are to have the effect on

<sup>122</sup> M. OLSON, *THE RISE AND DECLINE OF NATIONS* 18 (1982).

<sup>123</sup> For a discussion of the free rider problem, see R. POSNER, *ECONOMIC ANALYSIS OF LAW* 351 (2d ed. 1977).

<sup>124</sup> ESOPs must generally cover a minimum of 70% of all employees. See I.R.C. § 410(b)(1)(A) (1982). An ESOP must be a defined contribution plan that is a qualified stock bonus plan or a combination of a stock bonus plan and a money purchase plan. See *id.* § 4975(e)(7). A qualified stock bonus plan must contain a "definite pre-determined formula for allocating the contributions made to the plan among the participants." *Id.* Contributions are also fixed under a money purchase plan. See Treas. Reg. 1.401-1(b)(1)(i) to (iii) (1982).

<sup>125</sup> See *infra* note 133.

<sup>126</sup> See *supra* text accompanying notes 31-32.

<sup>127</sup> On this point, as on so many others, the empirical literature is uncertain. See, e.g., *supra* note 119. The Institute for Social Research at the University of Michigan found that employers who had implemented ESOPs were heavily influenced in this decision by their expectation that ownership would provide "an incentive for employees to work harder," or at least more conscientiously. This factor appeared to weigh more heavily than any other in the deliberations over whether to adopt an ESOP. SURVEY RESEARCH CENTER, *supra* note 116, at 170-71. Ninety-four percent of the responding companies in another survey believed that improving the productivity of employees was either a "very important" or "somewhat important" motivation for adopting an ESOP. Marsh and McAllister, *supra* note 116, at 602.

Other studies, however, have concluded that management is notably unimpressed

productivity that their proponents hope for, the anti-discrimination requirements must be deleted.

The free rider problem associated with the imposition of ESOPs may induce certain employees to work even less than before in the hope that other (greedier) employees will work harder and keep the overall wage level the same. An important implication of this is that the free rider problem becomes more acute in larger firms than in smaller firms.<sup>128</sup> As a firm becomes larger, the effects of increased efforts on the part of an individual employee become smaller. As such, all else being equal, we would expect larger firms to be less likely to develop ESOPs and instead to search for alternative schemes for compensating employees.<sup>129</sup> Empirical observation does not refute the free rider argument; not only does the incidence of ESOPs decline as firm size increases, but the extent of employee coverage "tends to decrease as company size increases."<sup>130</sup>

with the motivational potential of ESOPs. Only six percent of the respondents in one survey "felt that ESOPs were 'very important' in increasing productivity," while 59% either felt that ESOPs were "not too important" or of no consequence whatsoever in this regard. WILLIAM M. MERCER, INC., EMPLOYER ATTITUDES TOWARD COMPENSATION AND EMPLOYEE PRODUCTIVITY 12-17 (1980). Another study concluded that "most employers were not primarily concerned with ESOPs as a tool for enhancing employee morale or increasing productivity," noting that "[e]mployers had not attempted to determine what impact the ESOP was having on employees and could not provide any measure of increased productivity resulting from the plans." COMPTROLLER GENERAL OF THE U.S., *supra* note 116, at 39, 42.

<sup>128</sup> While the free rider problem limits the effectiveness of ESOPs as a means of raising worker productivity within large companies, various other features of these plans make ESOPs unsuitable for a broad range of other firms as well. For example, in 1975 the U.S. Railway Association commissioned a report to determine whether an ESOP should be formed for the employees of the Consolidated Rail Corporation (Conrail). That study recommended against the adoption of a plan, noting that a sizable proportion of Conrail's employees were over the age of 50. The report cited motivational research demonstrating "that older employees tend to be more interested in retirement income than in capital accumulation," and concluded that "the ideal situation for implementation of an ESOP is one in which [among other factors] . . . [t]he employee group is either heavily weighted with younger employees or only lightly weighted with older employees." U.S. RAILWAY ASS'N, *supra* note 116, at 692, 697.

<sup>129</sup> See Hennessee, *supra* note 113, at 168.

To date, the majority of the firms that have adopted ESOPs are smaller, closely held firms. If ESOPs are going to have any effect on the economy and the nation, large publicly held corporations will have to adopt them. This is where the majority of the nation's wealth is held. Therefore, if ESOPs are to make a significant contribution to the economy's capital needs, they will have to be attractive to large publicly held corporations.

*Id.*

<sup>130</sup> Marsh & McAllister, *supra* note 116, at 591-92. Only 15% of the private companies in this survey employed more than 500 workers, although private companies accounted for 81% of the firms in the total sample. *Id.* at 589-92. See also *supra* text accompanying notes 103 and 108.

Shareholders have strong incentives to increase the productivity of the employees in the firms they control.<sup>131</sup> Shareholders will be expected to invest in greater productivity until the cost of such investment is equal to the benefit to be derived from the increased output. Without the aid of tax incentives, the market has developed numerous methods of inducing workers to increase productivity.<sup>132</sup> Those compensation methods that tailor compensation to individual productivity are more successful than those that do not. To the extent that the tax system favors ESOPs as opposed to these other methods, particularly those that really do reward productivity, economic distortions are created.

There are significant efficiency costs to a regulatory system that exalts one particular market solution over others. The market mechanism itself is a discovery process.<sup>133</sup> Even if the proponents of ESOPs are correct that employees need a stronger sense of association with the firms where they work, the intervention of the state serves as an imperfect substitute for the

<sup>131</sup> See, e.g., A. SZILAGYI & M. WALLACE, READINGS IN ORGANIZATIONAL BEHAVIOR AND PERFORMANCE (3d. ed. 1983); M. BEER, B. SPECTOR, P. LAWRENCE, D. MILLS & R. WALTON, MANAGING HUMAN ASSETS (1984) [hereinafter cited as BEER & SPECTOR].

<sup>132</sup> For instance, executive compensation plans designed to encourage managers to maximize their firms value are both "wide-spread and becoming more popular. In 1970, 65% of medium-size and larger U.S. manufacturing companies had annual bonus plans, while in 1980, 90% of these firms had such plans." Smith & Watts, *Incentive and Tax Effects of Executive Compensation Plans*, AUSTL. J. OF MGMT., Dec. 1982, 139, at 140. The many management incentive plans in place in American industry today include: bonus plans, stock options, stock appreciation rights, restricted stock plans, phantom stock plans, dividend units, etc. *Id.* at 140-43. For other workers there are a panoply of merit salary increases, piece rate incentive systems, individual bonus plans, sales commission schedules and profit sharing plans. BEER & SPECTOR, *supra* note 131, at 139-46. The considerable amount of experimentation and diversity in this area plainly belies the impression many ESOP proponents give that firms must be bludgeoned into adopting programs that are designed to increase employee productivity. See, e.g., Marsh & McAllister, *supra* note 116, at 554. "[T]housands of additional companies must be coaxed into either adopting an ESOP or expanding an existing one" if the "ambitious goals" of ESOP proponents for "improving the American economic system" are to be met. *Id.*

<sup>133</sup> Perhaps the best known exposition of this view is to be found in the works of Friedrich A. Hayek. See F.A. HAYEK, INDIVIDUALISM AND THE ECONOMIC ORDER (1948); THE CONSTITUTION OF LIBERTY (1960); 1 RULES AND ORDER (LAW LEGISLATION AND LIBERTY) (1973); See also I. Kirzner, *Entrepreneurship, Choice and Freedom*, in PERCEPTION, OPPORTUNITY, AND PROFIT: STUDIES IN THE THEORY OF ENTREPRENEURSHIP 225, at 238 (1979).

The market process allows for a much greater use of information, as individual producers, consumers, suppliers, and financiers, etc., are left free to act on the knowledge that is available to them, adapting to changing circumstances as they judge best. Thus, new product lines will be introduced, new financing arrangements will be devised and more effective employee incentive plans will be implemented as the need arises.

spontaneous market process of discovery. The market process is likely to produce the best method for compensating workers. The preferential tax treatment afforded to ESOPs "may generate new (unintended and undesired) processes of market adjustments that produce a final outcome even less preferred than might have emerged in the free market."<sup>134</sup> This distortion of the normal process by which alternative incentive systems are developed will penalize the more innovative firms that might develop new, as yet unthought of, incentive systems. It will also harm those larger firms for which ESOPs are less attractive than alternative systems. These larger firms benefit less from the favorable treatment given ESOPs than do smaller firms. These smaller firms in turn may have adopted ESOPs of their own volition, without the need for tax incentives. Some larger firms, even in the face of tax advantages, might prefer bonus plans or other methods of incentive compensation. To give ESOPs favorable treatment is to give a regulatory preference to those firms that have a comparative advantage in offering ESOPs.

Presumably even those who believe that the market systematically undercompensates workers would prefer that the most efficient alternatives available be used to correct this market failure. But ESOPs are a particularly inefficient method of correcting undercompensation.

### C. *Employees Want Stock Ownership in Their Employers*

Underlying ESOP legislation is an unspoken assumption that employees want to hold their employer's stock as part of their portfolios. However, absent distortions created by the tax system, employees would not be likely to invest a substantial portion of their earnings in the firm for which they work. This stems from the fact that "investors, though seeking high expected returns, generally wish to avoid risk."<sup>135</sup> The evidence of investor risk aversion is "overwhelming."<sup>136</sup> Assuming that employees, when acting as investors, will not prefer taking risks to any

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<sup>134</sup> I. Kirzner, *The Perils of Regulation: A Market Process Approach* 13 (Law and Economics Center, University of Miami School of Law, Occasional Paper, 1978).

<sup>135</sup> J. LORIE & M. HAMILTON, *THE STOCK MARKET: THEORIES AND EVIDENCE* 171 (1973).

<sup>136</sup> *Id.* For example, it is commonplace that investors receive a lower rate of return on bonds than they do on common stock that they might own in the same company. R. POSNER, *supra* note 123, at 320.

greater extent than other investors, portfolio theory strongly suggests that rational investors will prefer diversified portfolios of securities to portfolios that are not diversified.<sup>137</sup> This fact is so well established that as a general rule, pension fiduciaries *are required* to diversify the holdings they control.<sup>138</sup> However, not only are ESOPs exempt from the fiduciary duty to diversify, ESOP trustees are *forbidden* to diversify.<sup>139</sup> ESOPs must "invest primarily in qualifying employer securities" in order to qualify for tax favored status.<sup>140</sup>

Portfolio theory<sup>141</sup> can be easily summarized.<sup>142</sup> The two salient features of any investment portfolio are its expected return and its riskiness.<sup>143</sup> If all else is equal, investors will maximize return for a given level of risk and minimize risk for a given level of return.<sup>144</sup> The implication of Markowitz's work is that it is possible to construct efficient portfolios based on three factors: (1) the expected return of every security; (2) the variance (or standard deviation) of each return from the mean return of all investments; and (3) the relationship between the return for each individual security and the return for all securities.<sup>145</sup>

Building on Markowitz's work, later financial economists recognized the importance of distinguishing between the two types of risk that are associated with stock ownership.<sup>146</sup> Non-systematic or firm-specific risk refers to risk associated with a particular firm.<sup>147</sup> The prospect that a firm's product will become obsolete, or that its managers will steal from the corporate coffers are examples of firm-specific risk. Systematic, or non-firm-specific risk refers to risk associated with the market generally.<sup>148</sup> Con-

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<sup>137</sup> See Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952).

<sup>138</sup> ERISA, *supra* note 21, at § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C).

<sup>139</sup> See *supra* notes 26-28 and accompanying text.

<sup>140</sup> I.R.C. § 4975(e)(7)(A) (1982). See *supra* notes 26-28 and accompanying text.

<sup>141</sup> See *supra* note 137. Portfolio theory has its origins in this celebrated article.

<sup>142</sup> For an overview of portfolio theory, see generally R. BREALEY, AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS 101-09 (2d ed. 1983); R. BREALEY & S. MEYERS, *supra* note 114, at 117-56; H. LEVY & M. SARNATT, PORTFOLIO AND INVESTMENT SELECTION: THEORY AND PRACTICE (1984); J. LORIE & M. HAMILTON, *supra* note 135, at 171-266; MANAGING INVESTMENT PORTFOLIOS: A DYNAMIC PROCESS (J. Maginn & D. Tuttle eds. 1983) [hereinafter cited as MANAGING INVESTMENT PORTFOLIOS]; R. POSNER, *supra* note 123, at 315-26.

<sup>143</sup> J. LORIE & M. HAMILTON, *supra* note 135, at 172.

<sup>144</sup> *Id.* at 173.

<sup>145</sup> *Id.* at 172.

<sup>146</sup> For a discussion of the concepts of systematic and non-systematic risk, see Modigliani & Pogue, *An Introduction to Risk and Return*, 30 FIN. ANALYSTS J. 68 (1974).

<sup>147</sup> *Id.* at 76.

<sup>148</sup> *Id.*



tractions in the money supply and uncontrolled government spending are examples of market risk. Non-systematic risk can be eliminated by diversification.<sup>149</sup> Empirical studies on the relationship between diversification and risk further suggest that rational investors will diversify; for example, a ten stock portfolio will reduce investor risk by eighty-seven percent as compared to a one stock portfolio.<sup>150</sup>

There is no meaningful justification for the requirement that ESOPs invest primarily in employer securities. One possible explanation for the existence of the requirement is that those who crafted ESOP legislation wanted to increase employee motivation by giving employees an ownership stake in the future of their firm.<sup>151</sup> Given the free rider problems associated with such motivational schemes, however, this explanation is unsatisfying.<sup>152</sup> As explained above, if employee stock ownership was such an effective way of improving worker motivation, there would be no need to promote the concept through the tax system.<sup>153</sup>

Another explanation is that the investment requirements are designed to force employers to share ownership with employees.<sup>154</sup> Yet the need for employees to diversify their investments as do other investors is particularly acute because so much of their economic well-being is already tied exclusively to the firm for which they work. Employees are unable to diversify away the risk to their employment that unforeseen developments will threaten the viability of the firm for which they work. All employees, especially executives and managers, "are undiversified risk bearers who invest their services in only one firm at a time."<sup>155</sup> Because of the simple inability of people to work for more than one firm at a time and the tendency of workers to develop industry-specific and often firm-specific skills, corpo-

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<sup>149</sup> See Ambachtsheer & Ambrose, *Basic Financial Concepts: Return and Risk*, in *MANAGING INVESTMENT PORTFOLIOS*, *supra* note 142, at 47. "As more securities are added to the portfolio, total risk falls at a decreasing rate. At the limit, unsystematic risk becomes zero (because of perfect diversification) and the only risk remaining is that associated with the market in general." See also Modigliani & Pogue, *supra* note 146, at 78.

<sup>150</sup> R. BREALEY & S. MEYERS, *supra* note 114, at 112.

<sup>151</sup> See *supra* text accompanying notes 113-15.

<sup>152</sup> See *supra* text accompanying notes 122-25.

<sup>153</sup> See *supra* text accompanying notes 83-90.

<sup>154</sup> See *supra* text accompanying notes 16-19.

<sup>155</sup> Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 *YALE L.J.* 857, 864 (1984).

rate employees are especially inefficient risk bearers.<sup>156</sup> It is far more efficient to place the firm-specific risks associated with stock ownership in the hands of those who are able to minimize such risk through diversification. Thus, there is a compelling need for corporate employees to diversify their investment holdings away from the firm and industry to which their human capital is tied.

All of this is another way of saying that where an ESOP holds an undiversified portfolio of employer stock for the benefit of a firm's employees, that stock is worth less to the employees than the same amount of the stock would be worth in the hands of investors who are able to diversify. It is not surprising, therefore, that substantial tax subsidies are needed to induce workers to accept compensation through an ESOP. Thus a major distortion created by the favored treatment given ESOPs is the shift away from the natural market bias towards diversified portfolios.

#### D. *ESOPs Promote Wealth Redistribution*

ESOPs are expected to transform the United States into a more productive and more egalitarian country. Proponents wish to rectify the current distribution of stock ownership in this country, where less than ten percent of the United States population holds over seventy percent of the market value of individually owned stock.<sup>157</sup> ESOPs are touted as a mechanism for renouncing the "Nation's crippling legacy of concentrated ownership."<sup>158</sup>

However, even putting aside the effects of any production distortions caused by ESOPs, it is not clear in what direction ESOP legislation redistributes wealth. Any wealth transfer generated by ESOP tax benefits is not a direct transfer from shareholders to workers, but rather comes from taxpayers in general and flows to a variety of advantageously situated parties. Since the beneficiaries of ESOPs often may be a firm's more affluent employees, the wealth transfer may be from less wealthy taxpayers to more wealthy employees, thereby leading to a greater concentration of wealth.

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<sup>156</sup> *Id.* at 871.

<sup>157</sup> 129 CONG. REC. S16,630 (daily ed. Nov. 17, 1983) (statement of Sen. Long (D-La.)).

<sup>158</sup> *Id.*

A second, related problem occurs because managerial agents, such as ESOP trustees, are able to use ESOPs for their own ends rather than for the benefit of their principals, the employee-shareholders.<sup>159</sup> Typically, market forces do much to align the interests of principals with the interests of their agents, but the high costs of monitoring and evaluating managerial performance prevent "anything like a total convergence of interest" between agents and principals.<sup>160</sup> This gap between the interests of agents and their principals is known as "agency cost."<sup>161</sup> Top echelon managers inevitably will have their own reasons for establishing ESOPs,<sup>162</sup> which may be unrelated to the interests of either the employees or the shareholders. The implication is that the establishment of an ESOP may not benefit the employees who are the ostensible beneficiaries of the plan.<sup>163</sup> Rather, an ESOP is more likely to benefit both incumbent management, who can use the plans to fend off unfriendly acquirors, and selling shareholders, who can take advantage of rollover provisions to delay

<sup>159</sup> See *infra* notes 160–79 and accompanying text.

<sup>160</sup> Kraakman, *supra* note 155, at 863. Kraakman also states:

[U]nless these managers are also principal shareholders, their interests will not dovetail with those of the shareholders. Managers' interests will instead depend on the corporation's return to their own specialized 'investment' of time, skill and reputation. Thus, managers will manage with an eye to increasing their own expected utility by maximizing future compensation including salary, job tenure, promotion prospects, informal perquisites, and opportunities for consuming leisure and other goods on the job.

*Id.*

<sup>161</sup> Jensen and Meckling define agency cost as "the sum of: (1) the monitoring expenditures by the principal," i.e., the costs involved in "measuring or observing the behavior of the agent," as well as "efforts on the part of the principal to 'control' the behavior of the agent through budget restrictions, compensation policies, operating rules, etc.;" (2) "the bonding expenditures by the agent," those resources expended by the agent "to guarantee that he will not take certain actions which would harm the principal, or to ensure that the principal will be compensated if he does take such actions;" and (3) "the residual loss," the dollar equivalent of the reduction in welfare experienced by the principal due to . . . [the] divergence between the agent's decisions and those decisions which would maximize the welfare of the principal." Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

<sup>162</sup> See Carlson, *ESOP and Universal Capitalism*, 31 TAX L. REV. 289, 294–95 (1976).

<sup>163</sup> One commentator concluded:

It is evident that the employee stock ownership plan as conceived by Kelso is designed primarily for the benefit of the employer-corporation. Its main function is to permit the employer to obtain the use of employee trust funds on highly favorable terms. ESOP proponents also invariably stress the many ways in which an employee stock ownership plan can be exploited to accomplish the business and financial objectives of management and stockholders; benefits for employees, if mentioned at all, are viewed as at best incidental and at worst an annoying necessity.

Carlson, *supra* note 162, at 294–95.

paying capital gains tax.<sup>164</sup> This agency cost problem is magnified because many of those affected by the plan have no say in whether the plan is established.<sup>165</sup> While employees are free to leave firms that shift wage payments from cash to stock ownership through ESOPs, the non-diversifiable, firm-specific human capital investments that employees frequently make impose heavy costs on those employees who wish to leave. These "agency cost" aspects of ESOPs all combine to exacerbate the distortion caused by the tax system and negate the attempt to use ESOPs as a wealth transfer device.

The above concerns are best illustrated by the use of ESOPs in leveraged buyouts, where an investor (often existing management) acquires a controlling interest in a company through the use of borrowed money. The lender generally requires the borrower to pledge as collateral for the loan the assets of the firm whose shares are being acquired.<sup>166</sup> When firm management arranges for the company ESOP (which management may effectively control)<sup>167</sup> to make the acquisition, serious conflicts between the public shareholders and the employees can arise.

The leveraged buyout of the Parsons Corporation by its ESOP illustrates this conflict.<sup>168</sup> The Parsons ESOP borrowed \$518 million to purchase all of the outstanding Parsons stock for \$32.00 per share.<sup>169</sup> Prior to the buyout, the company was publicly held, but insiders owned substantial blocks of stock. The current employees acquired ownership of the firm through the ESOP; however, these employees were not even entitled to vote on the proposed buyout. Such a vote is required only if the ESOP owns a majority of the stock in the company.<sup>170</sup>

At the time of the leveraged buyout, the firm's stock was trading for \$27.50 on the New York Stock Exchange.<sup>171</sup> Mr. William E. Leonard, the firm's chairman, received \$5.6 million for his 175,207 shares. The leveraged buyout resulted in total

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<sup>164</sup> See *infra* notes 185-230 and accompanying text.

<sup>165</sup> Neither ERISA nor any other regulations require shareholder approval for creating an ESOP. See I.R.C. § 422A(b)(1) (1982).

<sup>166</sup> For a description of a typical transaction, see Ronan, *supra* note 1, at 118.

<sup>167</sup> See *infra* text accompanying notes 168-75.

<sup>168</sup> Wall St. J., Jan. 29, 1985, at 4, col. 1.

<sup>169</sup> *Id.*

<sup>170</sup> I.R.C. § 409(e)(3) (West Supp. 1985). See Ronan, *supra* note 1, at 129. This fact further undercuts the argument of ESOP proponents that these plans give employees more control over the firms for which they work. For proposed changes in this area, see *infra* text accompanying notes 245-55.

<sup>171</sup> Wall St. J., *supra* note 168, at 4, col. 1.

payments to company executives of \$19 million.<sup>172</sup> Several employee groups have filed formal complaints with the Labor Department charging that under the plan the employees were forced to acquire ownership of the company.<sup>173</sup> As disenfranchised owners, these employees will have all of the risks of ownership but no voice in how the company will be run.<sup>174</sup>

As the Parsons situation illustrates, leveraged buyouts by ESOPs are extra-market transactions which provide the employee-purchasers with none of the safeguards inherent in typical going-private transactions. Where, as in the Parsons transaction, the management trustees are also large shareholders (or are influenced by large shareholders), conflicts of interest cannot be avoided. The management trustees are causing the ESOP to purchase their stock at above-market prices, frequently to avoid being taken over by rival management teams.

In the absence of market forces, the only protection given to ESOP participants is the fiduciary duty owed by the management trustees to the purchasing employees.<sup>175</sup> But in the case of ESOPs, even this *ad hoc* protection has been significantly reduced. Fiduciary duties prohibit most pension plans from purchasing stock from interested parties such as employers, major shareholders, officers and directors.<sup>176</sup> Such restrictions, which are part of the general fiduciary rules of ERISA, would prevent ESOPs from engaging in leveraged buyouts, but are inapplicable to ESOPs.<sup>177</sup> This ESOP exemption is justified by ESOP supporters as facilitating transfers of stock ownership from the current owners to workers.<sup>178</sup> This Article suggests that this exemption is harmful to the economic interests of the very employees it ostensibly benefits.<sup>179</sup>

There is a third reason to doubt that ESOPs are an effective means to redistribute wealth. Because large publicly held corporations are less likely to have ESOPs than small closely held firms,<sup>180</sup> in reality "very little capital is likely to pass into em-

<sup>172</sup> *Id.*

<sup>173</sup> *Id.*

<sup>174</sup> *Id.*

<sup>175</sup> See *ERISA*, *supra* note 21, at § 404(a), 29 U.S.C. § 1104(a) (1982) (containing codified fiduciary standards).

<sup>176</sup> See *ERISA*, *supra* note 21, at §§ 406(a), (b), 29 U.S.C. § 1106(a), (b) (1982).

<sup>177</sup> See *ERISA*, *supra* note 21, at §§ 404(a)(2), 407(d)(3), 29 U.S.C. §§ 1104(a)(2), 1107(d)(3) (1982).

<sup>178</sup> See *supra* notes 38–41 and accompanying text.

<sup>179</sup> See *supra* text accompanying notes 159–77.

<sup>180</sup> See *supra* notes 99–103 and accompanying text.

ployees hands as a result [of ESOPs]. More probably the effect will simply be to lighten the income tax burden of the corporations involved and that of their shareholders and executives, at the expense of the rest of us."<sup>181</sup>

Because ESOPs may well protect the interests of managers and more affluent employees rather than those rank and file workers, these devices should prove to be a far less important vehicle for reallocating wealth than advocates claim, despite considerable regulatory support.

### E. *ESOPs Preserve Businesses and Jobs*

If the present value of a firm's future income stream is less than its asset value on liquidation (accounting for liquidation costs), it is inefficient to artificially prop up these companies. Society would be better off if the assets of such companies could be redeployed. To the extent it prevents such firms from failing or workers from losing jobs, ESOP legislation perpetuates another market distortion. ESOP defenders, though, often credit ESOP legislation for saving firms and preserving jobs, as when the Chairman of the House Subcommittee on Economic Stabilization opened proceedings on ESOPs by commenting that "[t]his morning's subcommittee hearing is for the purpose of learning about employee-owned companies and particularly about companies which would have shut down had the employees not purchased them and kept them operating."<sup>182</sup> The subcommittee then heard testimony on the use of ESOPs to bail out companies whose market value as going concerns was less than their asset values on liquidation. One such story involved the South Bend Lathe Company, on the verge of liquidation, which was purchased by its employees through an ESOP.<sup>183</sup> The purchase was made possible with the help of a \$5,000,000 loan from the federal government to the ESOP at a highly subsidized three percent interest rate.<sup>184</sup>

Similarly, the Canterbury Printing Company established an ESOP which purchased all of the stock from its one hundred

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<sup>181</sup> Carlson, *supra* note 162, at 314.

<sup>182</sup> *Employee Stock Ownership Plans: Hearing Before the Subcomm. on Econ. Stabilization of the House Comm. on Banking, Finance, and Urban Affairs*, 96th Cong., 1st Sess. 1 (1979) (opening remarks of Chairman Moorehead (D-Pa.)) [hereinafter cited as *Subcomm. Hearing*].

<sup>183</sup> *Id.* at 4-9.

<sup>184</sup> *Id.* at 5.

percent owner.<sup>185</sup> As Senator Long commented, "As is often the case, Mr. West was looking for a way to reward his many loyal employees who might otherwise have lost their position by a sale to another entity."<sup>186</sup> Why would the employees have lost their jobs upon a sale? Would they be replaced by more efficient workers? Even if that was the case, there may be little objection to continued inefficiency if the workers were willing to subsidize their own inefficiency by accepting lower wages or a lower return on their investment. But objections should arise when the inefficiency is subsidized by other taxpayers through ESOP tax incentives.<sup>187</sup>

For example, Rath Packing Company, a nationally known meatpacker specializing in pork products, lost over \$20,000,000 during the 1970's. In order to remain competitive, Rath needed \$4,500,000 for modernization. An investor offered to purchase the company, but the proposal would have required workers to accept enormous wage and benefits cuts. As an alternative, the union presented its own proposal to purchase the company through an ESOP. The purchase was coordinated with \$7,500,000 of subsidized government loans. While some temporary wage concessions were made, the union essentially avoided market-required concessions through a combination of direct governmental loan subsidies and indirect tax subsidies provided by ESOP legislation.<sup>188</sup>

In a dynamic economy, efficiency demands that some businesses should be liquidated because the assets of those businesses are more valuable in alternative uses.<sup>189</sup> For other firms, greater efficiency will be achieved by selling the business to new owners who will make changes, including, in some cases, firing

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<sup>185</sup> The loan was made indirectly from the federal government through the City of South Bend to the South Bend Lathe Company. As part of the plan, the Economic Development Administration made a \$5,000,000 grant to the City of South Bend. *Id.* at 5.

<sup>186</sup> 129 CONG. REC. S5836 (daily ed. May 3, 1983) (statement of Sen. Long).

<sup>187</sup> To the extent that ESOP participants are blessed with favorable tax treatment, there will be a tax revenue shortfall that will burden taxpayers in general. *See, e.g., Hearings, supra* note 15, at 108. Another type of subsidization takes the form of government loans at below market interest rates, such as the three percent rate grant to South Bend Lathe Company. *See Subcomm. Hearing, supra* note 182, at 5.

<sup>188</sup> This account is drawn from Olson, *Union Experiences with Worker Ownership: Legal and Practical Issues Raised by ESOPs, TRASOPs, Stock Purchases and Cooperatives*, 1982 WIS. L. REV. 729, 753-60 (1982). The article contains similar rescue tales for a variety of companies including Chrysler, Ford, and Pan Am. *See id.* at 772-80.

<sup>189</sup> V. BRUDNEY AND M. CHIRELSTEIN, *CASES AND MATERIALS ON CORPORATE FINANCE* 3-6 (1979).

workers or cutting wages. These facts have not escaped Senator Long,<sup>190</sup> yet he still attempts to justify ESOP legislation as necessary for workers and communities who “must cope with swollen welfare rolls, and deficits, overburdened State and local relief efforts . . . .”<sup>191</sup> Thus, Senator Long champions ESOPs as a governmental second best solution to a host of problems created by other government subsidies.

Proponents of ESOP legislation seem trapped between the recognition that the tax benefits often represent a wealth transfer from taxpayers in general to those taxpayers who own and/or work at inefficient firms and the belief that inefficiency is not being subsidized:

[a] company that is not market responsive, a company that cannot meet its competition and turn a profit should not put its employees in the position of owning that company. ESOP-type financing is not intended for losers. It is intended, however, for those losers and for those marginally profitable firms who, with employee ownership, can become winners.<sup>192</sup>

Two difficulties arise with this reasoning: first, ESOP-type financing may not be *intended* for losers, but it is *available* for losers to perpetuate inefficiency; and second, if a loser can become a winner through employee ownership or any other type of change, there is no need for a tax incentive to bring the change about.

That there will be no market for the stock of a truly profitable company or that holders of such stock will be unable to borrow in order to pay estate taxes seems a bit implausible. One explanation may be that what proponents refer to as “profitable” companies are not so regarded by the market. Proponents often try to support this explanation by citing case studies showing how ESOP-owned firms rose from the ashes to prosperity, but counterexamples abound. Rath Packing Company’s employee buyout was attended by great publicity in 1980, but today the

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<sup>190</sup> As Senator Long remarked,

Mr. President, as any free market economist will tell you, it is the essence of capitalism to allow—indeed, encourage—financial capital to seek its highest return. It is this “invisible hand” that serves as the driving force of a market economy. By that measure plant closings make perfectly good economic sense, particularly to those financial managers hired to oversee that capital on their behalf.

129 CONG. REC. S16,636 (daily ed. Nov 17, 1983) (statement of Sen. Long).

<sup>191</sup> *Id.* at S16,637.

<sup>192</sup> *Id.*



company is undergoing bankruptcy reorganization in a Chapter 11 proceeding.<sup>193</sup> Even if some studies are true *ex post*, they do not vindicate government intervention *ex ante*. Profitability and efficiency are not necessarily synonymous. Simply stated, a firm with assets that produce a five percent return on investment uses those assets inefficiently if the assets can produce a nine percent return in some alternative use. A firm that seems to be profitable after an employee buyout may not be sufficiently profitable in the eyes of the market, given the risk level of the firm's activities. Moreover, this "profitability" of ESOP-owned firms is often purchased with the general taxpayers' dollars.

### III. ESOPs AND THE MARKET FOR CORPORATE CONTROL

The market for corporate control, also known as the takeover market, is the arena in which competing managerial teams vie for the right to manage corporate resources.<sup>194</sup> Increasingly, ESOPs are being adopted as a defensive technique by managerial teams seeking to avoid takeovers.<sup>195</sup> This move clearly illustrates that agency costs may allow management to manipulate ESOPs in the interest of self-preservation but at the expense of shareholders.<sup>196</sup>

In an important review article,<sup>197</sup> Michael Jensen and Richard Ruback conclude on the basis of dozens of independent studies that corporate takeovers "generate positive gains" and are therefore wealth-creating transactions.<sup>198</sup> A takeover can occur

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<sup>193</sup> Levin, *supra* note 3, at 30, col. 5.

<sup>194</sup> The seminal article is Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965); *see also*, McNider, *What is a Tender Offer?*, 37 WASH. & LEE L. REV. 908 (1980); *supra* text accompanying note 163.

<sup>195</sup> *See generally* Brecher, Lazarus & Gray, *The Function of Employee Retirement Plans as an Impediment to Takeovers*, 38 BUS. LAW. 503 (1983); Note, *Employee Stock Ownership Plans and Corporate Takeovers: Restraints on the Use of ESOPs by Corporate Officers and Directors to Avert Hostile Takeovers*, 10 PEPPERDINE L. J. 731 (1983); Note, *Employee Stock Ownership Plans and Other Defenses to Hostile Tender Offers*, 21 WASHBURN L. J. 580 (1982).

<sup>196</sup> *See supra* text accompanying notes 161-76.

<sup>197</sup> Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983).

<sup>198</sup> *Id.* at 47. On the basis of 13 studies, Jensen and Ruback concluded that "estimates of positive abnormal returns to targets of successful tender offers in the month or two surrounding the offer . . . are uniformly positive ranging from 16.9% to 34.1%, and the weighted average abnormal return . . . is 20.1%." *Id.* at 10. Moreover, those returns continued "through completion of the offers. Targets of *unsuccessful tender offers* earn significantly positive abnormal returns on the offer announcement and through the realization of the failure. However, those targets of unsuccessful tender offers that do

through merger, tender offer or proxy contest. Sometimes elements of all three are involved in one corporate control transaction.<sup>199</sup> In many cases, a firm's incumbent management is not willing to relinquish its managerial responsibilities and therefore takes steps to ensure that the right to manage corporate resources does not fall into the hands of a rival management team. Where this is anticipated, the rival management team will most likely launch a "hostile" tender offer for the shares of the firm it wishes to manage.<sup>200</sup> In these situations the target firm's management can use the ESOP to inhibit the rival firm from gaining control.<sup>201</sup> To a much lesser extent, the acquiring firm can use the financing advantages available through ESOPs to make the acquisition less costly.<sup>202</sup>

Tender offers can benefit shareholders of both the target and the acquiring firm. The shareholders of the target benefit because they can sell their shares at a premium over the current market price.<sup>203</sup> The bidder's shareholders can benefit by obtaining the difference between the new value of the firm and the payment to the old shareholders. The increases in wealth that fuel the market for corporate control stem from two primary sources. First, the target firm may be controlled by an inefficient management team; when control shifts, the new management

not receive additional offers in the next two years lose all previous announcement gains, and those targets that do receive new offers earn even higher returns." *Id.* at 15-16. Finally, "[t]he abnormal returns for bidders in successful tender offers . . . are all significantly positive and range from 2.4% to 6.7%, with a weighted average return of 3.8%," while "the generally negative returns to unsuccessful bidders in both mergers and tender offers are consistent with the hypothesis that mergers are positive net present value projects." *Id.* at 16-22.

<sup>199</sup> *Id.* at 6.

<sup>200</sup> Where incumbent management does not wish to lose control, acquirors prefer hostile tender offers to mergers because a merger requires approval of the target firm's board of directors, while no such approval is needed for a tender offer. *See, e.g.*, MODEL BUSINESS CORP. ACT §§ 71 (merger), 79 (sale of assets) (1969); DEL. CODE ANN. tit. 8, §§ 251 (merger), 271 (sale of assets) (1983 & Supp. 1984).

Hostile tender offers are preferred over proxy fights because the latter are often uneconomical:

Corporate law and economics combine to make the proxy fight an unattractive . . . mechanism for displacing incumbent management. As a practical matter, incumbent management may use corporate resources to resist the challenger's candidacy. The challenger, however, must use its own funds, which are unlikely to be reimbursed if the challenge fails.

Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 843 (1981).

<sup>201</sup> *See infra* text accompanying notes 216-38.

<sup>202</sup> *See infra* text accompanying notes 239-44.

<sup>203</sup> *See* Easterbrook and Fischel, *The Proper Role of a Target's Management in Response to a Tender Offer*, 94 HARV. L. REV. 1161, 1161 (1981).

team may more capably run the business.<sup>204</sup> Second, synergy gains may result from a combination of the particular assets of the two firms.<sup>205</sup> In either case, the parties to the transaction benefit, and society's resources are allocated in a more optimal manner.

Managers of a firm that is the subject of a takeover attempt may take steps to avoid being acquired even when they believe that the acquisition will be in the best interests of the shareholders of the firm. This is because a frequent consequence of a successful takeover attempt is the replacement of incumbent management.<sup>206</sup> Because there are "serious and unavoidable conflicts of interest inherent in any decision on one's own ouster," commentators have asserted that "courts ought not make available to a manager resisting a tender offer—and, in effect fighting against his own replacement—the same deference accorded to the decisions of a manager in good standing."<sup>207</sup>

In spite of these conflicts of interest, courts generally invoke the business judgment rule to shield the defensive conduct of managers who fight against hostile tender offers.<sup>208</sup> However,

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<sup>204</sup> See Manne, *supra* note 194, at 112.

While it is well established that the share prices of target companies rise after a successful takeover, often quite dramatically, *see supra* note 198, it is difficult, if not impossible, to isolate and identify all the causes for the increases in particular cases. Nonetheless, a number of studies have concluded that "[t]he long history of negative abnormal returns for . . . acquired firms is consistent with the hypothesis that these firms had been poorly managed." Ellert, *Mergers, Antitrust Law Enforcement and Stockholder Returns* 3 J. FIN. ECON. 715, 728 (1976); *see also* Asquith, *Merger Bids, Uncertainty, and Stockholder Returns*, 11 J. FIN. ECON. 51, 82-83 (1983); Maltesta, *The Wealth Effect of Merger Activity and the Objective Functions of Merging Firms*, 11 J. FIN. ECON. 155, 177-80 (1983).

To the extent, then, that an ineffective managerial group is able to entrench itself by using an ESOP defensively, share prices are likely to decline.

<sup>205</sup> One study concluded that "acquiring firms cannot theoretically and do not empirically profit from the appreciation of the target shares;" instead, "control of the target resources" is generally the object of corporate takeovers and the explanation for their profitability. Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. BUS. 345, 351 (1980). Synergy gains in takeovers occur where joining the assets of the target with the acquiring company results in the creation of a unit that is able, for reasons of economies of cost and organization, to make greater use of the combined corporate assets than was the case when the companies were separate. For a discussion of these "synergies" in the context of one particular merger, *see* Ruback, *The Conoco Takeover and Shareholder Returns*, 23 SLOAN MGMT. REV. 13, 22-23 (1982).

<sup>206</sup> Even managers who have been able to extract a commitment from the acquiring firm of continued employment with the company will have strong incentives to resist a takeover. These include the foreseeable loss of "power, prestige, and the value of organization-specific human capital" for the old management team once the target firm has been absorbed into another corporation. Jensen & Ruback, *supra* note 197, at 8.

<sup>207</sup> Easterbrook & Fischel, *supra* note 203, at 1198.

<sup>208</sup> The business judgment rule recognizes that courts generally are not competent to make business decisions and that their involvement in the day-to-day running of firms

this use of the business judgment rule has come under considerable attack.<sup>209</sup>

There is much debate about which defensive tactics<sup>210</sup> are most appropriate to achieve the widely agreed upon goal of maximizing shareholder and societal wealth. The best way to achieve this goal is to ensure that neither side is given an in-

and corporations would, as such, be counterproductive for all concerned. *See generally* Arsh, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979); Lynch, *The Business Judgment Rule Reconsidered*, 17 FORUM 452 (1981). Only when there is evidence of self-dealing, or some other conflict of interest on a director's or officer's part, will the business judgment rule give way to the stricter "duty of loyalty" standard, which scrutinizes corporate officers' transactions with their companies to determine whether they are "unfair to the corporation." *See* Marsh, *Are Directors Trustees?: Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 43 (1966). One judicial formulation of the rule provides that:

[d]irectors of corporations discharge their fiduciary duties when in good faith they exercise business judgment in making decisions regarding the corporation. When they act in good faith, they enjoy a presumption of sound business judgment, reposed in them as directors, which courts will not disturb if any rational business purpose can be attributed to their decisions. In the absence of fraud, bad faith, gross overreaching or abuse of discretion, courts will not interfere with the exercise of business judgment by corporate directors.

*Panter v. Marshall Field & Co.*, 486 F. Supp. 1168, 1194 (N.D. Ill. 1980), *aff'd*, 646 F.2d 271 (7th Cir. 1981), *cert. denied*, 454 U.S. 1092 (1981).

For cases applying the business judgment rule to directors' actions in the corporate control context, see *Panter v. Marshall Field & Co.*, 646 F.2d 271, 294 (7th Cir. 1981), *cert. denied*, 454 U.S. 1092 (director's decision to resist tender offer, which would have allowed target shareholders to sell their stock at a substantial premium, protected under the presumption that corporate officers will act in good faith); *Treadway Companies, Inc. v. Care Corp.*, 638 F.2d 357, 381 (2d Cir. 1980) (director's issuance of corporate stock to "white knight" not a breach of fiduciary duty in the absence of any affirmative showing of bad faith); *Johnson v. Trueblood*, 629 F.2d 287, 292 (3rd Cir. 1980) (decision not to tender stock to minority shareholders, if at least arguably made for the benefit of the corporation, protected under the business judgment rule).

<sup>209</sup> *See, e.g.*, Easterbrook & Fischel, *supra* note 203 at 1194-99; Easterbrook & Jarrell, *Do Targets Profit from Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277 (1984); Gilson, *supra* note 200, at 822-24; Johnson, *Anti-Takeover Actions and Defenses: Business Judgment or Breach of Duty?*, 28 VILL. L. REV. 51 (1982); Note, *Tender Offer Decisions: Effect of the Business Judgment Rule*, 45 ALB. L. REV. 1122 (1981).

Influential commentators have stated that "every economically-sophisticated commentator" has advocated the outright ban of defensive tactics. 1983 S.E.C. ADVISORY COMM. ON TENDER OFFERS REP. OF RECOMMENDATIONS 70, 100 (separate statement of Frank H. Easterbrook and Gregg A. Jarrell).

<sup>210</sup> *See, e.g.*, E. ARANOW, H. EINHORN & G. BERLSTEIN, *DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL* 193-206 (1977); A. FLEISCHER, *TENDER OFFERS: DEFENSES, RESPONSES AND PLANNING* (1978); Hochman & Folger, *Deflecting Takeovers: Charter and By-law Techniques*, 34 BUS. LAW. 537 (1979); Profusek, *Tender Offer Manipulation: Tactics and Strategies after Marathon*, 35 SW. L.J. 975 (1983); Comment, *A Review of the Literature on Defensive Tactics to Surprise Cash Tender Offers*, 13 CREIGHTON L. REV. 909 (1980); Weiss, *Defensive Responses to Tender Offers and the Williams Act's Prohibition Against Manipulation*, 35 VAND. L. REV. 1087 (1982); Comment, *Corporate Takeover Battles—Shark-Repellent Charter and Bylaw Provisions that Deter Hostile Tender Offers or Other Acquisitions—A Comprehensive Examination*, 27 HOW. L.J. 1683, 1708 (1984); Comment, *Anti-takeover Maneuvers: Developments in Defense Tactics and Target Actions for Injunctive Relief*, 35 SW.L.J. 617, 619 (1981).

appropriate advantage over the other in a battle for control of a corporation. The Williams Act,<sup>211</sup> the major federal legislation affecting tender offers, takes the position that there should be a "level playing field" as between bidding firms and target firms. Regardless of one's views as to the efficacy of such legislation, it is agreed that the success or failure of takeover rules should be judged on the basis of whether they achieve the goal of evenhandedness.<sup>212</sup>

ESOPs may be used by corporations both as a "shield" to counter unwanted takeover attempts<sup>213</sup> and as a "sword" to facilitate the acquisition of other firms.<sup>214</sup> In either case, to the extent that firms without ESOPs are on the other side of these transactions, distortions inevitably arise. The remainder of this Part evaluates more fully the nature of these distortions. Analyzing the tax provisions relating to ESOPs and observing how ESOPs have been used in actual control transactions reveals that ESOPs are significantly more valuable to incumbent management teams than to outsiders in battles for corporate control. In this regard, the rules and practices relating to ESOPs are in conflict with the general premise articulated in the federal securities laws, that the legal system should not favor one group over another in control transactions.<sup>215</sup>

### A. ESOPs as a Shield

Perhaps the most obvious use of ESOPs in corporate control transactions is by an incumbent management team that establishes an ESOP to acquire stock in its own firm for the purpose

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<sup>211</sup> Securities Exchange Act of 1934, §§ 13(d)-(g), 14(d)-(f), 15 U.S.C. §§ 78m(d)-(g), 78n(d)-(f) (1982).

<sup>212</sup> In its opinion in *Piper v. Chris-Craft Industries*, 430 U.S. 1 (1977), the Supreme Court noted that in enacting the Williams Act, "Congress was indeed committed to a policy of neutrality in contests for control," and held that the "sole purpose" of that legislation "was the protection of investors who are confronted with a tender offer." *Id.* at 29, 35. In *Edgar v. Mite Corp.*, 457 U.S. 624 (1982), the Court re-emphasized that:

it is also crystal clear that a major aspect of the effort to protect the investors was to avoid favoring either management or the takeover bidder . . . . As the legislation evolved, therefore, Congress . . . expressly embraced a policy of neutrality. As Senator Williams explained: "We have taken extreme care to avoid tipping the scales either in favor of management or in favor of the person making the takeover bids."

*Id.* at 633.

<sup>213</sup> See *infra* text accompanying notes 216-38.

<sup>214</sup> See *infra* text accompanying notes 239-44.

<sup>215</sup> See *supra* notes 211-12 and accompanying text.

of thwarting the acquisition plans of an unwanted suitor. The ESOP's acquisition of stock serves to dilute the voting strength of the acquiror's block of stock and increases the amount of stock an acquiror must acquire to obtain control.<sup>216</sup> This strategy is particularly attractive to management where there is significant overlap between the board of directors of the target company and the trustees of the ESOP.<sup>217</sup>

The tax provisions associated with ESOPs make it possible for firms to finance such stock acquisitions at subsidized rates.<sup>218</sup> Institutional lenders extending loans to enable an ESOP to acquire the employer's securities are allowed to exclude from income fifty percent of the interest received on such loans.<sup>219</sup> Consequently, the interest rate a lender charges an ESOP will be lower than the rate charged for a comparable non-subsidized acquiror, and the ESOP will have relatively more money to spend on stock purchases.<sup>220</sup>

The rollover provision of the Deficit Reduction Act of 1984<sup>221</sup> provides a particular advantage to the target firm. Prior to 1984, any gain realized by a seller on the sale of employer securities to an ESOP was taxed to the seller at normal capital gains rates.<sup>222</sup> The 1984 Act changed this to permit any person who sells employer stock to an ESOP to elect to defer the capital gain realized if the proceeds from the sale are used to acquire the stock of a domestic corporation.<sup>223</sup> This provision gives target firms a clear advantage over rival bidders in the acquisition of shareholder stock. If an ESOP is willing to pay the exact same price for stock as a rival bidder, selling shareholders will elect to sell to the employer-controlled ESOP in order to defer the payment of capital gains taxes. Even where the rival bidder

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<sup>216</sup> See, e.g., *Klaus v. Hi-Shear Corp.*, 528 F.2d 225, 228 (9th Cir. 1975) (target company guaranteed loan to ESOP that enabled ESOP to purchase 50,000 newly issued shares, after offeror had obtained approximately 45% of target's stock); *Texas International Airlines, Inc. v. Continental Air Lines*, No. 81-5514 (9th Cir., June 18, 1981) (affirming denial of preliminary injunction; after offeror obtained 48.5% of the target company's outstanding shares, the target set up an ESOP and guaranteed loans for it up to \$185 million for the purchase of newly issued stock).

<sup>217</sup> See, e.g., *Donovan v. Bierwirth*, 538 F. Supp. 463, 465-66 (E.D.N.Y. 1981), *aff'd as modified*, 680 F.2d 263 (2d Cir. 1982), *cert. denied*, 459 U.S. 1069 (1982).

<sup>218</sup> See *infra* notes 219-26 and accompanying text.

<sup>219</sup> I.R.C. § 133(a) (West Supp. 1985). See *supra* text accompanying notes 58-59, 71-72.

<sup>220</sup> See *supra* text accompanying notes 58-59, 71-72.

<sup>221</sup> I.R.C. § 1042 (West Supp. 1985). See *supra* text accompanying notes 54-55, 80.

<sup>222</sup> I.R.C. §§ 61, 1202, 1222 (1982).

<sup>223</sup> *Id.* §§ 1042 (a) and (c)(3) (West Supp. 1985). See *supra* text accompanying note 55.

is prepared to pay more for the stock, the preferred capital gains treatment given to the ESOP's purchase may result in the rival, which values the firm more, losing a control battle to the incumbent management team. Where this occurs, the favorable tax treatment afforded ESOP purchases of employer stock results in an inefficient allocation of resources.

While the rationale for the rollover provision was to shift the ownership structure of corporations away from large individual stockholders and towards ESOPs and worker control,<sup>224</sup> an unintended consequence is strongly to favor incumbent management in battles for corporate control. ESOPs could be encouraged to acquire employer stock without distorting the market for corporate control simply by restricting favorable tax treatment to sales of *non-voting* stock. In this way employees could acquire an economic interest in the firm for which they work without giving unwarranted advantages to incumbent management. Such a rule would conform to many of the articulated goals that underlie the favorable treatment given to ESOPs, but would not distort the market for corporate control.<sup>225</sup> Yet the restrictions actually imposed on sales of employer stock to ESOPs are precisely the opposite of those suggested here; deferral of capital gains treatment is only permitted on employer common stock that has voting power equal to or in excess of that class of employer common stock that has the greatest voting power.<sup>226</sup> This voting provision exacerbates the distortions created by the rollover provisions on the market for corporate control.

Incumbent management also may use ESOPs to prevent loss of control by causing the ESOP to make purchases of employer stock well in advance of the announcement of a hostile tender offer. If management creates an ESOP and it begins acquiring stock after a hostile tender is launched, it seems particularly likely that the purpose of the ESOP is to thwart a shift in control. And where it can be shown that the primary purpose of the ESOP is to evade a change of control, the ESOP will be struck

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<sup>224</sup> See *supra* text accompanying notes 82–83. Of course, allowing ESOPs to purchase non-voting stock would not give employees any control over management of a company. But the primary advantages of ESOPs cited by proponents occur by giving employees a financial stake in the economic performance of a company, not by giving them voting control. See *id.*

<sup>225</sup> See *supra* notes 2, 82–83 and accompanying text.

<sup>226</sup> I.R.C. §§ 1042(a)(1) and 409(l) (West Supp. 1985).

down as a breach of the management's fiduciary duty of loyalty to the shareholders.<sup>227</sup>

A graphic illustration of how ESOPs may be used in this respect and how courts will treat such plans arose in *Norlin v. Rooney Pace*.<sup>228</sup> Piezo Electric Products, Inc. and Rooney Pace, Inc. (Piezo's investment banker) began buying large blocks of stock in the Norlin Corporation. To prevent these firms from gaining control of the corporation, Norlin created an ESOP and caused it to purchase newly created Norlin common and preferred voting stock.<sup>229</sup> The trustees of the ESOP were all members of the Norlin board of directors, and voting control of the ESOP was retained by the directors.<sup>230</sup> In an action to enjoin Norlin from voting the common stock, the Second Circuit refused to accord the decisions made by Norlin the deference typically given to managers under the business judgment rule because the transaction was tainted by self-interest.<sup>231</sup> Evidence of management self-interest was found in the fact that the board offered its shareholders no rationale for the transfers other than its determination to oppose a shift in control at all costs.<sup>232</sup> In addition, the ESOP was created only five days after a district court had refused to grant Norlin an injunction against further stock purchases by Piezo, "at a time when Norlin's officers were clearly casting about for strategies to deter a challenge to their control."<sup>233</sup> As is typical in cases where the target firm issues shares to an ESOP shortly after a challenge to corporate control,<sup>234</sup> the court found that the transfer of shares to the ESOP "gives rise to an inference of improper motive."<sup>235</sup>

While actions taken subsequent to the tender offer are likely to be struck down, "if actions can be taken *prior* to a tender offer, the risk of such theories being successfully asserted can

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<sup>227</sup> See, e.g., *Podesta v. Calumet Industries, Inc.* [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,433 (N.D. Ill. 1978); *Donovan*, 538 F. Supp. at 463.

<sup>228</sup> 744 F.2d 255 (2d. Cir. 1984).

<sup>229</sup> See *id.* at 259.

<sup>230</sup> *Id.*

<sup>231</sup> The court noted that:

the business judgment rule governs only where the directors are not shown to have a self-interest in the transaction at issue . . . . Once self-dealing or bad faith is demonstrated, the duty of loyalty supersedes the duty of care, and the burden shifts to the directors to 'prove that the transaction was fair and reasonable to the corporation.'

*Id.* at 265.

<sup>232</sup> *Id.*

<sup>233</sup> *Id.* at 266.

<sup>234</sup> See *supra* note 227 and accompanying text.

<sup>235</sup> *Id.* at 266 n.10.



be significantly reduced provided there are other legitimate purposes for implementing or maintaining an employee benefit plan that owns employer stock."<sup>236</sup> While there is often little doubt that the true purpose of the ESOP is to lower the probability of a future shift of control, it is clear that ESOPs established before the announcement of a hostile tender offer are much less subject to attack. This is so because: (1) it is "difficult for the offeror to prove that such actions taken before a tender offer were taken to fend off an unfriendly offer instead of for legitimate corporate purposes;"<sup>237</sup> (2) it is easier for ESOP trustees to show compliance with their fiduciary duties if actions are taken before the tender offer; and (3) courts are more likely to accept the explanation that other legitimate purposes exist for the ESOP if it is established in advance of the tender offer.<sup>238</sup> Thus, while courts will occasionally step in to prevent incumbent management from using an ESOP solely as a means to retain corporate control, ESOPs generally can be a significant impediment to takeovers.

### B. *ESOPs as a Sword*

At first blush it may seem as though ESOPs do not distort the market for corporate control because the plans may be used by both the acquiror and the acquired firm. Just as the target may establish an ESOP in order to borrow money at subsidized rates, buy its own stock and thereby acquire its own shares, so also a raider may set up an ESOP to acquire shares in the target. The acquiror causes the ESOP to borrow money from a bank (also at subsidized rates), and uses this money to purchase its own shares. The proceeds from the sale of stock to the ESOP may be used by the acquiror to purchase shares of the target firm. The acquiror generally will be required to guarantee the ESOP's bank loan and make periodic contributions to the ESOP to enable it to repay the loan, but it also will receive a tax deduction for these contributions.<sup>239</sup>

While it may *seem* that ESOPs provide advantages to both target firms and raiders, there are a number of factors that make ESOPs more useful to target firms than to acquiring firms in the

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<sup>236</sup> Brecher, Lazarus & Gray, *supra* note 195, at 504.

<sup>237</sup> *Id.* at 513.

<sup>238</sup> See *supra* text accompanying note 236.

<sup>239</sup> See *supra* note 51.

battle for corporate control. First, because management of the target firm typically controls the ESOP, it controls the "float" or number of shares that the target firm has outstanding. The outsider must locate shares in the open market and purchase them above the current market price. As the *Norlin* case illustrates, incumbent management does not have to rely on market purchases, but can cause the ESOP to purchase previously unissued shares.<sup>240</sup> Thus, while the acquiror may find it difficult to acquire shares at the market price because the supply of such shares is inelastic, the target has no such problem because it can simply (and literally) print the additional shares it wants to purchase.<sup>241</sup>

Second, even where the target firm and the raider are both bidding for shares owned by current shareholders, the rollover provisions of the Deficit Reduction Act of 1984<sup>242</sup> give selling shareholders a strong economic incentive to sell to the target firm rather than to the acquiror.<sup>243</sup> Selling to the target firm's ESOP enables the selling shareholder to avoid paying capital gains taxes on the sale.<sup>244</sup> Thus, while ESOPs are becoming a potent weapon in the arsenal of incumbent management seeking to retain control of their firm, these plans have not proved as useful to management teams attempting to obtain control.

#### IV. COMPREHENSIVE TAX REFORM AND ESOPs

The call for tax simplification and reform is in the air. Accordingly, one might expect the inefficient and technically complex ESOP provisions to be eliminated. Indeed, President Reagan's "Tax Proposals to the Congress for Fairness, Growth and Simplicity" ("Proposal") notes some of the problems with the current ESOP provisions: "Despite the intentions behind [the ESOP] provisions, they represent a confused mix of incentives and requirements which fails to encourage direct employee ownership . . . . Indeed, if participation in the ESOP is in lieu of current compensation, such deferral [of benefits] may actually

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<sup>240</sup> The board of directors of the target company in *Norlin* transferred 185,000 shares of the firm's common stock to its newly created ESOP. See *Norlin*, 744 F.2d at 259.

<sup>241</sup> See, e.g., *Klaus v. Hi-Shear Corp.*, 528 F.2d 225, 255 (9th Cir. 1975); *Texas International Airlines v. Continental Air Lines*, No. 81-5514 (9th Cir., June 18, 1981).

<sup>242</sup> See *supra* note 54.

<sup>243</sup> See *supra* text accompanying notes 54-56.

<sup>244</sup> See *supra* text accompanying note 54.

lessen employees' overall incentive to increase productivity."<sup>245</sup> The Proposal goes on to point out that the vesting requirements and contribution and distribution limits associated with retirement plans, when applied to ESOPs, "unnecessarily restrict the ability of an employer to provide the benefits of owning employer securities to its employees."<sup>246</sup>

Notwithstanding these enunciated reasons for change, the Proposal would preserve the ESOP concept, albeit in a revised set of provisions. Curiously, the proposal never justifies the preservation of the ESOP concept.

The thrust of the changes incorporated in the Proposal is to provide employees with greater control over stock received pursuant to the ESOP provisions.<sup>247</sup> "Direct ownership of employer securities, with the attendant rights and benefits, is far more likely to be an incentive for employee productivity than a speculative benefit to be realized only upon separation from service."<sup>248</sup> Consequently, the Proposal requires the employee stock ownership trust to distribute annually to participants a portion of the securities held by the trust as well as all dividends paid during the year.<sup>249</sup> Employees would not have taxable income upon distribution of securities from the trust.<sup>250</sup>

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<sup>245</sup> *President's Tax Proposals to the Congress for Fairness, Growth and Simplicity*, 72 *STAND. FED. TAX REP.* (CCH) 315 (extra ed. May 29, 1985) [hereinafter cited as *Proposal*].

<sup>246</sup> *Id.* at 316.

<sup>247</sup> *Id.* at 316-17.

<sup>248</sup> *Id.* at 318. In addition to the changes discussed *infra* at text accompanying notes 249-63, the Proposal would repeal the special deduction limits available to a leveraged ESOP and replace them with provisions allowing a deduction up to 25% of aggregate employee compensation for principal payments on a loan taken out by the employer to purchase stock contributed to an employee stock ownership trust. To qualify for the 25% limit, the yearly principal payments must be between 8.3% and 20% of the original principal balance, or equal and amounting to a complete payoff in 10 years or less. See *Proposal, supra* note 245, at 316. The special exception for ESOPs to the prohibited transaction rules would be repealed as would the provision allowing an ESOP to assume a decedent's estate tax liability. See *Proposal, supra* note 245, at 317-18.

Stock must be distributed to employees in accordance with their respective compensation amounts, with amounts over \$50,000 disregarded. The employee would be entitled to a put-option beginning three years after stock is distributed and continuing for a specified period of time each year thereafter. Dividends paid by the employer would still be deductible, but a corresponding nondeductible payment to the employee receiving the dividend would be required in an amount offsetting the tax saving. *Id.*

<sup>249</sup> *Proposal, supra* note 245, at 316-17. The portion is equal to scheduled principal repayments for the leveraged ESOP stock for the year. The Proposal does not indicate what must be distributed in the case of a non-leveraged ESOP.

The Proposal does allow a trust agreement to imbue the trust with nominal ownership of the securities so long as the employees had all rights of direct ownership, including the right to receive dividends, the right to vote, and the right to transfer the securities. *Id.*

<sup>250</sup> *Proposal, supra* note 245, at 317.

The distribution of securities has several implications. First, future dividends made on the distributed securities go directly to the employee-shareholder. Second, the employee-shareholder could vote on all corporate matters.<sup>251</sup> Third, and probably most important, employee-shareholders could choose to diversify their investments by selling their shares in the open market.<sup>252</sup>

In addition, an employee-shareholder may be able to take advantage of the deferral provisions enacted as part of the Deficit Reduction Act of 1984.<sup>253</sup> Accordingly, the ESOP beneficiary could sell the employer securities to the employee stock ownership trust and reinvest the proceeds in a timely fashion in securities of another corporation, thereby postponing any recognition of gain.<sup>254</sup>

In its analysis of the suggested revisions, the Proposal notes:

[E]mployees should receive the benefits of owning the stock currently, including the right to decide whether the employer securities are an appropriate investment, rather than being required, as under current law, to maintain an investment in the employer through the ESOP. If ownership of employer securities is a sound investment, the employees will readily agree to continue that tax deferred investment and work to enhance its value. On the other hand, if the employer stock is a bad investment, employees should enjoy the same freedom to dispose of it as any other rational investor. Employees are poorly served where the tax law overrides their own judgments.<sup>255</sup>

Providing employee-shareholders with the freedom to diversify their portfolios is wholly consistent with the criticisms lev-  
elled in this Article at existing ESOP provisions.<sup>256</sup> However,

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<sup>251</sup> Under the existing provisions, it is not required that beneficiaries of the employee stock ownership trust vote on all corporate matters. See *supra* text accompanying note 43.

<sup>252</sup> The present requirement that ESOPs invest "primarily" in employer securities severely restricts the diversification potential of the plans. See *supra* text accompanying notes 135-57.

Under the Proposal, an employer would be required periodically to grant employees the right to "put" the securities to the employer at their fair market value, starting three years after receipt. See *Proposal, supra* note 245, at 317. The seller essentially would have ordinary income on that portion of the sales proceeds equal to the fair market value at the time of distribution and capital gains on any excess. *Id.*

<sup>253</sup> See *supra* text accompanying note 55. It is not clear if the Proposal would permit an employee to use the rollover provision. I.R.C. § 1042(c)(1)(C) (West Supp. 1985) contains a caveat that securities acquired under a "qualified plan" are not eligible for rollover treatment. But see *Proposal, supra* note 245, at 319.

<sup>254</sup> The basis in the newly purchased securities would preserve the unrecognized gain. See *supra* note 55.

<sup>255</sup> *Proposal, supra* note 245, at 319.

<sup>256</sup> See *supra* text accompanying notes 135-56.

the Proposal grants freedom in a convoluted and costly manner—one that maintains existing distortions. Even with the Proposal's liberalized grants of sovereignty to employee-shareholders, the ESOP provisions would retain many of their distortive features in the nature of tax advantages: loans to employee stock ownership trusts would remain subsidized through an interest exclusion for the lender;<sup>257</sup> gain on stock sold to an employee stock ownership trust could still be deferred while deferral is unavailable for stock sales in general;<sup>258</sup> dividends on ESOP stock would still be deductible by the employer while dividends on non-ESOP stock are not deductible;<sup>259</sup> and ESOP benefits would still favor labor rather than capital investment.<sup>260</sup>

In fact, a far more effective mechanism for promoting worker capitalism would be available with some modest revisions in the existing laws governing individual retirement accounts. Suppose, for example, that an employee received \$100 in cash from X Corporation (X Corp.). This amount would be fully taxable. The employee could purchase stock of X Corp. pursuant to the individual retirement account (IRA) provisions.<sup>261</sup> The tax consequences of such a purchase would be a \$100 deduction offsetting the \$100 of income. The same tax consequences result if the employee purchased securities of Y Corporation instead of X Corp. In such a case, the same opportunities for increased worker capitalism are available through the simple operation of IRAs as through the labyrinthian ESOP provisions. Full enjoyment of those advantages would require some modifications of

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<sup>257</sup> See *Proposal*, *supra* note 245, at 317. See also *supra* text accompanying notes 58–74 (explanation of the interest exclusion).

<sup>258</sup> See *Proposal*, *supra* note 245, at 317; see also *supra* note 253. Retention of the rollover feature introduced by the Deficit Reduction Act of 1984 perpetuates the imbalance between target and acquiror companies discussed *supra* at text accompanying notes 221–24.

<sup>259</sup> The Proposal attempts to ensure that the benefits of that deduction are passed on in their entirety to the employee-shareholders by conditioning the deduction on an additional nondeductible cash payment to ESOP recipients equal to the tax saving from the deduction. *Proposal*, *supra* note 245, at 317–18. Regardless of the Proposal's attempt, the way that the dividend deduction is divided between employer and recipient is a function of the demand and supply curve for labor. For example, if the supply curve for labor is very inelastic, granting a tax benefit for dividends paid to employee-shareholders will largely benefit the employers. The converse is true if the supply curve is elastic. Where Congress legislates who is to receive the benefit of the deduction, the employer and shareholder-employees will find other ways to reach market equilibrium. If the market has an elastic labor supply curve, other compensation will be lowered to offset the legislated payment. See also *supra* note 72.

<sup>260</sup> See *supra* text accompanying notes 95–112.

<sup>261</sup> See I.R.C. § 219 (1982). I am treating I.R.C. § 219 at this point as if it did not contain its restrictive provisions. See *infra* text accompanying notes 264–68.

existing IRAs. The deduction currently available to taxpayers contributing to an IRA is limited to \$2000, with an additional \$250 for a spousal IRA.<sup>262</sup> The Proposal would increase the spousal IRA to \$2000, thus permitting an overall \$4000 deduction per joint return.<sup>263</sup> If the IRA concept replaced the ESOP provisions as well as other special tax incentives aimed at increased investment, other restrictions would have to be eliminated.<sup>264</sup> For example, the deduction limits, even as increased under the Proposal, should be eliminated.<sup>265</sup> In addition, the restrictions on premature withdrawal<sup>266</sup> should be eliminated so that taxpayers can move in and out of investments as the market dictates.

Eliminating the ESOP provisions in favor of expanded IRA provisions would be efficient in at least two respects. First, the costs of implementation and enforcement of the complex ESOP provisions would be eliminated.<sup>267</sup> Second, the distortions discussed in this Article associated with the ESOP provisions would be eliminated.<sup>268</sup>

## V. CONCLUSION

Tax subsidized ESOPs cause significant market distortions for little benefit, but they are not alone in this regard. Our criticisms of the ESOP provisions are equally applicable to a host of other isolated provisions<sup>269</sup> that provide tax benefits in order to encourage investment under an income tax system that promotes consumption over investment.<sup>270</sup> Our preferred response to these criticisms is movement to a consumption tax which would in principle allow a deduction for savings and investment.<sup>271</sup> Broadening the IRA provisions is consistent with that response and would obviate the need for the existing welter of deferred

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<sup>262</sup> See I.R.C. § 219 (1982).

<sup>263</sup> See *Proposal*, *supra* note 245, at 340-41.

<sup>264</sup> For a description of the restrictions and requirements associated with IRAs, see Lipsig, *Individual Retirement Arrangements* [1984] TAX MGMT. (BNA) No. 355.

<sup>265</sup> See *Proposal*, *supra* note 245, at 317-18.

<sup>266</sup> See I.R.C. § 408(f) (1982).

<sup>267</sup> See *supra* text accompanying notes 23-49 for a discussion of ESOP requirements.

<sup>268</sup> See *supra* text accompanying notes 84-193.

<sup>269</sup> See, e.g., I.R.C. § 38 (1982) (investment tax credit); I.R.C. § 613 (1982) (percentage depletion); I.R.C. § 1202 (1982) (capital gains deduction); I.R.C. § 168 (1982) (accelerated depreciation).

<sup>270</sup> See *supra* text accompanying notes 4-5 and 84-91.

<sup>271</sup> See R. HALL & A. RABUSHKA, *supra* note 4; Doernberg, *supra* note 4.

compensation arrangements, each with their special tax advantages and concomitant economic distortions.<sup>272</sup> Moreover, the heart of the ESOP provisions—the deduction to the employer and deferral by the employee-shareholders—can be realized through the already existing IRA concept without the distorting tax advantages presently associated with the ESOP provisions.

Would expanding the IRA provisions (or adopting a full fledged consumption tax) lead to greater worker capitalism and productivity, a goal of ESOP proponents? This is, of course, a complicated question. But there is a direct, revealing response. Workers given cash compensation will vote with their dollars. Some dollars will go to current consumption, some to investments in the employer's stock and some to outside investments. Just as employees would be free to vote with their dollars, employers convinced that worker productivity does increase with employee ownership could insist on compensating workers in part with the employer's stock. The market would then determine whether employees would choose such a compensation package or would opt for alternative packages (perhaps all cash) offered by the employer's competitors.

In any case, it is clear that at any given level of compensation firms will choose that compensation package which attracts the most productive employees. Thus, removing ESOP restrictions will lead to greater worker productivity, if not greater worker capitalism. If worker capitalism is inconsistent with worker productivity, no amount of regulation will cause that inconsistency miraculously to disappear.

The distortion of the taxpayer's consumption/investment decision which is caused by the income tax<sup>273</sup> could be eliminated by moving to a consumption tax (which would allow a deduction for investment). This, in turn, would eliminate the need for special legislation designed to increase worker productivity and worker capitalism. Unless ESOP proponents can point to some sort of market failure to support the tax policies currently in place, we suggest that employers and employees determine in the free market the appropriate level of employee stock ownership rather than the Congress through tax incentives.

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<sup>272</sup> See *Proposal*, *supra* note 245, at 339–82.

<sup>273</sup> See *supra* text accompanying notes 83–91.





# NOTE

## EXPLORING THE LIMITS OF LEGAL DUTY: A UNION'S RESPONSIBILITIES WITH RESPECT TO FETAL PROTECTION POLICIES

PATRICIA A. TIMKO\*

*Fetal protection policies—policies limiting or prohibiting the placement of women in certain jobs—are ostensibly adopted to protect fetuses from exposure to harmful substances in the mother's workplace. Existing federal health and safety regulations provide little guidance in this area, leaving the choice of adoption and content of workplace fetal protection policies primarily to the employer. Critics argue that many such policies merely mask impermissible sex discrimination. Three Courts of Appeals have adapted traditional Title VII law to deal with these challenges, suggesting that some fetal protection policies may indeed be discriminatory.*

*This Note analyzes recent judicial decisions, as well as existing labor law, to determine the extent to which labor unions are required to challenge potentially discriminatory fetal protection policies. The author concludes that Title VII and the union's duty of fair representation do require unions to investigate fetal protection grievances and to suggest alternatives to discriminatory exclusion policies. The union obligation to oppose potentially discriminatory policies does not extend, however, to calling strikes, filing lawsuits, or other more active responses. While applauding further voluntary union action, the author argues that unions may not possess the resources or the mandate to become more deeply involved in the complicated fetal protection policy issue.*

Fetal protection policies typically ban all women of childbearing capacity from jobs involving exposure to substances considered unsafe for fetuses.<sup>1</sup> These policies, which are usually instituted by employers, raise questions about the adequacy of the federal regulatory schemes designed to protect the health

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<sup>1</sup> Some fetal protection policies ban only women who are already pregnant. See *Hayes v. Shelby Memorial Hosp.*, 726 F.2d 1543, 1546 (11th Cir. 1984); *Zuniga v. Kleberg County Hosp.*, 692 F.2d 986, 988 (5th Cir. 1982). The term "fetal protection policy" could also be used to describe a policy prohibiting the employment of both fertile men and women from jobs involving exposure to substances that harm fetuses or that damage male or female reproductive cells in ways causing harm to the offspring of exposed individuals. Such a policy would be a logical outgrowth of the scientific data in this area, see *infra* notes 37-47 and accompanying text, and might be socially desirable. See *Hayes*, 726 F.2d at 1550 n.11. The most troubling policies, however, and those most common in major industries, ban all women of childbearing capacity from a range of jobs. See *Williams, Firing the Woman to Protect the Fetus: The Reconciliation of Fetal Protection with Employment Opportunity Goals under Title VII*, 69 GEO. L.J. 641, 642 n.11 (1981).

and safety of workers, to prevent employment discrimination, and to promote harmonious relations between labor and management.<sup>2</sup> The lack of comprehensive regulation in the area of reproductive hazards<sup>3</sup> has led some women employees to oppose individual policies as over- or under-inclusive, scientifically unsupported, and sexually discriminatory.<sup>4</sup> Recent lawsuits brought by these women under Title VII of the Civil Rights Act of 1964 have triggered intense judicial scrutiny of the necessity for, and alternatives to, fetal protection policies.<sup>5</sup>

Although much of the litigation concerning fetal protection policies has involved workers in unionized production jobs,<sup>6</sup> labor unions have not played a very significant role in either developing or challenging fetal protection policies.<sup>7</sup> The complexity of the scientific data involved, the unsettled state of the law governing the legality of the policies, and the ill-defined scope of a labor union's legal duty to challenge an arguably discriminatory policy may explain union reluctance to address this issue.

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<sup>2</sup> The policies also raise difficult questions about the relationship between maternal and fetal rights. This Note focuses only on the relationship between women of child-bearing capacity and third parties—employers, unions, and the federal government—under our existing legal scheme. The creation and application of a new, coherent legal framework for fetal rights is beyond the scope of this discussion.

<sup>3</sup> The Equal Employment Opportunity Commission (EEOC) and the Federal Office of Contract Compliance (FOCC) have unsuccessfully attempted to promulgate standards for fetal protection programs. See *infra* notes 94–111 and accompanying text. Existing health and safety regulatory schemes are not adequate to handle the problem. See *infra* text accompanying notes 58–93.

<sup>4</sup> See *infra* notes 18–25 and accompanying text.

<sup>5</sup> See *Hayes*, 726 F.2d at 1553–54 (firing pregnant x-ray technician violated Title VII because of availability of alternative safety measures); *Wright v. Olin Corp.*, 697 F.2d 1172, 1191 (4th Cir. 1982) (employer must justify fetal protection policy in industrial production by comparison with other safety alternatives); *Zuniga*, 692 F.2d at 992–93 (firing pregnant x-ray technician violated Title VII because less discriminatory alternatives were available).

<sup>6</sup> American Cyanamid's highly publicized policy, see *infra* note 8, was implemented in the company's Willow Island, West Virginia plant, where workers were represented by the Oil, Chemical and Atomic Workers International Union. See *Oil, Chemical, & Atomic Workers Int'l Union v. American Cyanamid Co.*, 741 F.2d 444 (D.C. Cir. 1984). The plaintiff in *Wright* worked in a factory represented by the United Paperworkers International Union. See *Wright*, 697 F.2d at 1176 n.1. Another major company with a fetal protection policy, General Motors, bargains with the United Automobile Workers. See Swinton, *Regulating Reproductive Hazards in the Workplace: Balancing Equality and Health*, 33 U. TORONTO L.J. 45, 60 (1983).

<sup>7</sup> See Swinton, *supra* note 6, at 68. In *Wright*, 697 F.2d at 1176 n.1, the union was joined as a co-defendant. The union did not file an appellate brief, however, even though the case was one of first impression. *Id.* at 1184. One exception to the general pattern of union ambivalence toward fetal protection policies is the Oil, Chemical, and Atomic Workers International Union, which brought an unsuccessful Occupational Safety and Health Act (OSH Act) challenge to American Cyanamid's policy. See *American Cyanamid*, 741 F.2d 444.

This Note first describes the basic features of fetal protection policies, the scientific support for such programs, and the failure of federal health and safety regulatory regimes to deal with reproductive hazards. Then, the questionable validity of the policies under current Title VII law will be discussed. Finally, the Note analyzes a union's legal duties with respect to fetal protection policies under the duty of fair representation and Title VII.

It is unlikely that the federal government will soon create a comprehensive regulatory scheme for reproductive hazards. Affected employees will continue to resort to individual Title VII lawsuits to obtain governmental scrutiny of an employer's fetal protection policy. Recent judicial decisions indicate that these challenges may succeed because the policies are not scientifically supported or because less discriminatory alternatives to the exclusion of women exist. A union's decision to participate actively in such challenges is highly discretionary. The judiciary should not undercut that discretion. Voluntary union involvement, however, is desirable from many perspectives: those of employees of both sexes, the union, and society generally. This Note concludes that such involvement should be encouraged.

## I. FACTUAL BACKGROUND

### A. *A Description of Fetal Protection Programs*

In 1978, five female employees at American Cyanamid's plant in Willow Island, West Virginia, underwent voluntary surgical sterilizations. The women were sterilized to avoid losing their jobs under American Cyanamid's fetal protection policy.<sup>8</sup> That policy prohibited female employees between the ages of sixteen and fifty<sup>9</sup> "from being assigned to, bidding into, or holding any production job at that plant which involved occupational expo-

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<sup>8</sup> *Oil, Chemical & Atomic Workers Int'l Union v. Occupational Safety & Health Review Comm'n*, 671 F.2d 643, 645 (D.C. Cir. 1982), *cert. denied*, 459 U.S. 905 (1982). American Cyanamid's policy received national press attention. *See, e.g.*, Bronson, *Issue of Fetal Damage Stirrs Women Workers at Chemical Plants*, *Wall St. J.*, Feb. 9, 1979, at 1, col. 1 [hereinafter cited as Bronson, *Issues of Fetal Harm*]; Bronson, *Chemical Firms Move to Protect Women from Substances That May Harm Fetuses*, *Wall St. J.*, Nov. 7, 1977, at 7, col. 1 [hereinafter cited as Bronson, *Chemical Firms*].

<sup>9</sup> *Oil, Chemical & Atomic Workers Int'l Union v. American Cyanamid Co.*, 741 F.2d 444, 446 (D.C. Cir. 1984).

sure to toxic substances identified as harmful to the fetus," unless they had been surgically sterilized.<sup>10</sup> Another well-known policy regulates employment at Olin Corporation's cigarette packaging plant in Pisgah Forest, North Carolina.<sup>11</sup> Under Olin's plan, jobs are classified into three groups: restricted jobs, which women aged five through sixty-three may not perform unless they can prove that they are incapable of having children; controlled jobs, which pregnant women may perform only after individual evaluation and clearance, and which non-pregnant women may perform only after signing a statement recognizing the risks involved; and unrestricted jobs, which are open to everyone.<sup>12</sup>

American Cyanamid and Olin Corporation are not unique. B.F. Goodrich instituted a similar policy regarding exposure to vinyl chloride.<sup>13</sup> Other major companies, such as Allied Chemical, Dow Chemical, DuPont, Firestone, General Motors, Good-year, Gulf Oil, Monsanto, and Sun Oil have had or currently do have fetal protection policies.<sup>14</sup> The issue has also arisen with respect to medical technicians working with x-rays<sup>15</sup> or with common anesthetic gases.<sup>16</sup> Because as many as twenty million jobs potentially involve reproductive hazards,<sup>17</sup> the existing policies may foreshadow a widespread employment practice.

Fetal protection policies have been criticized by legal com-

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<sup>10</sup> *Oil, Chemical & Atomic Workers*, 671 F.2d at 645.

<sup>11</sup> Although the popular press has not covered Olin Corporation's fetal protection policy as extensively as it did that of American Cyanamid, Olin's policy has been discussed at length in legal literature because it was the subject of the landmark case on fetal protection policies. See, e.g., Note, *Wright v. Olin Corp.: Title VII and the Exclusion of Women from the Fetally Toxic Workplace*, 62 N.C.L. REV. 1068 (1984) [hereinafter cited as Note, *Exclusion of Women*]; Note, *Fetal Vulnerability and the 1978 Pregnancy Amendments: Wright v. Olin Corp.*, 19 WAKE FOREST L. REV. 905 (1983) [hereinafter cited as Note, *Fetal Vulnerability*]; Case Comment, *Fetal Vulnerability Plan: Disparate Treatment Absent Intent*, 36 S.C.L. REV. 179 (1985); Case Comment, *The Legality of Fetal Protection Policies Under Title VII: Wright v. Olin Corp.*, 34 SYRACUSE L. REV. 1131 (1983).

<sup>12</sup> *Wright*, 697 F.2d at 1182.

<sup>13</sup> See *Doerr v. B.F. Goodrich Co.*, 484 F. Supp. 320, 321 (N.D. Ohio 1979).

<sup>14</sup> Rothstein, *Reproductive Hazards and Sex Discrimination in the Workplace: New Legal Concerns in Industry and On Campus*, 10 J. COLLEGE & U.L. 495, 509 (1984).

<sup>15</sup> See *Hayes v. Shelby Memorial Hosp.*, 726 F.2d 1543 (11th Cir. 1984); *Zuniga v. Kleberg County Hosp.*, 692 F.2d 986 (5th Cir. 1982).

<sup>16</sup> See Valentine & Plough, *Protecting the Reproductive Health of Workers: Problems in Science and Public Policy*, 8 J. HEALTH POL., POL'Y & L. 144, 149 (1983).

<sup>17</sup> Introduction to Proposed Interpretive Guidelines on Employment Discrimination and Reproductive Hazards, 45 Fed. Reg. 7514 (1980), *withdrawn*, 46 Fed. Reg. 3916 (1981) [hereinafter cited as Proposed Guidelines].

mentators,<sup>18</sup> affected employees,<sup>19</sup> and even the federal government.<sup>20</sup> Most critics recognize the important societal interest in protecting fetuses from birth defects caused by toxic chemicals.<sup>21</sup> They argue, however, that fetal protection policies do not achieve fetal safety, and merely mask impermissible sex discrimination. First, critics argue that the plans are underinclusive because they do not address the danger posed to the offspring of male workers<sup>22</sup> and do not extend to cover exposure of women workers in traditionally female jobs.<sup>23</sup> Second, critics contend that the programs are overinclusive in that they assume that any fertile woman might become pregnant, despite conscientious use of effective birth control.<sup>24</sup> Opponents of the policies conclude, therefore, that fetal protection programs are merely an excuse for barring women from traditionally male jobs.<sup>25</sup>

Defenders of fetal protection policies respond by emphasizing that substantially lower levels of workplace substances are required to harm a fetus through maternal exposure than to harm male reproductive cells or pregnant spouses through the transportation of substances into the home.<sup>26</sup> They also state that

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<sup>18</sup> See, e.g., Williams, *supra* note 1, at 653-65; Rothstein, *supra* note 14, at 509-11; Ashford & Caldart, *The Control of Reproductive Hazards in the Workplace: A Prescription for Prevention*, 5 INDUS. REL. L.J. 523, 534-35, 543-47 (1983); Furnish, *Prenatal Exposure to Fetally Toxic Work Environments: The Dilemma of the 1978 Pregnancy Amendment to Title VII of the Civil Rights Act of 1964*, 66 IOWA L. REV. 63, 64-67, 115-19 (1980); J. Bertin, *Potential Discriminatory Effects of Human Monitoring*, 1-6 (May 24, 1983) (paper presented at the American Industrial Hygiene Conference, Philadelphia, Pa.) [on file at HARV. J. ON LEGIS.].

<sup>19</sup> See, e.g., *Oil, Chemical & Atomic Workers*, 741 F.2d 444; *Wright*, 697 F.2d 1172; *Christman v. American Cyanamid*, 578 F. Supp. 63 (N.D. W. Va. 1983); *Doerr*, 484 F. Supp. 320.

<sup>20</sup> See Proposed Guidelines, *supra* note 17, at 7514-15.

<sup>21</sup> See, e.g., Williams, *supra* note 1, at 645; Furnish, *supra* note 18, at 105-09. But see Otten, *Women's Rights vs. Fetal Rights Looms as a Thorny and Divisive Issue*, Wall St. J., Apr. 12, 1985, at 31, col. 4 (feminist attorney questioning interest in fetus of anyone but mother).

<sup>22</sup> See, e.g., Howard, *Hazardous Substances in the Workplace: Implications for the Employment Rights of Women*, 129 U. PA. L. REV. 798, 803-06 (1981); Williams, *supra* note 1, at 657 & nn.102-03; see also Proposed Guidelines, *supra* note 17, at 7515 (arguing that employers do not exhibit concern for men).

<sup>23</sup> See, e.g., J. Bertin, *supra* note 18, at 2-3 & n.1 (if employers were really concerned with fetal health, women would be excluded not only from traditionally male jobs but also from traditionally female jobs, such as textile laboratory work, which hold the potential for fetal harm).

<sup>24</sup> See Rothstein, *supra* note 14, at 510.

<sup>25</sup> See, e.g., J. Bertin, *supra* note 18, at 3.

<sup>26</sup> See *Wright v. Olin Corp.*, 585 F. Supp. 1447, 1451 (W.D.N.C. 1984) [hereinafter cited as *Wright II*]; Williams, *supra* note 1, at 657 & nn.102-03 (harm to pregnant women and their fetuses from exposure to hazardous substances on workers' clothes or hair is well-documented; unconfirmed theories suggest harm could result from vaginal

studies linking chemicals to harm to the offspring of male workers are inconclusive, whereas the harmful effects of chemicals on pregnant women and their fetuses have been proven.<sup>27</sup> Finally, proponents argue that the most severe harm occurs in the first few weeks of fetal development, before a woman knows she is pregnant.<sup>28</sup> Consequently, they conclude that nothing short of a total ban on female employment in particularly hazardous jobs fully protects fetuses.<sup>29</sup>

Both the opponents and the proponents of fetal protection policies can cite scientific literature to support their arguments. The validity of their claims depends largely on the nature and amount of the particular chemical to which workers are exposed. A brief explanation of the scientific background is therefore necessary for an understanding of the reproductive hazards that existing fetal protection policies do and do not address.

### B. *A Summary of the Relevant Science*

A large number of workplace chemicals, including lead, benzene, and vinyl chloride may harm fetuses.<sup>30</sup> These chemicals may interfere with a fetus' normal development in up to three different ways: as fetal toxins, teratogens, and/or mutagens. A fetal toxin penetrates the placenta and poisons the fetus, causing either spontaneous abortion, stillbirth, or birth defects.<sup>31</sup> A teratogen passes through the placenta to the fetus or alters the mother's physiology so as to retard or alter fetal development. This interference in normal growth can cause deformities, dis-

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absorption of exposed workers' seminal fluid during intercourse); Rothstein, *supra* note 14, at 511-12.

<sup>27</sup> See *Wright II*, 585 F. Supp. at 1451-52; Rothstein, *supra* note 14, at 511.

<sup>28</sup> See *Wright II*, 585 F. Supp. at 1450.

<sup>29</sup> *Id.*

<sup>30</sup> Although these three substances are the most commonly identified hazards, the list of hazardous substances is substantially longer. See Proposed Guidelines, *supra* note 17, at 7514; Williams, *supra* note 1, at 647-48. For a chart indicating the most common effects on fetuses of maternal and paternal exposure to a number of substances, see Buffler, *Some Problems Involved in Recognizing Teratogens Used in Industry*, in *EPIDEMIOLOGICAL METHODS FOR THE DETECTION OF TERATOGENS* 118, 124-25 (M.A. Klingberg & S.A.C. Weatherall, eds. 1977). For a chart of common hazards by occupation, see J. STELLMAN, *WOMEN'S WORK, WOMEN'S HEALTH: MYTHS AND REALITIES* 158-59 (1977).

<sup>31</sup> Ashford & Caldart, *supra* note 18, at 524-25.

ease, and death.<sup>32</sup> A mutagen may cause birth defects or fetal death in the offspring of exposed workers by altering the genetic structure of the male or female reproductive cells.<sup>33</sup> Serious harm from fetal toxins and teratogens may occur in the early weeks of fetal life, before a woman knows she is pregnant.<sup>34</sup> Exposure to a mutagen, however, may endanger the health of workers' offspring even before conception.<sup>35</sup>

Fetal protection policies, which prohibit maternal but not paternal exposure, are aimed at controlling fetal toxins and teratogens.<sup>36</sup> At sufficiently high levels of exposure, one chemical may have fetally toxic, teratogenic, and mutagenic effects.<sup>37</sup> The policies do not address the mutagenic effects, however. To the extent that a workplace chemical at a given level of exposure is a mutagen as well as a fetal toxin and/or a teratogen, existing fetal protection policies are underinclusive. They fail to protect a male worker's potential offspring from damage resulting from their father's exposure to dangerous chemicals.

The transportation of dangerous chemicals into the home increases the danger posed to the children of exposed workers of both sexes. Substances that are not mutagens may nevertheless harm the offspring of male workers by being transported into the home or transmitted to the worker's partner through sexual intercourse.<sup>38</sup> The levels of home exposure may be lower than

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<sup>32</sup> *Id.* at 525. For an understandable overview of the biological effects of teratogens, see Harbison, *Teratogens*, in CASARETT AND DOULL'S TOXICOLOGY: THE BASIC SCIENCE OF POISONS 158 (Doull, Klaassen, & Amdur 2d ed. 1980) [hereinafter cited as CASARETT AND DOULL'S TOXICOLOGY].

<sup>33</sup> Ashford & Caldart, *supra* note 18, at 525. For a scientific overview of the workings of mutagens, see Thilly & Liber, *Genetic Toxicology* in CASARETT AND DOULL'S TOXICOLOGY, *supra* note 32, at 139-57.

<sup>34</sup> Harbison, *supra* note 32, at 160-61.

<sup>35</sup> Thilly & Liber, *supra* note 33, at 139, 155.

<sup>36</sup> See, e.g., *Wright v. Olin Corp.*, 697 F.2d 1172, 1182 (4th Cir. 1982) (defining restricted jobs as those exposing a worker to abortifacients and teratogens, not to mutagens).

<sup>37</sup> Vinyl chloride is the best example of a substance that causes harm both through maternal exposure and through mutation of paternal germ cells. See Wagoner, *Genetic Effects Associated with Industrial Chemicals* in CONFERENCE ON WOMEN AND THE WORKPLACE 100, 109 (E. Bingham ed. 1976).

<sup>38</sup> Studies have linked the higher incidence of spontaneous abortions in the wives of male dentists to the transfer of anesthetic gases into the home. Valnio, Sorsa & Hemminki, *Biological Monitoring in Surveillance of Exposure to Genotoxicants*, in REPRODUCTIVE TOXICOLOGY 87, 95-96 (D. Mattison ed. 1983). The transmission of substances to the wives of workers through seminal fluid has also been hypothesized. See Manson & Simon, *Influence of Environmental Agents on Male Reproductive Failure* in WORK AND HEALTH OF WOMEN 171, 332-33 (V. Hunt ed. 1979), cited in Williams, *supra* note 1, at 657 n.103.

those at the workplace, however, and harmful effects vary significantly with exposure levels.<sup>39</sup>

Effects also vary according to the age and physical condition of the subject, thus complicating the task of regulating exposure to workplace chemicals. Lead, a known fetal toxin and teratogen, and a suspected mutagen,<sup>40</sup> provides an excellent illustration of this problem. The presence of lead in the blood at levels of up to 40 micrograms/100 grams is legally acceptable as reasonably safe for adult workers.<sup>41</sup> Concentrations of lead above 30 micrograms/100 grams, however, are considered potentially hazardous for expectant mothers,<sup>42</sup> and concentrations as low as 25 micrograms/100 grams have been found to have adverse effects on children.<sup>43</sup> These different safety levels lend credence to supporters of fetal protection policies who argue that potentially pregnant women can be harmed in workplaces considered safe for men.

Although scientists can identify the effects of lead on human health, they know little about the consequences of exposure to many other workplace chemicals. Scientific inquiry into reproductive hazards has focused on females, particularly those in male-dominated occupations.<sup>44</sup> Uncertainty about the effects of many workplace chemicals on men is pervasive. Even with respect to pregnant women, uncertainty can persist for years while a study is being conducted.<sup>45</sup> In addition, data previously collected through retrospective human studies conducted without control groups may be inaccurate.<sup>46</sup> Alternatives to human testing, such as live animal testing and the development of microbial cultures, have become increasingly popular.<sup>47</sup> Still, it could take years to evaluate fully the reproductive hazards that

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<sup>39</sup> Harbison, *supra* note 32, at 163-64.

<sup>40</sup> Thomas & Brogan, *Some Actions of Lead on the Sperm and on the Male Reproductive System* in REPRODUCTIVE TOXICOLOGY 127 (D. Mattison ed. 1983).

<sup>41</sup> At 40 micrograms/100 grams, the employer is required to begin protective action. Occupational Safety & Health Standards for Lead, 29 C.F.R. § 1910.1025(j)(2)(iv) (1984).

<sup>42</sup> Occupational Exposure to Lead: Final Standard, 29 C.F.R. § 1910.1025 (1984).

<sup>43</sup> *Id.*

<sup>44</sup> Hemminki, Axelson, Nieme & Ahlberg, *Assessment of Methods & Results of Reproductive Occupational Epidemiology: Spontaneous Abortions & Malformations in the Offspring of Working Women* in REPRODUCTIVE TOXICOLOGY 293, 294 (D. Mattison ed. 1983); Thomas & Brogan, *supra* note 40, at 127.

<sup>45</sup> The Environmental Protection Agency (EPA) has taken up to two years to review a chemical that is a potentially dangerous substance. F. ANDERSON, D. MANDELKER & A. TARLOCK, ENVIRONMENTAL PROTECTION: LAW AND POLICY 527 (1984).

<sup>46</sup> See Valentine & Plough, *supra* note 16, at 150-51.

<sup>47</sup> *Id.* at 151-54.



currently exist, and decades to develop technologies to abate these harms. Because of these delays, the controversy over fetal protection policies becomes a question of what to do in the potentially lethal interim.

## II. THE FAILURE OF THE CURRENT REGULATORY REGIMES

Comprehensive federal regulation of fetal protection policies is not unthinkable. The federal government currently regulates both employment discrimination<sup>48</sup> and workplace hazards.<sup>49</sup> The government also has a widely recognized interest in fetal life and health. Even in *Roe v. Wade*, the Supreme Court identified a valid state interest in fetal health.<sup>50</sup> The key issue in *Roe v. Wade* was not whether the state had an interest, but at what point the state's interest overrode a woman's right to privacy.<sup>51</sup>

Federal intervention to protect fetuses from dangerous workplace chemicals can be distinguished from federal intervention in the context of abortion.<sup>52</sup> Because the state would be regulating the behavior of employers rather than the behavior of pregnant women, the compelling interest of maternal privacy that concerned the Court in *Roe v. Wade* is not implicated by regulation of workplace hazards. Unlike abortion, in which a woman makes a knowing decision to end fetal life, workplace hazards may harm a worker's reproductive system or unborn offspring without his or her knowledge or consent. Many employers currently make decisions about these dangers without consulting the affected workers or society. The federal government should

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<sup>48</sup> See Title VII of the Civil Rights Act of 1964 (as amended), 42 U.S.C. §§ 2000e to 2000e-17 (1982).

<sup>49</sup> See Occupational Safety and Health Act, 29 U.S.C. §§ 651-678 (1982) [hereinafter cited as OSH Act]; Toxic Substances Control Act 15 U.S.C. §§ 2601-2629 (1982) [hereinafter cited as TSCA].

<sup>50</sup> *Roe v. Wade*, 410 U.S. 113, 154 (1973).

<sup>51</sup> "A State may properly assert important interests in safeguarding health, in maintaining medical standards, and in protecting potential life. At some point in pregnancy, these respective interests become sufficiently compelling to sustain regulation . . . ." *Id.* at 154; see also Nothstein & Ayres, *Sex-Based Considerations of Differentiation in the Workplace: Exploring the Biomedical Interface between OSHA and Title VII*, 26 VILL. L. REV. 239, 315-16 (1981) (the state has an interest in preventing birth defects outside the abortion context).

<sup>52</sup> See *Wright v. Olin Corp.*, 697 F.2d 1172, 1189 n.25 (4th Cir. 1982) (distinguishing fetal protection regulation from the context of abortion); cf. Parness, *Crimes Against the Unborn: Protecting and Respecting the Potentiality of Human Life*, 22 HARV. J. ON LEGIS. 97, 97-103 (1985) (harm inflicted from outside sources differs fundamentally from abortion, and fetuses should be safeguarded from such harm, apart from their status in the abortion context).

intervene, if only to provide a balance to these decisions made unilaterally by the employer.

Such intervention has not been forthcoming. Despite the urgings of commentators<sup>53</sup> and courts,<sup>54</sup> the federal government has not implemented a comprehensive regulatory scheme addressing fetal protection. The lack of comprehensive federal regulation of harmful workplace substances or fetal protection policies is due to gaps in existing regulatory frameworks,<sup>55</sup> delays in scientific inquiry,<sup>56</sup> and the policies of the Reagan administration.<sup>57</sup> Affected employees must rely on workplace bargaining or individual lawsuits to influence employers' fetal protection decisions.

### A. *The Occupational Safety and Health Act*

The stated purpose of the Occupational Safety and Health Act (OSH Act) is to provide "safe and healthful working conditions and to preserve our human resources."<sup>58</sup> To achieve this goal, the OSH Act requires employers to adhere to mandatory safety and health standards<sup>59</sup> and to assume a general duty of ensuring workplace safety.<sup>60</sup> Although the scheme provides a mechanism for increasing workplace safety, the Occupational Safety and Health Administration (OSHA) has not adequately applied the OSH Act to the fetal protection problem.<sup>61</sup>

OSHA could regulate almost all of the fetal hazards to some degree. Mutagens, which harm employees' germ cells, are clearly regulable under the OSH Act. Because many chemicals simultaneously have mutagenic, teratogenic, and fetally toxic effects, a scheme that regulated mutagens would also encompass many teratogens and fetal toxins. To the extent that the presence

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<sup>53</sup> See, e.g., Furnish, *supra* note 18, at 115-19 (urging congressional amendment of Title VII); Note, *Exclusion of Women*, *supra* note 11, at 1090 (urging congressional action); cf. Note, *Occupationally Induced Cancer Susceptibility: Regulating the Risk*, 96 HARV. L. REV. 697, 708 (1983) (urging agency action to balance conflicting interests in cytogenetic testing).

<sup>54</sup> See, e.g., *Oil, Chemical & Atomic Workers Int'l Union v. American Cyanamid Co.*, 741 F.2d 444, 445 (D.C. Cir. 1984).

<sup>55</sup> See *infra* notes 64-83, 88-93, and accompanying text.

<sup>56</sup> See *supra* text accompanying notes 44-47; *infra* text accompanying note 90.

<sup>57</sup> See *infra* notes 64, 91, and accompanying text.

<sup>58</sup> OSH Act § 2(b), 29 U.S.C. § 651(b) (1982).

<sup>59</sup> *Id.* at § 5(a)(2), 29 U.S.C. § 654(a)(2).

<sup>60</sup> *Id.* at § 5(a)(1), 29 U.S.C. § 654(a)(1).

<sup>61</sup> For a general discussion of OSHA inadequacy, see Howard, *supra* note 22, at 808-10; Ashford & Cالدart, *supra* note 18, at 335-38.

of teratogens and fetal toxins causes mental or emotional injury to a parent, the OSH Act arguably covers these hazards as well.<sup>62</sup> Given this opportunity, OSHA should consider the potential harm to both the employee and his or her unborn child when promulgating standards.<sup>63</sup>

Although the hazards involved fall within OSHA's jurisdiction, the agency has taken action on only a few workplace toxins. Budget cuts, interagency rivalries, and inactive leadership have virtually halted the promulgation of new standards under the Reagan administration.<sup>64</sup> Consequently, there may currently be no standard establishing permissible workplace levels of a particular substance suspected of causing substantial harm.<sup>65</sup> Even if a standard exists, it may not provide enough protection for fetuses. Because OSHA standards must be "feasible,"<sup>66</sup> the agency may permit a level that is known to cause fetal harm and even some harm to adults.<sup>67</sup>

An employer does have a general duty under the OSH Act, apart from the responsibility of complying with existing OSHA standards, to provide a workplace "free from recognized hazards that are . . . likely to cause . . . serious physical harm to

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<sup>62</sup> Ashford & Caldart, *supra* note 18, at 531-32.

<sup>63</sup> At least one court has identified a responsibility on OSHA's part to promulgate rules expeditiously where unregulated chemicals threaten the health of workers' progeny. See Public Citizen Health Research Group v. Aucther, 702 F.2d 1150, 1157 (D.C. Cir. 1983).

<sup>64</sup> See Douglas, *Fear in Unknown Quantities*, STUDENT LAW., Mar. 1985, at 18, 21 (interagency squabbling causes delay); Trost, *Low Key Style of Labor Agency's Acting Chief Bolsters Complaints that Department is Adrift*, Wall St. J., Feb. 12, 1985, at 64, col. 2 (leadership problems cause delay). Although OSHA's purpose is to prevent accidents before they occur, see Whirlpool Corp. v. Marshall, 445 U.S. 1, 12-13 (1980), commentators state that the policy of the Reagan administration is to regulate a substance only after it has been linked to a number of cases of illness. See Valentine & Plough, *supra* note 16, at 159. Another knowledgeable commentator states that "OSHA has more than changed—it has been gutted." Ashford, *The Demise of the Occupational Safety and Health Administration*, in *Chemical Hazards at Work: Whose Business?*, 9 HARV. ENVTL. L. REV. 331, 339 (1985).

<sup>65</sup> Ethylene oxide is the most recent example of this problem. Although experts suspect that ethylene oxide in short bursts causes sterility, OSHA has deliberately decided not to promulgate standards for the chemical. See Trost, *supra* note 64, at 64, col. 3.

<sup>66</sup> OSH Act § 6(b)(5), 29 U.S.C. § 655(b)(5).

<sup>67</sup> The lead standard is an example of a standard influenced by the feasibility requirement. When the standard was promulgated, OSHA was aware that hazards to some individuals, such as expectant mothers, existed at levels below those designated as acceptable by the agency. Limiting lead exposure to these lower levels, however, was found to be technologically and economically infeasible. Consequently, the standard was set at a point presumed to be at least somewhat harmful to some workers. See Occupational Exposure to Lead: Final Standard, 29 C.F.R. § 1910.1025 (1984); see generally Furnish, *supra* note 18, at 70-74 (trade-offs made in promulgating lead standard).

his employees.”<sup>68</sup> Some commentators infer that the general duties clause could be construed to require employers to develop fetal protection policies.<sup>69</sup> Others argue that the clause bans such policies.<sup>70</sup> Both positions are insupportable.

Under the general duties clause, an employer must do everything feasible to reduce recognized hazards. Proponents of fetal protection policies might suggest that such policies are a feasible way to reduce harm and that employers must therefore enact them. There are two problems with this argument. First, the judicial gloss placed on the word “recognized” has imposed a general duty on employers to protect workers against technologically preventable harms.<sup>71</sup> “Prevention” has been interpreted as meaning the exclusion of the hazard,<sup>72</sup> not the exclusion of the employee.<sup>73</sup> Second, fetal protection policies as they currently exist may not go far enough to protect the offspring of male workers exposed to these chemicals.<sup>74</sup> Consequently, even if there were a general duty to remove workers from hazardous jobs, the policies currently in use would not meet that duty. Policies meeting that duty might involve hiring only sterile males and sterile or post-menopausal females. That, employers might argue, places an infeasible restriction on their hiring policies, which OSHA cannot require.<sup>75</sup>

Professor Nicholas Ashford and his associate Charles Caldart advance the opposite position. They argue that fetal protection policies inherently violate the general duties clause.<sup>76</sup> According

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<sup>68</sup> OSH Act § 5(a)(1), 29 U.S.C. § 654(a)(1).

<sup>69</sup> See, e.g., Nothstein & Ayres, *supra* note 51, at 268–70.

<sup>70</sup> See, e.g., Ashford & Caldart, *supra* note 18, at 534–35.

<sup>71</sup> National Realty & Constr. Co. v. Occupational Safety & Health Review Comm’n, 489 F.2d 1257, 1265–67 (D.C. Cir. 1973).

<sup>72</sup> *Id.* at 1266–67.

<sup>73</sup> See *id.* at 1266 (no suggestion that reckless employee must be fired); see generally Note, *Remedies for Sex Discriminatory Health and Safety Conditions in Male-Dominated Industrial Jobs*, 10 GOLDEN GATE U. L. REV. 1087, 1095–98, 1101–05 (1980) (pointing out that the limits of “recognized” hazards and “feasible” compliance create no general duty liability for certain workplace hazards) [hereinafter cited as Note, *Remedies for Health*]; Note, *Birth Defects Caused by Parental Exposure to Workplace Hazards: The Interface of Title VII with OSHA and Tort Law*, 12 U. MICH. J.L. REF. 237, 251–52 (1979) (arguing that if the harm to both sexes is technologically preventable, then OSHA and Title VII mesh to require an employer to clean up the workplace, and if it is not preventable, then there is no general duty for an employer to act because “Congress in passing OSHA did not intend to throw workers out of work”) [hereinafter cited as Note, *Birth Defects*].

<sup>74</sup> See *supra* notes 36–38 and accompanying text.

<sup>75</sup> See Williams, *supra* note 1, at 704. “A workplace composed exclusively of sterile men and women and post-menopausal women will be unappealing to most employers.” *Id.*

<sup>76</sup> See Ashford & Caldart, *supra* note 18, at 534–35.

to their position, such policies encourage sterilization and thereby constitute "hazards" to the reproductive capacity of female employees.<sup>77</sup> Even though the policies do not require sterilization, they leave little choice to employees with limited employment opportunities. Consequently, Ashford and Caldart argue that placing the burden of workplace safety on the employee violates the fundamental policy of the Act.<sup>78</sup>

Ashford and Caldart's theory was advanced unsuccessfully in *Oil, Chemical & Atomic Workers International Union v. American Cyanamid Co.*<sup>79</sup> The Court of Appeals for the District of Columbia Circuit recognized the "distressing choice"<sup>80</sup> facing female employees at American Cyanamid's Willow Island plant. The court held, however, that the word "hazard" in the general duties clause of the OSH Act was intended to cover only physical workplace conditions and could not be stretched to reach the consequences of a fetal protection policy.<sup>81</sup> Because American Cyanamid was already in compliance with OSHA's standard regarding lead levels in the workplace,<sup>82</sup> the court concluded that the workers' problem was simply beyond the scope of the OSH Act.<sup>83</sup>

### B. *The Toxic Substances Control Act*

The Toxic Substances Control Act<sup>84</sup> (TSCA) provides for pre-market testing of new chemicals and of existing chemicals identified shortly after the TSCA's enactment.<sup>85</sup> If a substance is suspected of presenting a "significant" risk to health, the Environmental Protection Agency (EPA) is empowered to take a number of actions, including regulating the substance.<sup>86</sup> TSCA by its terms permits EPA assessment of most, if not all, of the

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<sup>77</sup> *Id.* at 534.

<sup>78</sup> *Id.* at 535.

<sup>79</sup> 741 F.2d 444 (D.C. Cir. 1984).

<sup>80</sup> *Id.* at 445.

<sup>81</sup> *Id.* at 448-49.

<sup>82</sup> *Id.* at 446.

<sup>83</sup> *Id.* at 445, 449. In closing, the court suggested that Title VII may provide some relief for female employees. The employees had brought a Title VII suit, which was settled. *Id.* at 450 n.1.

<sup>84</sup> 15 U.S.C. §§ 2601-2629 (1982).

<sup>85</sup> F. ANDERSON, D. MANDELKER & A. TARLOCK, *supra* note 45, at 524; TSCA, 15 U.S.C. § 2603(a)(1)(A)(i).

<sup>86</sup> *See* TSCA § 4(f), 15 U.S.C. § 2603(f).

reproductive hazards which fetal protection policies purport to address.<sup>87</sup>

Despite its broad scope, TSCA's usefulness in dealing with fetal toxins, teratogens, and mutagens has been limited. The EPA has substantial discretion under the statute,<sup>88</sup> and the agency has tended to exercise this discretion to avoid active regulation.<sup>89</sup> The EPA has announced that it intends to regulate at most two or three substances per year, with relevant studies taking up to two years per substance to prepare.<sup>90</sup> The Office of Management and Budget under the Reagan administration has been relentless in criticizing the EPA's modest efforts to regulate dangerous chemicals.<sup>91</sup> Consequently, fetal toxins, mutagens, and teratogens have escaped regulatory review.

When the EPA does examine a chemical, it may consider the availability of substitutes and the economic consequences of regulation before making a pre-regulation determination that the chemical poses an "unreasonable risk."<sup>92</sup> Furthermore, the promulgation of regulations involves consideration not only of their economic consequences but also of the available level of technology.<sup>93</sup> A consideration of both these factors would probably lead to an acceptance of hazards that may not pose significant risks to employees but do pose grave risks to their unborn children.

### C. Regulation by the Equal Employment Opportunity Commission

After a flurry of publicity about fetal protection policies in the late 1970's,<sup>94</sup> the Equal Employment Opportunity Commis-

<sup>87</sup> *Id.* at § 4(b)(2)(A), 15 U.S.C. § 2603(b)(2)(A). "The . . . effects for which standards for the development of test data may be prescribed include . . . mutagenesis, teratogenesis, . . . and any other effect which may present an unreasonable risk of injury to health . . ." *Id.*

<sup>88</sup> Under TSCA § 4(f), 15 U.S.C. § 2603(f), the Administrator of the EPA is empowered to initiate "appropriate" action. This action may range from declaring that the risk is not "unreasonable," *id.*, to regulating the substance under TSCA § 6, 15 U.S.C. § 2605.

<sup>89</sup> See *Environmental Defense Fund, Inc. v. EPA*, 636 F.2d 1267, 1271, 1287 (D.C. Cir. 1980). See also F. ANDERSON, D. MANDELKER, A. TARLOCK, *supra* note 45, at 534. For an argument that agency inaction violates the mandate of TSCA § 4(f), 15 U.S.C. § 2603(f), see Ashford & Caldart, *supra* note 18, at 538-40.

<sup>90</sup> F. ANDERSON, D. MANDELKER & A. TARLOCK, *supra* note 45, at 527.

<sup>91</sup> Douglas, *supra* note 64, at 21.

<sup>92</sup> See *Environmental Defense Fund*, 636 F.2d at 1276-79.

<sup>93</sup> TSCA § 6(c)(1)(D), 15 U.S.C. § 2605(c)(1)(D).

<sup>94</sup> See, e.g., Bronson, *Issue of Fetal Damage*, *supra* note 8, at 1; Bronson, *Chemical Firms*, *supra* note 8, at 7.

sion (EEOC) and the Department of Labor attempted to set some guidelines for the policies.<sup>95</sup> Governmental regulation of the exclusion of women from the workplace seemed desirable.<sup>96</sup> In all respects, however, the proposed regulations were a dismal failure.

The EEOC's standards required an employer to write a facially neutral policy<sup>97</sup> which could be justified by a number of factors. These factors included scientific evidence,<sup>98</sup> compliance with OSHA regulations,<sup>99</sup> consistent application of the policy to all recognized reproductive hazards,<sup>100</sup> and the lack of viable alternatives to the exclusion of employees.<sup>101</sup> The standards provided for a temporary exclusion of the affected employees of up to two years while an employer completed the scientific studies necessary to justify the policy.<sup>102</sup> OSHA assistance was available to those employers unable to complete the research independently.<sup>103</sup>

The guidelines can be criticized both for what they included and for what they excluded.<sup>104</sup> The guidelines did not address employee and union involvement in fetal protection policies. They made no provision for the pay or seniority lost by excluded employees. The EEOC also professed a naive faith in the ability of all employers, regardless of size and sophistication, to make the required scientific assessments correctly and quickly. For example, the time frame for completion of scientific studies was unrealistic.<sup>105</sup> Moreover, the promise of OSHA assistance was illusory, particularly in light of OSHA's troubled past.<sup>106</sup> The most obvious flaw in the guidelines was their failure to explain how fetal protection plans fit into traditional Title VII analysis.<sup>107</sup> Because litigation had already been filed when the guidelines were written, this omission seems inexcusable. Although the

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<sup>95</sup> See Proposed Guidelines, *supra* note 17, at 7514.

<sup>96</sup> See *supra* text accompanying notes 48-57.

<sup>97</sup> Proposed Guidelines, *supra* note 17, at 7516 (policies which by their terms exclude employees on the basis of sex are not permitted).

<sup>98</sup> *Id.* at 7516-17.

<sup>99</sup> *Id.* at 7516.

<sup>100</sup> *Id.*

<sup>101</sup> *Id.* at 7516-17.

<sup>102</sup> *Id.* at 7517.

<sup>103</sup> *Id.*

<sup>104</sup> For particularly coherent criticism of the Proposed Guidelines, see Furnish, *supra* note 18, at 112-15.

<sup>105</sup> See *supra* text accompanying notes 44-47.

<sup>106</sup> See *supra* notes 64-67 and accompanying text.

<sup>107</sup> Furnish, *supra* note 18, at 114.

guidelines do not bind the courts,<sup>108</sup> the EEOC's thoughts on the problem merit employer and judicial consideration.

After wide criticism, the EEOC and the Department of Labor withdrew the guidelines within a year of their proposal.<sup>109</sup> The agencies offered no explanation for the withdrawal, merely stating that they had decided to review fetal protection policies on a case-by-case basis.<sup>110</sup> Intense EEOC scrutiny has not been forthcoming, however. The EEOC has generally limited its involvement to the issuance of right to sue notices.<sup>111</sup> Beyond the preliminary investigations, employees affected by employer-created protection policies are left to their own devices.

### III. CHALLENGES TO INDIVIDUAL FETAL PROTECTION POLICIES

Affected employees currently challenge fetal protection policies through sex discrimination lawsuits under Title VII.<sup>112</sup> The three Courts of Appeals that have considered fetal protection policies have significantly adapted traditional Title VII law in their analyses.<sup>113</sup> Although these adaptations have taken different forms, the decisions have all hinged on the validity of the scientific evidence supporting the policies and the feasibility of alternatives to worker exclusion.<sup>114</sup> When attempting to justify these policies, employers have uniformly borne a heavy bur-

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<sup>108</sup> See *General Electric Co. v. Gilbert*, 429 U.S. 125, 140-46 (1976); see also *Furnish*, *supra* note 18, at 113.

<sup>109</sup> *Withdrawal of Proposed Interpretive Guidelines on Employment Discrimination and Reproductive Hazards*, 46 Fed. Reg. 3916 (1981).

<sup>110</sup> *Id.*

<sup>111</sup> See Title VII § 706(f)(1), 42 U.S.C. § 2000e-5(f)(1) (1982); see, e.g., *Zuniga v. Kleberg County Hosp.*, 692 F.2d 986, 988 (5th Cir. 1982); cf. *Doerr v. B.F. Goodrich Co.*, 484 F. Supp. 320 (N.D. Ohio 1979) (case dismissed without prejudice for plaintiff's failure to receive right-to-sue notice). The EEOC did not play any role in the fetal protection aspect of *Wright v. Olin Corp.*, 697 F.2d 1172, 1178-79 (4th Cir. 1982). It did, however, participate as an amicus in *Hayes v. Shelby Memorial Hosp.*, 726 F.2d 1543, 1545 (11th Cir. 1984).

<sup>112</sup> The suits allege violations of Title VII § 703(a), 42 U.S.C. § 2000e-2(a) (1982). For an argument that traditional Title VII analysis is too disjointed to provide an acceptable solution to the problem of reproductive hazards, see Howard, *supra* note 22, at 843 n.209.

<sup>113</sup> See *Hayes v. Shelby Memorial Hosp.*, 726 F.2d 1543 (11th Cir. 1984); *Wright v. Olin Corp.*, 697 F.2d 1172 (4th Cir. 1982); *Zuniga v. Kleberg County Hosp.*, 692 F.2d 986 (5th Cir. 1982).

<sup>114</sup> See *Hayes*, 726 F.2d at 1550-54; *Wright*, 697 F.2d at 1190-91; *Zuniga*, 692 F.2d at 992-94.



den,<sup>115</sup> one which they have not always satisfied.<sup>116</sup> A basic understanding of these leading cases is crucial for evaluating the legality of a particular protection policy and the desirability of union involvement in challenging it.

### A. An Overview of Traditional Title VII Law

Traditional Title VII case law provides three analytic frameworks for categorizing improper discrimination.<sup>117</sup> The first framework applies to facial discrimination, which typically occurs when an employer declares that a job is open only to men.<sup>118</sup> In response to a claim of facial discrimination, an employer may assert the defense that sex is a bona fide occupational qualification (BFOQ).<sup>119</sup> The BFOQ defense is “extremely narrow,”<sup>120</sup> and protects only sex-based classifications that are “reasonably necessary to the normal operation of the business.”<sup>121</sup> The defense applies only when an employee’s sex renders him or her incapable of performing the job.<sup>122</sup>

The second framework applies to pretextual discrimination. An employer may refuse to hire or promote a woman, offering a “neutral” reason—some reason other than the employee’s

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<sup>115</sup> See, e.g., Vanderwaert, *Resolving the Conflict Between Hazardous Substances in the Workplace and Equal Employment Opportunity*, 21 Am. Bus. L.J. 157, 176 (1983); Rothstein, *supra* note 14, at 504; Note, *Birth Defects*, *supra* note 73, at 258; J. Bertin, *supra* note 18, at 9–10 (all arguing that employer will generally lose Title VII challenge to fetal protection policy under traditional analysis).

<sup>116</sup> The employers lost in both *Hayes*, 726 F.2d at 1553–54, and *Zuniga*, 692 F.2d at 994, because less discriminatory protective measures were possible. Although commentators have argued that *Wright* puts an extreme burden on the employer, see Rothstein, *supra* note 14, at 504, the company successfully justified its program on remand. See *Wright v. Olin Corp.*, 585 F. Supp. 1447 (W.D.N.C. 1984).

<sup>117</sup> See *Hayes v. Shelby Memorial Hosp.*, 726 F.2d 1543, 1547 (11th Cir. 1984). Although published before the recent court decisions dealing with fetal protection plans, Williams, *supra* note 1, at 665–703, offers an excellent analysis of the application of traditional Title VII doctrine to fetal protection cases.

<sup>118</sup> An example of a facially discriminatory policy is the policy at issue in *Dothard v. Rawlinson*, 433 U.S. 321 (1977), under which the Alabama prison system would hire only men to serve as guards in all-male prisons.

<sup>119</sup> See *Dothard v. Rawlinson*, 433 U.S. at 334–35; *Hayes v. Shelby Memorial Hosp.*, 726 F.2d at 1547; *Harris v. Pan American World Airways Inc.*, 649 F.2d 670, 674 & n.2 (9th Cir. 1980); B. SCHLEI & P. GROSSMAN, *EMPLOYMENT DISCRIMINATION LAW* 340–41 (2d ed. 1983).

<sup>120</sup> *Dothard*, 433 U.S. at 334.

<sup>121</sup> Title VII § 703(e), 42 U.S.C. § 2000e-2(e) (1982).

<sup>122</sup> *Hayes v. Shelby Memorial Hosp.*, 726 F.2d at 1549. In *Dothard* the Supreme Court rejected the BFOQ defense that “a particular job is too dangerous for women.” Rather, the Court focused on a woman’s ability to serve as a prison guard. *Dothard*, 433 U.S. at 335–36.

sex—as the basis for the decision. The employee or job applicant must then demonstrate that the proffered reason is a pretext for discrimination on the basis of sex.<sup>123</sup> The courts have refused to categorize fetal protection as a “neutral” reason meriting consideration under the pretextual discrimination framework.<sup>124</sup> Consequently, employees have not been required to prove that the policies are mere pretexts. Rather, once the policy is identified, the court’s analysis moves directly to the employer’s defense.<sup>125</sup>

Both facial discrimination and pretextual discrimination are cases of “disparate treatment,”<sup>126</sup> because the employer is charged with treating employees differently on the basis of their sex.<sup>127</sup> Intent is a necessary element of a successful disparate treatment claim, but the requisite motive may be inferred from a sufficient disparity in treatment.<sup>128</sup>

The third analytic framework applies to facially neutral policies which have a disparate impact, affecting one group more harshly than another.<sup>129</sup> Under a disparate impact approach, the court focuses not on the employer’s motivation, but on the consequences of his or her practices.<sup>130</sup>

<sup>123</sup> The Supreme Court set out the framework for finding pretextual discrimination in a hiring case, *McDonnell Douglas Corp. v. Green*, 411 U.S. 792 (1973). A plaintiff can establish a prima facie case of discriminatory treatment if she establishes that (i) she belongs to a group protected by Title VII; (ii) she applied for and was qualified for an open job; (iii) she was rejected; and (iv) the position remained open after the rejection and the employer continued to seek out applications from individuals with similar qualifications to those of the plaintiff. *Id.* at 802. Once the plaintiff establishes the existence of these factors, the defendant must “articulate some legitimate, non-discriminatory reason for the employee’s rejection.” *Id.* The plaintiff can then attempt to prove that the employer’s reason was merely a pretext for discrimination. *Id.* at 804–05. See also *Furnco Constr. Co. v. Waters*, 438 U.S. 567, 575–78 (1978).

<sup>124</sup> In *Wright v. Olin Corp.*, 697 F.2d 1172, 1185 n.20 (4th Cir. 1982), the Fourth Circuit claimed that pretextual analysis was a “wholly inappropriate” framework for the discussion. The Eleventh Circuit admitted that pretextual analysis may have some merit but refused to apply it because a rule admittedly based on pregnancy “can never be ‘neutral.’” *Hayes*, 726 F.2d at 1547 & n.5.

<sup>125</sup> See, e.g., *Wright*, 697 F.2d at 1185 n.20; *Hayes*, 726 F.2d at 1547–48.

<sup>126</sup> *Hayes*, 726 F.2d at 1547; *Williams*, *supra* note 1, at 669.

<sup>127</sup> See *International Bhd. of Teamsters v. United States*, 431 U.S. 324, 335 n.15 (1977).

<sup>128</sup> *Id.*

<sup>129</sup> See *Teamsters*, 431 U.S. at 335 n.15. The disparate impact theory was first enunciated in *Griggs v. Duke Power Co.*, 401 U.S. 424 (1971). In *Griggs*, the Court struck down an employer’s requirement of a high school diploma or a passing score on intelligence tests as a discriminatory barrier measuring skills unrelated to job performance. *Id.* at 431.

<sup>130</sup> See *Griggs*, 401 U.S. at 432. “Congress directed the thrust of the Act to the

"Business necessity" is the judicially created defense to a disparate impact claim.<sup>131</sup> This defense is perceived as being broader than the BFOQ defense.<sup>132</sup> Although the Supreme Court has not enunciated a detailed business necessity test, a number of other courts have adopted the formula developed by the Fourth Circuit in *Robinson v. Lorillard Corp.*<sup>133</sup> The court stated that the existence of a business necessity justifying a disparate impact on workers of different races hinges on:

whether there exists an overriding legitimate business purpose such that the practice is necessary to the safe and efficient operation of the business. Thus, the business purpose must be sufficiently compelling to override any racial impact; the challenged practice must effectively carry out the business purpose it is alleged to serve; and there must be available no acceptable alternative policies or practices which would better accomplish the business purpose advanced, or accomplish it equally well with a lesser differential racial impact.<sup>134</sup>

Courts have traditionally applied this formulation in cases involving sexually discriminatory disparate impact.<sup>135</sup> Some courts have also permitted employers to assert a business necessity defense in fetal protection cases.<sup>136</sup> The considerable judicial effort expended on creating a workable hybrid of the disparate impact/business necessity and facial discrimination/BFOQ frameworks<sup>137</sup> is laudable. Nevertheless, the courts have not yet developed a consistent Title VII analysis that adequately addresses the fetal protection issue.

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consequences of employment practices, not simply the motivation." *Id.* (emphasis in original).

<sup>131</sup> *Hayes*, 726 F.2d at 1547; *Harriss*, 649 F.2d at 674 & n.2; B. SCHLEI & P. GROSSMAN, *supra* note 119, at 359.

<sup>132</sup> See *Wright*, 697 F.2d at 1185 n. 21.

<sup>133</sup> 444 F.2d 791, 798 (4th Cir. 1971), *cert. dismissed*, 404 U.S. 1006-07 (1971). The frequency with which other circuits, as well as commentators, have relied on *Robinson* indicates the widespread acceptance of the test developed by the Fourth Circuit. See, e.g., *Zuniga v. Kleberg Hosp.*, 692 F.2d 986, 992 (5th Cir. 1982) (citing *Robinson*, 444 F.2d at 798); *Pettway v. American Cast Iron Pipe Co.*, 494 F.2d 211, 245 (5th Cir. 1974) (citing *Robinson*, 444 F.2d at 798); see also B. SCHLEI & P. GROSSMAN, *supra* note 119, at 359 & n.36; Bartholet, *Application of Title VII to Jobs in High Places*, 95 HARV. L. REV. 945, 951 & n.11 (1982) (citing *Robinson*, 444 F.2d at 798).

<sup>134</sup> *Robinson*, 444 F.2d at 798.

<sup>135</sup> See B. SCHLEI & P. GROSSMAN, *supra* note 119, at 359 & n.36.

<sup>136</sup> See, e.g., *Wright*, 697 F.2d at 1187-88.

<sup>137</sup> See *Id.* at 1184.

B. *The Title VII Framework in Fetal Protection Decisions*

## 1. Background Case Law

In *Wright v. Olin Corp.*, the Fourth Circuit properly approached the problem of fitting fetal protection cases into one of the conceptual frameworks developed in Title VII litigation as an open question.<sup>138</sup> The Supreme Court's two forays into employment benefits and pregnancy, *General Electric Co. v. Gilbert*,<sup>139</sup> and *Nashville Gas Co. v. Satty*,<sup>140</sup> had been superseded by passage of the Pregnancy Discrimination Act (PDA) in 1978.<sup>141</sup> In *Gilbert*, the Supreme Court refused to apply a disparate treatment analysis to a Title VII claim that a disability policy denying coverage for pregnancy was sexually discriminatory.<sup>142</sup> In *Satty*, the Court applied a disparate impact analysis and concluded that an employer's practice of requiring women to forfeit accumulated seniority when they returned from pregnancy leave was discriminatory,<sup>143</sup> because it imposed a burden on women alone in violation of Title VII.<sup>144</sup> The legislative history of the PDA indicates that Congress intended to overturn the *Gilbert* decision<sup>145</sup> and to make disparate treatment, in addition to disparate impact, available to claimants in pregnancy discrimination cases.<sup>146</sup> In 1983, the Supreme Court acknowledged this congressional intent in *Newport News Shipbuilding & Dry Dock Co. v. EEOC*.<sup>147</sup> When the Fourth Circuit approached the fetal protection policy question in the *Wright* case in late 1982, however, it had no Supreme Court guidance.<sup>148</sup>

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<sup>138</sup> *Id.*

<sup>139</sup> 429 U.S. 125 (1976).

<sup>140</sup> 434 U.S. 136 (1977).

<sup>141</sup> Pub. L. No. 95-955, 92 Stat. 2076 (1978), codified at 42 U.S.C. § 2000e(k) (1982).

<sup>142</sup> In *Gilbert*, the Court analogized the Title VII charge to a similar complaint under the Fourteenth Amendment which was decided in *Geduldig v. Aiello*, 417 U.S. 484 (1974). *Gilbert*, 429 U.S. at 133-36.

<sup>143</sup> *Satty*, 434 U.S. at 141-43 (1977).

<sup>144</sup> *Id.*

<sup>145</sup> See H.R. REP. NO. 948, 95th Cong., 2d Sess. 5, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 4749, 4753.

<sup>146</sup> *Id.* at 3, reprinted in 1978 U.S. CODE CONG. & AD. NEWS at 4751.

<sup>147</sup> 462 U.S. 669, 676 (1983) (holding that a health insurance plan which provided female employees, but not the spouses of male employees, with hospitalization benefits for pregnancy discriminated against male employees violated Title VII).

<sup>148</sup> The Fourth Circuit did look for guidance in *Burwell v. Eastern Airlines*, 633 F.2d 361 (4th Cir. 1980) cert. denied, 450 U.S. 966 (1980), a case involving mandatory pregnancy leave policies for stewardesses. See *Wright*, 697 F.2d at 1184, 1188-91. In *Burwell*, the court used a disparate impact analysis to decide that passenger safety provided a legitimate business necessity for grounding stewardesses after a certain point

## 2. Fetal Protection Decisions

Courts of appeals addressing the fetal protection policy question properly have focused their analysis on the scientific justifications for and the alternatives to the policies. *Zuniga v. Kleberg County Hospital* was the first appellate decision dealing with an avowed fetal protection decision.<sup>149</sup> *Zuniga* involved a pregnant x-ray technician dismissed from her job because of the possibility of harm to her fetus from radiation. Because the events took place before the PDA became effective,<sup>150</sup> the Fifth Circuit simply applied a *Satty* disparate impact analysis.<sup>151</sup> The court quickly decided that the plaintiff's claim presented a prima facie case of discrimination,<sup>152</sup> but had difficulty identifying an appropriate business necessity defense. In a footnote, the court suggested that although concern for fetal health alone was not a sufficient defense, the economic consequences of a potential tort suit on behalf of an injured fetus might provide the requisite business necessity.<sup>153</sup> The court did not have to determine what factors might have established a valid business necessity defense, however, because the employer had failed to use available protections that were less discriminatory than exclusion.<sup>154</sup> Consequently, exclusion of women was not "necessary,"<sup>155</sup> and the employer's defense was undermined.<sup>156</sup>

In *Wright v. Olin Corp.*, the Fourth Circuit constructed a different analytical framework, together with applicable de-

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in their pregnancies. *Burwell*, 633 F.2d at 373. A better-reasoned opinion on the same subject is *Harriss v. Pan American Airways, Inc.*, 649 F.2d 670 (9th Cir. 1980). See B. SCHLEI & P. GROSSMAN, *supra* note 119, at 356-60; cf. *Levin v. Delta Airlines, Inc.*, 730 F.2d 994, 996-97 (adopting *Harriss* analysis). In *Harriss*, the court applied a disparate impact/business necessity theory to activity taking place before the Pregnancy Discrimination Act of 1978 (PDA) was passed, *Harriss*, 649 F.2d at 676, and a facial discrimination/BFOQ framework to post-PDA conduct, *id.* at 676-77. The court held that passenger safety provided both a business necessity, *id.* at 676, and a BFOQ defense, *id.* at 676-77. Because the passenger safety rationale was available, neither court decided the question of whether fetal safety alone justified grounding pregnant stewardesses. See *Burwell*, 633 F.2d at 371 (dismissing fetal safety argument).

<sup>149</sup> 692 F.2d 986 (5th Cir. 1982). *Zuniga* was decided on December 6, 1982. *Id.* The *Wright* decision, which also involved appellate court analysis of a fetal protection policy, was decided a little over two weeks later. See *Wright v. Olin Corp.*, 697 F.2d 1172 (4th Cir. 1982).

<sup>150</sup> *Zuniga*, 692 F.2d at 989 n.6.

<sup>151</sup> *Id.* at 989-91.

<sup>152</sup> See *id.* at 991 n.8. "It is difficult to conceive of a more straightforward prima facie case of sex discrimination under 703(a)(2)." *Id.*

<sup>153</sup> *Id.* at 992 n.10.

<sup>154</sup> *Id.* at 992.

<sup>155</sup> *Id.* at 992, 994.

<sup>156</sup> *Id.* at 994.

fenses. *Wright* involved both pre-PDA and post-PDA behavior for which there were few, if any, alternatives. The court chose to apply a disparate impact/business necessity scheme to Olin's fetal protection policy to cover both pre-PDA and post-PDA conduct.<sup>157</sup> The court rejected the facial discrimination/BFOQ framework because it perceived a properly limited BFOQ defense as too confining for the defense that Olin was "entitled to present."<sup>158</sup> Because the critical feature of Olin's policy was its consequences, not the employer's intent, the court concluded that an impact analysis was appropriate.<sup>159</sup>

The Fourth Circuit then outlined the elements of the business necessity defense. First, the court considered the *Robinson* formulation of the defense,<sup>160</sup> focusing on the "safe" operation of the business as a necessity.<sup>161</sup> The court then extended the passenger safety rationale from the context of airlines<sup>162</sup> to recognize an employer's duty of care to all invitees and licensees legitimately on an employer's property, including fetuses carried by employees as a "special category" within that class.<sup>163</sup> An employer, the court declared, can establish the requisite business necessity by demonstrating that a particular hazard caused harm through maternal, but not paternal exposure.<sup>164</sup> The employer is required to present a significant body of scientific opinion in support of this proposition,<sup>165</sup> not merely a subjective good faith belief that harm would result from maternal exposure.<sup>166</sup> The plaintiff can undermine the business necessity defense by proving the existence of "acceptable alternatives" to exclusion.<sup>167</sup> The court then remanded the case for development of the relevant scientific facts.<sup>168</sup> Despite the predictions of com-

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<sup>157</sup> *Wright*, 697 F.2d at 1185.

<sup>158</sup> *Id.* at 1185 n.21. The court admitted that facial discrimination analysis applied to the case but it chose to proceed on an impact theory.

<sup>159</sup> *See id.* at 1186. The court carefully explained that the technical facial neutrality of Olin's policy did not influence its choice of the disparate impact/business necessity theory. *Id.*

<sup>160</sup> *See supra* text accompanying note 134.

<sup>161</sup> *Wright*, 697 F.2d at 1188.

<sup>162</sup> *See supra* note 148.

<sup>163</sup> *Wright*, 697 F.2d at 1189.

<sup>164</sup> *Id.* at 1190.

<sup>165</sup> *Id.* at 1191.

<sup>166</sup> *Id.* at 1190.

<sup>167</sup> *Id.* at 1191 (citing *Robinson*). Placement of this burden on the plaintiff was an adaptation of Fourth Circuit precedent to accommodate recent developments in the Supreme Court. *Id.*

<sup>168</sup> *Id.* at 1192.

mentators,<sup>169</sup> on remand *Olin* successfully established a business necessity defense.<sup>170</sup>

In *Hayes v. Shelby Memorial Hospital*,<sup>171</sup> the Eleventh Circuit expanded the *Wright* analysis<sup>172</sup> and addressed *Zuniga's* dicta concerning business necessity.<sup>173</sup> *Hayes*, like *Zuniga*, involved a pregnant x-ray technician dismissed on the grounds that workplace radiation might harm her fetus.<sup>174</sup> Because the activities in *Hayes*, unlike those in *Zuniga*, occurred after passage of the PDA, the Eleventh Circuit was required to construct a new analytic framework. The *Hayes* analysis, like the test in *Wright*, ultimately rested on an employer's showing of scientific proof and a lack of alternatives to exclusion.<sup>175</sup> The Eleventh Circuit's analytic framework, however, was fairly novel.

The *Hayes* court began by establishing a rebuttable presumption that a fetal protection policy is facially discriminatory.<sup>176</sup> The employer can rebut the presumption by showing that a substantial risk of fetal harm resulted from the exposure of fertile women, but not from the exposure of men to the given substance.<sup>177</sup> If the employer does not meet this burden, the presumption of facial discrimination stands, and the employer's only defense is the BFOQ claim.<sup>178</sup> Because the female employee will generally be able to perform her job,<sup>179</sup> the BFOQ defense will fail, and the employer will be subject to liability for the program. If the employer does rebut the presumption of facial discrimination, the plaintiff still has an "automatic prima

<sup>169</sup> See, e.g., J. Bertin, *supra* note 18, at 9-10; Rothstein, *supra* note 14, at 504.

<sup>170</sup> See *Wright v. Olin Corp.*, 585 F. Supp. 1447 (W.D.N.C. 1984).

<sup>171</sup> 726 F.2d 1543 (11th Cir. 1984).

<sup>172</sup> *Id.* at 1546 n.2. "Although we believe *Olin* reaches a correct result, we have endeavored to present a clearer picture of the overall framework under which such a case should be analyzed." *Id.*

<sup>173</sup> *Id.* at 1552 n.15.

<sup>174</sup> *Id.* at 1546.

<sup>175</sup> Compare *id.* at 1552, 1553-54 (holdings on scientific necessity and alternatives) with *Wright*, 697 F.2d at 1191 (explanation of scientific evidence required and plaintiff's opportunity to prove available alternatives).

<sup>176</sup> *Hayes*, 726 F.2d at 1548.

<sup>177</sup> *Id.* *Shelby Memorial Hospital* failed to meet this requirement. Although radiation generally is linked to fetal harm, the levels at issue in this case did not pose an unreasonable risk of harm to the fetus. *Id.* at 1550. The court's use of the phrase "substantial risk" earlier in the opinion, *id.* at 1548, suggests that reasonableness is defined by the severity and probability of fetal harm. Considerations such as alternatives and cost are factored in after the reasonableness threshold has been passed.

<sup>178</sup> *Id.* at 1549.

<sup>179</sup> See *supra* notes 119-122 and accompanying text. The court refused to expand the traditionally narrow reading of BFOQ. *Hayes*, 726 F.2d at 1549.

facie case of disparate impact."<sup>180</sup> The employer can then defend the policy as a business necessity.<sup>181</sup> The plaintiff can rebut this defense by proving the availability of acceptable alternative policies.<sup>182</sup> Because the hospital failed to meet the requisite scientific test<sup>183</sup> and failed to consider acceptable alternatives,<sup>184</sup> the plaintiff prevailed in *Hayes*.

### 3. The Choice Between Analytic Frameworks

The system of shifting presumptions developed in *Hayes* is, by the court's own admission, "theoretical and perhaps confusing."<sup>185</sup> Nevertheless, it is more defensible under current Title VII law than *Wright's* conventional disparate impact analysis. Neither court, however, properly handled the identification of a business necessity.

The starting point in categorizing fetal protection policies for judicial purposes must be facial discrimination analysis. Section 703(k) of Title VII, which codifies the PDA, states that discrimination "because of sex" includes treatment "on the basis of pregnancy, childbirth, or related medical conditions."<sup>186</sup> The legislative history indicates that the PDA encompasses "the whole range of matters concerning the childbearing process,"<sup>187</sup> including the capacity to become pregnant.<sup>188</sup> Treatment based on "pregnancy, childbirth, or related medical conditions" is a prima facie violation of Title VII.<sup>189</sup> Congress intended facial discrimination analysis, as well as disparate impact analysis, to

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<sup>180</sup> 726 F.2d at 1552.

<sup>181</sup> *Id.*

<sup>182</sup> *Id.* at 1553.

<sup>183</sup> See *supra* note 177.

<sup>184</sup> *Hayes*, 726 F.2d at 1553-54.

<sup>185</sup> *Id.* at 1554.

<sup>186</sup> Pregnancy Discrimination Act, § 1, 42 U.S.C. § 2000e(k) (1982).

<sup>187</sup> H.R. REP. NO. 948, 95th Cong., 2d Sess. 5, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 4749, 4753.

<sup>188</sup> See *id.* at 2, reprinted in 1978 U.S. CODE CONG. & AD. NEWS at 4750-51 (quoting Justice Stevens' dissent in *Gilbert* that the capacity to become pregnant is the key difference between men and women). "It is the [House Education and Labor Committee's] view that the dissenting justices correctly interpreted the act." *Id.* See also Finneran, *Title VII and Restrictions on Employment of Fertile Women*, 31 LABOR L.J. 223, 226 (1980); Note, *Fetal Vulnerability*, *supra* note 11, at 918. But see B. SCHLEI & P. GROSSMAN, *supra* note 119, at 402 (arguing that the PDA applies only to pregnancy-related medical conditions and that the ability to conceive is not a medical condition).

<sup>189</sup> 29 C.F.R. § 1604.10(a) (1984).



be available to plaintiffs under the PDA.<sup>190</sup> The *Wright* court's dismissal of the plaintiff's attempt to use a facial discrimination analysis was therefore incorrect.<sup>191</sup>

Although the PDA says nothing about the creation and rebuttal of presumptions, the *Hayes* approach is consistent with the framework established by Title VII as amended by the PDA. Other courts have readily acknowledged that both disparate treatment and disparate impact analysis can apply to one case,<sup>192</sup> and have urged flexibility in applying Title VII doctrine to particular problems.<sup>193</sup> In addition, Professor Elizabeth Bartholet has proposed a shifting analysis in the context of racial discrimination in "upper level" employment.<sup>194</sup> The *Hayes* analysis offers a similar structure for using Title VII's flexibility to protect the plaintiffs in sexual discrimination cases to the full extent intended by Congress.<sup>195</sup>

The shifting analytical approach is fair to both employers and employees. It permits employers to present a flexible business necessity rationale in defense of scientifically supported fetal protection policies. Because employers cannot invoke the defense without providing scientific justification, the *Hayes* ap-

<sup>190</sup> See, e.g., *Newport News Shipbuilding & Dry Dock Co. v. EEOC*, 462 U.S. 669, 684 (1983) (The PDA "has now made clear that for all Title VII purposes, discrimination based on a woman's pregnancy is, on its face, discrimination because of her sex."); H.R. REP. NO. 948, *supra* note 187, at 2-3, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS at 4751. "[T]he bill would eliminate the need in most instances to rely on the impact approach and thus would obviate the difficulties in applying the distinctions created in *Saty*." *Id.* The PDA, however, did not make disparate impact analysis unavailable. It permits the use of both types of analysis. See Note, *Employment Equality Under the Pregnancy Discrimination Act of 1978*, 94 YALE L.J. 929, 934-39 (1985) [hereinafter cited as Note, *Employment Equality*].

<sup>191</sup> The court has been severely criticized on this point. See, e.g., Note, *Exclusion of Women*, *supra* note 11, at 1083; Note, *Fetal Vulnerability*, *supra* note 11, at 925. One writer has concluded that the *Wright* court should have put a BFOQ label on its analysis of the employer's defense. See *id.* at 925-28. While this would have superficially avoided undesirable interchangeability, merely altering the label on the defense does not cure the fundamental difficulty in *Wright*. Altering the label but keeping the *Wright* rationale undermines the job performance requirement that has always been integral to a BFOQ defense. See *supra* note 122 and accompanying text. When the business necessity defense is properly seen as an attempt by the employer to avoid potential tort liability, see *infra* text accompanying notes 201-206, the distinction between a BFOQ/employee ability argument and a business necessity/corporate survival argument is clear.

<sup>192</sup> See, e.g., *Furnco Constr. Co. v. Waters*, 438 U.S. 567, 583-84 (1978) (Marshall, J., concurring in part & dissenting in part); *International Bhd. of Teamsters v. United States*, 431 U.S. 324, 335 n.15 (1977); *Segar v. Smith*, 738 F.2d 1249, 1265 (D.C. Cir. 1984).

<sup>193</sup> See, e.g., *Teamsters*, 431 U.S. at 358; *Segar*, 738 F.2d at 1298 (Edwards, J., concurring); *Wright v. Olin Corp.*, 697 F.2d 1172, 1184 (4th Cir. 1982).

<sup>194</sup> See Bartholet, *supra* note 133, at 1005-06.

<sup>195</sup> Cf. Note, *Employment Equality*, *supra* note 190 (aggressive application of all variants of Title VII necessary to accomplish congressional objectives).

proach also prevents employer abuse of the business necessity defense. Most importantly, this approach does not improperly loosen the strict BFOQ defense to make it virtually interchangeable with the more flexible business necessity defense.<sup>196</sup> Moreover, it does not create a special exception permitting application of the business necessity test to cases of disparate treatment. The *Hayes* formulation thus avoids altering traditional Title VII law in such a way as to undermine the existing legal regime.<sup>197</sup>

Assuming that a fetal protection policy is scientifically justifiable, the key to the Title VII decision lies in defining the parameters of the business necessity defense. Courts have employed a variety of criteria to establish these parameters. In *Hayes*, the Eleventh Circuit stated that a humanitarian desire to protect fetuses provides a legitimate business necessity defense in and of itself.<sup>198</sup> One employer's vision of social welfare, however, is not a recognized defense to a Title VII suit.<sup>199</sup> The *Hayes* definition of business necessity should not prevail in the long run, because Title VII was designed to undercut an employer's ability to make such unilateral public policy choices.<sup>200</sup>

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<sup>196</sup> Courts have occasionally acted as though the defenses were interchangeable. *See, e.g.,* *Chastang v. Flynn & Emrich Co.*, 541 F.2d 1040, 1042-43 (4th Cir. 1976) (applying both BFOQ and business necessity defenses to a disparate treatment case); *Diaz v. Pan American World Airways, Inc.*, 442 F.2d 385, 388 (5th Cir.), *cert. denied*, 404 U.S. 950 (1971) (mixing business necessity language with BFOQ language); *see also* *Nothstein & Ayres*, *supra* note 51, at 306 (noting merging of two defenses). While the defenses do overlap, they are not identical. *See* *Harriss v. Pan American World Airways, Inc.*, 649 F.2d 670, 676 (9th Cir. 1980) ("the two defenses, though related and similar, are not identical"). The difference between the defenses rests in their foci, *see* B. SCHLEI & P. GROSSMAN, *supra* note 119, at 359 (focus of BFOQ is "legitimacy of . . . [a] . . . stereotype;" focus of business necessity is "validity of various stated job qualifications"), and in their responsiveness to different wrongs. *See* *Howard*, *supra* note 22, at 841 & n.200 (wrong of intentional disparate treatment more offensive than wrong of disparate consequences).

<sup>197</sup> *See* *Howard*, *supra* note 22, at 841 & n.200.

<sup>198</sup> *Hayes*, 726 F.2d at 1552 n.14.

<sup>199</sup> *See* *Burwell v. Eastern Airlines, Inc.*, 633 F.2d 361, 371 (4th Cir. 1980) (personal compassion for the safety of an unborn child is commendable, but it does not constitute a business necessity). Although a state law creating a fetal protection defense, such as CONN. GEN. STAT. ANN. §§ 46a-60(a)(7), (9), (10) (West Supp. 1984), might relieve an employer of back-pay liability, compliance with a discriminatory state law is not a defense to a Title VII charge. *See, e.g.,* *Albemarle Paper Co. v. Moody*, 422 U.S. 405, 447, 448 (1975) (Blackmun, J., concurring); *Williams v. General Foods Corp.*, 492 F.2d 399, 404 (7th Cir. 1974); *Manning v. International Union*, 466 F.2d 812, 813-16 (6th Cir. 1972), *cert. denied*, 410 U.S. 946 (1973); *Rosenfeld v. Southern Pacific Co.*, 444 F.2d 1219, 1225-27 (9th Cir. 1971). If Congress decides that it is socially desirable to protect fetal life, it should amend Title VII to permit an employer to justify his conduct solely on that basis. *Cf.* *Howard*, *supra* note 22, at 845-47 & n.214 (outlining a new defense based purely on fetal safety).

<sup>200</sup> The best example of Title VII's intent to end paternalism is the treatment of state

An approach based on the needs of a business as a legally, as opposed to a socially, responsible entity comes closer to providing the requisite business necessity. In *Wright*, the Fourth Circuit found that an employer's legal duty of care to a fetus as an invitee or licensee on the business premises constituted an acceptable business necessity defense.<sup>201</sup> In *Zuniga*, the court suggested that the potential economic cost of tort awards to injured children establishes the defense.<sup>202</sup> Both of these tort-based arguments, however, overstate potential liability under current law. A fetus simply does not meet the requirements for licensee or invitee status as it is currently defined.<sup>203</sup> Although economic cost is one of several factors in the business necessity calculus,<sup>204</sup> it has never provided the sole basis for a business necessity defense.<sup>205</sup> Courts should nevertheless recognize such

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laws limiting the hours or strenuousness of work for women. Work hour limitations for women were initially enacted and upheld as being in the "public interest" because they ensured that America would be populated with "vigorous offspring." *Muller v. Oregon*, 208 U.S. 412, 421 (1908). After passage of Title VII, however, these protective state laws were either repealed or overturned by the courts because they violated Title VII. *See, e.g.*, *Kober v. Westinghouse Elec. Co.*, 480 F.2d 240, 245-46 (3d Cir. 1973). Women were given the right to determine for themselves the level of physical stress their bodies could withstand.

<sup>201</sup> *Wright*, 697 F.2d at 1189.

<sup>202</sup> *Zuniga*, 692 F.2d at 992 n.10.

<sup>203</sup> Both licensee and invitee are defined as applying to "people," *see* RESTATEMENT (SECOND) OF TORTS § 330 (1965) (licensee defined); *id.* § 332 (invitee defined), and the legal "personhood" of a fetus is questionable under current law. Additionally, both invitation and license require an employer's knowledge and consent to fetal presence. *See, e.g.*, *Missouri-Kansas Texas R.R. Co. v. Mathis*, 349 F.2d 897, 899 (10th Cir. 1965) (child as licensee); RESTATEMENT (SECOND) OF TORTS, *supra*, §§ 330, 332. Because neither the employer nor the employee may know of a recently conceived fetus, such consent will be difficult to establish.

<sup>204</sup> *See Robinson v. Lorillard Corp.*, 444 F.2d 791, 799 n.8 (4th Cir. 1972), *cert. dismissed*, 404 U.S. 1006-07 (1972) ("considerations of economy . . . will often be relevant").

<sup>205</sup> The fact that economic cost has never before supplied a business necessity defense does not foreclose a tort-based rationale. *Los Angeles Dep't of Water and Power v. Manhart*, 435 U.S. 702 (1978), the case on which the Fourth Circuit relied in dismissing an economically founded business necessity defense (*see Wright*, 697 F.2d at 1190 n.26) is easily distinguishable from the cases concerning possible harm to fetuses. *Manhart* involved predictable, avoidable pension contributions. *See Manhart*, 435 U.S. at 717-18. Harm to fetuses is not necessarily predictable, *see supra* note 203 (lack of awareness of pregnancy), and the damage exposure may be neither manageable nor avoidable. Tort damages could amount to millions of dollars, *see Rothstein, supra* note 14, at 508 (suits for paternal exposure to mutagens settled for over \$10 million), and insurance may not be available to cover the risk. *See Mattison, The Pregnancy Amendment: Fetal Rights and the Workplace*, 86 CASE & COM. 33, 38, Nov.-Dec. 1981; Walsh, *Insurers are Shunning Coverage of Chemical and Other Pollution*, Wall St. J., Mar. 19, 1985, at 1, col. 6. Furthermore, the fetus' claim may not be subject to waiver. *See, e.g.*, *Seel v. Hotchkiss*, 264 N.C. 185, 191, 141 S.E.2d 259, 264 (1965) (court approval needed to waive child's tort claim). Consequently, potential tort awards do pose a serious problem for businesses. *See Finneran, supra* note 188, at 228-30.

a defense in business-oriented concerns such as economics or legal liability, rather than invite businesses to engage in unilateral decisionmaking about the best interests of society.<sup>206</sup>

### C. Implications for Future Plaintiffs and Their Unions

A prospective plaintiff can draw several conclusions from the above analysis. Regardless of which court or commentator a trial judge finds persuasive, he or she will probably create a baroque legal framework involving fine distinctions and shifting burdens of proof. To be properly handled, a case will require extremely competent counsel. Since none of the fetal protection/Title VII cases to date have been litigated by the EEOC,<sup>207</sup> that counsel may have to be privately retained. Even if the attorneys serve on a pro bono basis, the required technological and scientific evidence involves the effort of potentially expensive experts.

The substantial investment required from the plaintiff and her counsel could reap handsome rewards, however. Since most courts of appeals have not yet addressed the validity of fetal protection policies, any one case could have substantial impact beyond the plaintiff's own workplace. Furthermore, it is possible that a given employer will be unable to meet its burden of proving that a substance harms fetuses only through maternal and not paternal exposure.<sup>208</sup> This failure would mean victory for the plaintiffs, and a safer workplace for both male and female workers. An employer may also fail to rebut the plaintiff's evidence of acceptable alternative protective technology. The lawsuit may therefore force an employer to keep abreast of developments in protective technologies as well as occupational hazards.

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<sup>206</sup> The Eleventh Circuit's dismissal of any sort of tort-based necessity in favor of a humanitarian justification is fatally flawed. The court dismissed all tort-based rationales because many workplace activities are potentially hazardous and not all of them should provide Title VII defenses. See *Hayes*, 726 F.2d at 1552 nn.14-15. The hazards identified by the court, however, can be handled through other remedial schemes such as OSHA's general duties clause, OSH Act § 25(a)(1), 29 U.S.C. § 654(a)(1)(1982), or through less discriminatory alternatives to the total exclusion of women.

<sup>207</sup> The EEOC was involved in part of the *Wright* case, but it did not handle the fetal protection claim. *Wright v. Olin Corp.*, 697 F.2d 1172, 1177 (4th Cir. 1982). The EEOC was an amicus in *Hayes v. Shelby Memorial Hosp.*, 726 F.2d 1543, 1545 (11th Cir. 1984).

<sup>208</sup> See *supra* notes 37-39 and accompanying text.

If the plaintiffs considering a Title VII challenge are unionized, these generalizations have serious ramifications for their labor unions. If the union participates in the administration of a fetal protection policy which violates Title VII, or the collective bargaining agreement mandates such a policy, the union may be independently liable for a Title VII violation.<sup>209</sup> The unsettled state of the law is not a Title VII defense,<sup>210</sup> so unions have a self-interested motive for resisting discriminatory fetal protection policies to some degree. Even if there is no threat of union liability, Title VII challenges could yield data about workplace hazards affecting the safety of all workers and their offspring. The suits could also yield adjustments in safety equipment and job duties.<sup>211</sup> On a broader scale, a landmark suit could affect the handling of fetal toxins, mutagens, and teratogens throughout an industry. These wide-reaching consequences create a persuasive case for voluntary union participation in an employer's fetal protection decisions. The remainder of this Note will address the extent to which such participation is currently required by law, and the extent to which it should be required.

#### IV. THE ROLE OF UNIONS IN FETAL PROTECTION POLICIES

##### A. *The Relationship between the Duty of Fair Representation and Title VII*

Many fetal protection policies cover employees in production jobs in major American industries. The women affected by these policies are often unionized.<sup>212</sup> The majority of the members of their union locals are male.<sup>213</sup>

The union's duty to its female members stems from two sources: the duty of fair representation (DFR) and Title VII of the Civil Rights Act of 1964.<sup>214</sup> A single union action may violate

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<sup>209</sup> See *infra* notes 306-14 and accompanying text.

<sup>210</sup> See *United States v. United States Steel Corp.*, 520 F.2d 1043, 1058-59 (5th Cir. 1975), *cert. denied*, 429 U.S. 817 (1976); *Johnson v. Goodyear Tire & Rubber Co.*, 491 F.2d 1364, 1377 (5th Cir. 1974).

<sup>211</sup> In *Hayes*, for example, the employer could have reassigned the pregnant technician from day to night duty. See *Hayes*, 726 F.2d at 1551.

<sup>212</sup> See *supra* note 6.

<sup>213</sup> J. Bertin, *supra* note 18, at 2.

<sup>214</sup> Title VII § 703(c), 42 U.S.C. § 2000e-2(c) (1982).

both duties. For example, if a union refuses to process an employee grievance simply because the complainant is female, the union has violated both its duty to avoid arbitrary conduct under the DFR<sup>215</sup> and its duty not to discriminate under Title VII.<sup>216</sup> Some courts have failed to distinguish between these two duties.<sup>217</sup>

Sweeping judicial statements which do not separate the two duties are confusing and incorrect. Both the Supreme Court and Congress have indicated that the two remedial schemes function independently.<sup>218</sup> Different substantive and procedural laws apply to each, and the remedies available under the two schemes are different.<sup>219</sup>

Moreover, the underlying philosophies and purposes of Title VII and the DFR are different. The National Labor Relations Act (NLRA) was enacted as a privately ordered scheme of industrial peace.<sup>220</sup> The DFR is a judicial limit on that scheme that was designed to protect an individual from unfair exercises of union power.<sup>221</sup> The DFR extends to each union member and covers union conduct based on race, sex, or religion.<sup>222</sup> If a

<sup>215</sup> See *Vaca v. Sipes*, 386 U.S. 171, 177 (1967).

<sup>216</sup> See Title VII § 703(c)(1), (3), 42 U.S.C. § 2000e-2(c)(1), (3) (it is unlawful for a labor organization to "otherwise discriminate against" any individual because of sex).

<sup>217</sup> See, e.g., *Farmer v. ARA Serv., Inc.*, 660 F.2d 1096, 1104 (6th Cir. 1981) ("almost axiomatic" that DFR breach also breaches Title VII); *Causey v. Ford Motor Co.*, 516 F.2d 416, 425 n.12 (5th Cir. 1975) ("*Vaca* standards apply in Title VII cases"). In *Macklin v. Spector Freight Sys., Inc.*, 478 F.2d 979, 988-89 (D.C. Cir. 1973), Judge Skelly Wright stated that a union's failure to stop an employer from discriminating could violate both the DFR and Title VII. Although this statement may have been true given the facts of *Macklin*, Wright broadly indicated that the duties were co-extensive and that both covered a union's acquiescence to discrimination. *Id.* For a criticism of *Macklin* on this ground, see Note, *Union Liability under Title VII for Employer Discrimination*, 68 GEO. L.J. 959, 978-79 & n.160 (1980).

<sup>218</sup> See *Emporium Capwell Co. v. Western Addition Community Org.*, 420 U.S. 50, 71-73 (1975) (distinguishing between activity protected by the National Labor Relations Act and by Title VII); 110 CONG. REC. 7206 (1964) reprinted in U.S. EQUAL EMPLOYMENT OPPORTUNITY COMM'N, LEGISLATIVE HISTORY OF TITLES VII & XI OF CIVIL RIGHTS ACT OF 1964 3244 (1976) (statement of Sen. Clark (D-Pa.) [hereinafter cited as "U.S. E.E.O.C. Legislative History"]). An employee can pursue both a Title VII suit and a suit under the labor contract. See *Alexander v. Gardner-Denver Co.*, 415 U.S. 36 (1974); see also *Romero v. Union Pacific R.R.*, 615 F.2d 1303, 1310 (10th Cir. 1980) (Title VII claim "creates an independent statutory right"); *Guerra v. Manchester Terminal Corp.*, 498 F.2d 641, 658 n.46 (5th Cir. 1974) (two remedial schemes may overlap but they are not identical).

<sup>219</sup> For example, damages for emotional and mental distress are available under the DFR, whereas only back pay is available under Title VII. See *Farmer v. ARA Serv., Inc.*, 660 F.2d 1096, 1107 (6th Cir. 1981).

<sup>220</sup> See National Labor Relations Act § 1, 29 U.S.C. § 151 (1982).

<sup>221</sup> See *Steele v. Louisville & Nashville R.R.*, 323 U.S. 192, 199 (1944) (Congress did not "confer plenary power upon the union to sacrifice . . . rights of the minority").

<sup>222</sup> See *Vaca*, 386 U.S. at 177.

union is not the exclusive representative for a given purpose,<sup>223</sup> the protective rationale for the DFR weakens considerably.<sup>224</sup>

A labor organization's obligations under Title VII, on the other hand, attach regardless of the organization's exclusivity.<sup>225</sup> Title VII provides protections against racial, sexual, or religious discrimination in employment, beyond those that existed before the Act was passed.<sup>226</sup>

A careful analysis of union duties with respect to fetal protection policies must consider Title VII and the DFR separately. Given the origins of the two schemes, the duty imposed by Title VII might extend beyond that imposed by the DFR. The wisdom of such a judicial extension of Title VII is questioned in Part C of this Section.

## B. A Union's Obligations under the DFR

### 1. General Outlines of the DFR

A union violates its DFR when its actions are "arbitrary, discriminatory, or in bad faith."<sup>227</sup> Although this standard was initially read as requiring "something akin to factual malice,"<sup>228</sup> judicial attention was drawn to the word "or" in the mid-1970's, and courts began holding that arbitrary or irrational conduct,

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<sup>223</sup> The DFR has been thought to be constitutionally required if exclusivity is governmentally mandated. See *Vaca*, 386 U.S. at 182; *Bowman v. Tennessee Valley Auth.*, 744 F.2d 1207, 1212 (6th Cir. 1984), *cert. denied*, 105 S.Ct. 1843 (1985); *NAACP v. Detroit Police Officers' Ass'n*, 591 F. Supp. 1194, 1210-11 (E.D. Mich. 1984).

<sup>224</sup> See *Graf v. Elgin, Joliet & E. Ry.*, 697 F.2d 771, 780 (7th Cir. 1983) (strict DFR unnecessary if exclusive union authority to prosecute grievance is not involved).

<sup>225</sup> Title VII § 703(c), 42 U.S.C. § 2000e-2(c); see *id.* § 701(d), 42 U.S.C. § 2000(e)(d) (definition of labor organization).

<sup>226</sup> See *Alexander*, 415 U.S. at 58 n.19 (1974) (discusses union's representative status in relation to individual workers under Title VII and the DFR); *Sears v. Bennett*, 645 F.2d 1365, 1375 (10th Cir. 1981), *cert. denied*, 456 U.S. 964 (1982) (Title VII goes beyond Railway Labor Act); *Air Line Stewards & Stewardesses Ass'n Local 550 v. American Airlines, Inc.*, 490 F.2d 636, 641 (7th Cir. 1973), *cert. denied*, 416 U.S. 993 (1974) (Title VII goes beyond the DFR). See generally *Murphy, The Duty of Fair Representation under Taft-Hartley*, 30 Mo. L. Rev. 373, 385 (1965) (Title VII "goes farther than the duty of fair representation").

<sup>227</sup> *Vaca*, 386 U.S. at 190; see also *DelCostello v. International Bhd. of Teamsters*, 462 U.S. 151 (1983) (DFR covers "discriminatory, dishonest, arbitrary, or perfunctory" conduct). Use of the word "discriminatory" in defining the DFR does not imply that Title VII has been subsumed into the DFR.

<sup>228</sup> *Jackson v. Trans World Airlines, Inc.*, 457 F.2d 202, 204 (2d Cir. 1972); see also *Brady v. Trans World Airlines, Inc.*, 401 F.2d 87, 104 (3d Cir. 1968), *cert. denied*, 393 U.S. 1048 (1969).

even without bad faith, violated the duty.<sup>229</sup> Thus, union conduct that is either malicious, or not based in fact on rational<sup>230</sup> or relevant<sup>231</sup> decisional factors violates the duty.<sup>232</sup>

A union is bound by the DFR both when it negotiates a new contract and when it administers an existing one.<sup>233</sup> Application of the DFR in the two contexts varies, however. In negotiations, a union is permitted a "wide range of reasonableness" in accepting contract terms;<sup>234</sup> in contract administration, a union's discretion is more constrained.<sup>235</sup> A union's obligations with respect to fetal protection policies will be analyzed separately in the two contexts.<sup>236</sup>

## 2. Union Obligations in Contract Administration

A union's responsibilities in contract administration include deciding whether to pursue a grievance, representing the employee in the grievance process, and enforcing the contract independent of particular grievances. Courts scrutinize the exercise of union discretion in the first two areas more closely than in the third.

<sup>229</sup> See *Tedford v. Peabody Coal Co.*, 533 F.2d 952, 957 (5th Cir. 1976); see also *Buchanon v. NLRB*, 597 F.2d 388, 394 n.12 (4th Cir. 1979); *Ruzicka v. General Motors Corp.*, 523 F.2d 306, 309 (6th Cir. 1975), cert. denied 464 U.S. 982 (1983); *Vander Velde, A Fair Process Model for the Union's Fair Representation Duty*, 67 MINN. L. REV. 1079, 1096-97 (1983).

<sup>230</sup> Clark, *The Duty of Fair Representation: A Theoretical Structure*, 51 TEX. L. REV. 1119, 1130-32 (1973) (interpreting DFR as requiring a rational decisionmaking process).

<sup>231</sup> Note, *Two-Tier Wage Discrimination and the Duty of Fair Representation*, 98 HARV. L. REV. 631, 638 (1985) [hereinafter cited as Note, *Two-Tier Wage Discrimination*] (pointing out that the courts allow a union to treat employees differently on the basis of factors "relevant" to union's statutory purposes).

<sup>232</sup> A non-arbitrary decision is one which is "(1) based upon relevant, permissible union factors which excludes the possibility of it being based on motivations such as personal animosity or political favoritism; (2) a rational result of the consideration of these factors; and (3) inclusive of a fair and impartial consideration of the interests of all employees." *Tedford*, 533 F.2d at 957. See generally Freed, Polsby, & Spitzer, *Unions, Fairness, and the Conundrums of Collective Choice*, 56 S. CAL. L. REV. 461, 474-90 (1983) (survey of attempts to rationalize the DFR).

<sup>233</sup> See *Amalgamated Ass'n of St., Elec., Ry., & Motor Coach Employees v. Lockridge*, 403 U.S. 274, reh'g denied 404 U.S. 874 (1971) (DFR in negotiation setting); *Vaca*, 386 U.S. 171 (DFR in grievance arbitration).

<sup>234</sup> *Ford Motor Co. v. Huffman*, 345 U.S. 330, 338 (1953).

<sup>235</sup> See Levine & Hollander, *The Union's Duty of Fair Representation in Contract Administration*, 7 EMPLOYEE REL. L.J. 193, 198-99 (1981); Summers, *The Individual Employee's Rights under the Collective Agreement: What Constitutes Fair Representation?*, 126 U. PA. L. REV. 251, 254-57 (1977).

<sup>236</sup> This division is traditional in DFR analysis. See *Elgin, Joliet, & E. Ry. v. Burley*, 325 U.S. 711, 723 (1945) ("Congress has drawn major lines of difference between the two classes of controversy," with contract negotiations seen as involving major disputes and grievance administrations as involving minor disputes).



A union must investigate a grievance in more than a perfunctory manner<sup>237</sup> before deciding that the grievance is not meritorious, or that it is of questionable merit.<sup>238</sup> Unions may consider the cost of pursuing a grievance,<sup>239</sup> the impact of a particular grievance on other employees,<sup>240</sup> and the comparable strength of grievances<sup>241</sup> in deciding which grievances to pursue. Even commentators who believe that an employee is entitled to have a clear-cut grievance arbitrated admit that factors beyond the merits of a particular case can properly affect union decisions to pursue questionable claims.<sup>242</sup>

Once a union decides to pursue a grievance, its discretion is more constrained. Although it may settle a claim before completing the grievance process,<sup>243</sup> the union must act rationally and must keep the employee informed of union decisions and employee options.<sup>244</sup> A union is required to pursue a grievance with a minimal level of competence, but zealous advocacy is not required.<sup>245</sup> Moreover, the DFR is not necessarily breached

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<sup>237</sup> See, e.g., *Ruzicka v. General Motors Corp.*, 523 F.2d 306, 310 (6th Cir. 1975) (permitting grievance to expire without evaluating merits breaches DFR); *Local 12, United Rubber, Cork, Linoleum, & Plastic Workers v. NLRB*, 368 F.2d 12, 17 (5th Cir.), cert. denied, 389 U.S. 837 (1967) (duty to investigate claim); see also *Vander Velde*, supra note 256, at 1113-14.

<sup>238</sup> See *Clark*, supra note 230, at 1163-65.

<sup>239</sup> See *Baker v. Amsted Indus.*, 656 F.2d 1245, 1250 (7th Cir. 1981), cert. denied, 456 U.S. 945 (1982); *Encina v. Tony Lama Boot Co.*, 448 F.2d 1264, 1265 (5th Cir. 1971).

<sup>240</sup> See *Baker*, 656 F.2d at 1250; *Milstead v. International Bhd. of Teamsters, Local Union No. 957*, 580 F.2d 232, 236 (6th Cir. 1978), cert. denied, 454 U.S. 889 (1981); *Tedford v. Peabody Coal Co.*, 533 F.2d 952, 957 (5th Cir. 1982).

<sup>241</sup> See *Baker*, 656 F.2d at 1250; *Buchholtz v. Swift & Co.*, 609 F.2d 317, 327 (8th Cir. 1979), cert. denied, 444 U.S. 1018 (1980).

<sup>242</sup> See, e.g., *Cox, Rights Under a Labor Agreement*, 69 HARV. L. REV. 601, 633-34 (1956) (a union should have no power to waive a claim where relief is "plainly due"; otherwise a union is free to consider the merits of a claim, the effect of the claim on other employees, and the future implications of a settlement); *Summers, The Contract of Employment and the Rights of Individual Employees: Fair Representation and Employment at Will*, 52 FORDHAM L. REV. 1082, 1096 (1984) (if contract is ambiguous or facts are in dispute, union has reasonable discretion); *Vander Velde*, supra note 229, at 1145-53 (limited financial resources and limited strategic options are valid reasons for a union to refuse to pursue a grievance "in the gray area"); *Clark*, supra note 230, at 1163-66 (advocates union discretion to deal with various levels of grievances).

<sup>243</sup> See *Vaca v. Sipes*, 386 U.S. 171, 192-93 (1967).

<sup>244</sup> *Robesky v. Qantas Empire Airways, Ltd.*, 573 F.2d 1082, 1090 n.17 (9th Cir. 1978); *Paint, Chemical, Clerical, Warehouse & Indus. Workers Union Local 310*, 270 N.L.R.B. Case No. 90, p. 506, 1983-84 (May 11, 1984).

<sup>245</sup> Mere negligent representation does not breach the DFR. *Ruzicka v. General Motors Corp.*, 649 F.2d 1207, 1212 (6th Cir. 1981), cert. denied, 464 U.S. 982 (1983). Representation that is grossly careless, however, even if unintentional, may breach the DFR. See *Harris v. Schwerman Trucking Co.*, 668 F.2d 1204, 1206-207 (11th Cir. 1982); *Robesky v. Qantas Empire Airways, Ltd.*, 573 F.2d 1082, 1089-90 (9th Cir. 1978); *Findley v. Jones Motor Freight*, 639 F.2d 953, 960 & n.2 (3d Cir. 1981). But see *Hines v. Anchor Motor Freight, Inc.*, 424 U.S. 554, 573, 575 (1976) (Rehnquist, J., dissenting)

because an unpursued or unsuccessful grievance is arguably meritorious. If the handling of the grievance was not arbitrary, discriminatory, or in bad faith, the union has fulfilled its duty.<sup>246</sup>

Grievances brought under a health and safety clause in the union's collective bargaining agreement with the employer could provide one opening for union involvement in fetal protection decisionmaking. For example, if workers complain about toxic substances, the union has a duty to investigate those grievances. If scientific information regarding the toxic substance is confusing and incomplete, however, the union need only cite that part of the available scientific opinion that supports the employer's decision as an acceptable reason for not pursuing the grievance themselves. A union might also argue that a complex, scientifically based grievance requires more resources than the union can muster. Consequently, a health and safety grievance permits, but does not guarantee, union involvement in fetal protection decisions.

If the contract has a sex discrimination clause, female employees could attempt to force union action under that clause as well.<sup>247</sup> Grievances under this clause, like those under a health and safety clause, do not guarantee union action, however. Although a union cannot refuse to handle a sex discrimination grievance solely because the number of women in the unit is small,<sup>248</sup> there are other rationales available to support a union's decision not to pursue the grievance. Because the legality of fetal protection policies under Title VII is unclear, a union might rationally decide either that a policy is not discriminatory or that ascertaining the presence of discrimination would require too great an expenditure of union resources. The scientific complexity of the fetal protection issue could be held to mitigate a

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("Nowhere is any provision made for vacation of an award due to ineffective representation of the case.").

<sup>246</sup> See *Hines v. Anchor Motor Freight, Inc.*, 424 U.S. 554, 571 (1976) (errors in arbitration alone would not breach DFR); *Vaca*, 386 U.S. at 194-95; *Findley v. Jones Motor Freight*, 639 F.2d 953, 958 (3d Cir. 1981); *Tedford v. Peabody Coal Co.*, 533 F.2d 952, 959 (5th Cir. 1976).

<sup>247</sup> One Canadian union has become involved in the fetal protection issue by representing women under a sex discrimination clause. See Swinton, *supra* note 6, at 60 (arbitration between UAW and General Motors of Canada).

<sup>248</sup> See *Peterson v. Rath Packing Co.*, 461 F.2d 312, 316 (8th Cir. 1972) (court suspicious of a decision concerning whether or not to pursue female employees' sex discrimination claims based on membership vote). *But see Myers v. Gilman Paper Co.*, 392 F. Supp. 413, 422 (S.D. Ga. 1975), *aff'd in part, rev'd in part*, 544 F.2d 837 (5th Cir.), *cert. dismissed*, 434 U.S. 801 (1977) (decision to drop grievance after membership vote reasonable because no evidence of race discrimination).

union's duty to pursue a sex discrimination claim, as it mitigates the union's duty to pursue a health and safety grievance. Furthermore, union pursuit of a grievance does not guarantee success, even if the policy is sexually discriminatory.<sup>249</sup>

Unions have occasionally been charged with violating their DFR by failing to enforce a contract, even if no grievances have been filed by members. Enforcement may take two forms: fighting mid-term modifications of a contract and policing provisions to which the employer has already agreed. The mid-term modification problem is considered below in Part B.3.

The policing problem frequently arises after a plant accident, when union members or their relatives attempt to hold a union responsible for failing to enforce contractually required safety standards.<sup>250</sup> Although the National Labor Relations Board has spoken broadly of a union's duty to police its safety agreements,<sup>251</sup> courts have not imposed DFR liability for a union's failure to insist on compliance with safety standards.<sup>252</sup> Courts have excused unions from liability because workplace safety is seen as predominantly an employer's responsibility,<sup>253</sup> or be-

<sup>249</sup> In the Canadian arbitration, *see supra* note 247, the union lost because the arbitrator accepted the employer's scientific data. Swinton, *supra* note 6, at 60.

<sup>250</sup> *See Bryant v. United Mine Workers*, 467 F.2d 1 (6th Cir. 1972), *cert. denied*, 410 U.S. 930 (1973); *House v. Mine Safety Appliances Co.*, 417 F. Supp. 939 (D. Idaho 1976). For a general discussion of a union's health and safety duties, see Drapkin & Davis, *Health and Safety Provisions in Union Contracts: Power or Liability?* 65 MINN. L. REV. 635 (1981); O'Reilly, *Driving a Soft Bargain: Unions, Toxic Materials, and Right to Know Legislation*, 9 HARV. ENVTL. L. REV. 307 (1985); Note, *Responsibility for Safe Working Conditions: Expanding the Limits of Union Liability*, 32 SYRACUSE L. REV. 681 (1981).

<sup>251</sup> *See Minnesota Mining & Mfg. Co.*, 261 N.L.R.B. 27, 29 & n.10 (1982), *aff'd sub. nom.* *Oil, Chemical, & Atomic Workers Local 6-418 v. NLRB*, 711 F.2d 348 (D.C. Cir. 1983).

<sup>252</sup> *See Bryant*, 467 F.2d at 6; *House*, 417 F. Supp. at 947. Union members have attempted to sue the union not for breaching its DFR but for negligence under state tort law. Some courts have held that the union has no legal duty beyond that imposed by the DFR and have found the suits pre-empted by federal law. *See, e.g.*, *Condon v. Local 2944, United Steelworkers*, 683 F.2d 590 (1st Cir. 1980); *Bryant*, 467 F.2d at 5. Others have held that an independent state law duty exists and that the state tort suits are not pre-empted. *See, e.g.*, *Helton v. Hake*, 386 F. Supp. 1027 (W.D. Mo. 1974). The key to these decisions is whether the duty allegedly breached is "so inextricably intertwined with the collective bargaining agreement that only a duty of fair representation claim is available, thereby pre-empting any claim for a common law tort." *Hechler v. Electrical Workers*, 120 L.R.R.M. (BNA) 2633, 2639 (11th Cir. 1985) (failure to ensure that one employee was properly trained for job establishes state tort case because craft unions historically have controlled apprenticeships and journeyman training, regardless of collective bargaining agreement). In the context of fetal protection, the state suit probably would be pre-empted because unions traditionally have not had a state law duty to protect employees from employer-initiated chemical hazards or to protect the unborn children of members.

<sup>253</sup> *See House*, 417 F. Supp. at 946; Drapkin & Davis, *supra* note 250, at 643-44.

cause enforcement liability might deter unions from writing safety terms into contracts.<sup>254</sup> Furthermore, enforcement liability might destroy the budget and the effectiveness of an otherwise necessary union.<sup>255</sup> It is doubtful, therefore, that a court would find that a union had breached its DFR by failing to monitor the use of fetal toxins, mutagens, or teratogens in the workplace.

Potential union liability for failure to police an anti-discrimination clause has been advanced as a justification for union acquisition of statistics about the racial and sexual composition of the workforce.<sup>256</sup> Nonetheless, courts have never imposed liability under the DFR for failure to police an anti-discrimination agreement. Although thorough discussion of the issue has been avoided in the information-gathering cases,<sup>257</sup> critics have argued that the acquisition and evaluation of such data is beyond the proper scope of union activities.<sup>258</sup> Thus, if a union can avoid pursuing the complaints of affected employees by claiming that it is difficult to assess the merits of fetal protection grievances or that the union needs to preserve resources for other grievances,<sup>259</sup> such reasons should be sufficient to absolve the union of wrongdoing in the absence of a specific employee complaint of sex discrimination. Although union involvement in challenges to fetal protection policies would not breach the DFR, it is doubtful that a recalcitrant union can be forced by its contract administration duties to enter the fray.

### 3. Union Obligations in Contract Negotiations

Courts of Appeals have concluded that the standard for evaluating union contract negotiations is an objective one,<sup>260</sup> allow-

<sup>254</sup> See *Bryant*, 467 F.2d at 6; *House*, 417 F. Supp. at 946; Drapkin & Davis, *supra* note 250, at 643-44.

<sup>255</sup> See *House*, 417 F. Supp. at 946; Drapkin & Davis, *supra* note 250, at 643-44.

<sup>256</sup> See *International Union of Elec., Radio & Machine Workers v. NLRB*, 648 F.2d 18, 25 (D.C. Cir. 1980), *modifying* *General Motors Corp.*, 243 N.L.R.B. 186 (1976) and *Westinghouse Elec. Corp.*, 239 N.L.R.B. 106 (1978).

<sup>257</sup> See *International Union*, 648 F.2d at 24 & n.5 (dodging question of whether the right to information gives the union the duty to exercise that right); *Westinghouse Elec. Corp.*, 239 N.L.R.B. 106, 111 n.38 (1978), *modified on other grounds sub nom. International Union of Elec., Radio & Machine Workers v. NLRB*, 648 F.2d 18 (D.C. Cir. 1980) (refusing to decide if failure to initiate Title VII suit breaches DFR).

<sup>258</sup> See, e.g., *Westinghouse*, 239 N.L.R.B. at 117-19 (Murphy, member, dissenting); Comment, *Union as Title VII Plaintiff: Affirmative Obligation to Litigate?* 126 U. PA. L. REV. 1388, 1393 (1978) [hereinafter cited as Comment, *Union as Plaintiff*].

<sup>259</sup> See *supra* text accompanying notes 246-49.

<sup>260</sup> See, e.g., *Bowman v. Tennessee Valley Auth.*, 744 F.2d 1207, 1214 (5th Cir. 1984),

ing unions a "wide range of reasonableness" under the DFR.<sup>261</sup> An agreement does not violate the DFR simply because it differentiates between groups of employees.<sup>262</sup> The Supreme Court has recognized that the interests of employees will conflict and that a union must bargain some interests away for the benefit of employees as a whole.<sup>263</sup> A union's decision to compromise the desires of a particular group is therefore warranted, unless it is based on the raw political power of the groups involved<sup>264</sup> or on overt invidious discrimination.<sup>265</sup> Because courts have not scrutinized union negotiation decisions closely,<sup>266</sup> all but the most blatantly discriminatory trade-offs will probably pass judicial muster.

A union cannot propose the adoption of a fetal protection program without violating its DFR. Such a scheme would be an unlawful attempt to redistribute female jobs to male workers.<sup>267</sup> Unlike the employer,<sup>268</sup> unions cannot assert potentially crippling tort liability for work-related fetal harms as a justification for their discrimination.<sup>269</sup> Conversely, a union would also violate its DFR if it opposed an employer's attempt to phase out a policy that banned only women. Analogous union opposition to an employer's attempt to desegregate his workplace has been found to violate the DFR.<sup>270</sup>

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*cert. denied*, 105 S. Ct. 1843 (1985); *Farmer v. ARA Serv., Inc.*, 660 F.2d 1096, 1103 (6th Cir. 1981); *Williams v. Pacific Maritime Ass'n*, 617 F.2d 1321, 1332 (9th Cir. 1980), *cert. denied*, 449 U.S. 1101 (1981); *Jones v. Trans World Airlines, Inc.*, 495 F.2d 790, 797-98 (2d Cir. 1974); *NAACP v. Detroit Police Officers' Ass'n*, 591 F. Supp. 1194, 1212 (E.D. Mich. 1984).

<sup>261</sup> *Ford Motor Co. v. Huffman*, 345 U.S. 330, 338 (1953).

<sup>262</sup> *Williams*, 617 F.2d at 1333.

<sup>263</sup> *See Humphrey v. Moore*, 375 U.S. 335, 349-50 (1964); *Ford*, 345 U.S. at 338.

<sup>264</sup> *Barton Brands Ltd. v. NLRB*, 529 F.2d 793, 798-99 (7th Cir. 1976); *Petersen v. Rath Packing Co.*, 461 F.2d 312, 316 (8th Cir. 1972); *Ferro v. Railway Express Agency*, 296 F.2d 847, 851 (2d Cir. 1961).

<sup>265</sup> *See Steele v. Louisville & Nashville R.R.*, 323 U.S. 192 (1944) (race discrimination); *Amalgamated Ass'n of St., Elec., Ry. & Motor Coach Employees v. Lockridge*, 403 U.S. 274, 301 (1971).

<sup>266</sup> *See Ford*, 345 U.S. at 338 (wide range of reasonableness in negotiation); *Local 12, United Rubber, Cork, Linoleum & Plastic Workers v. NLRB*, 368 F.2d 12, 17 (5th Cir. 1966), *cert. denied*, 389 U.S. 837 (1967) (scrutinizing every compromise union makes in negotiations would undermine union effectiveness); *see also Clark, supra* note 258, at 1160 (court should refrain from overturning union negotiation decisions if choices are rational); *Cox, The Duty of Fair Representation*, 2 VILL. L. REV. 151, 161-62 (1957) [hereinafter cited as *Cox, DFR*] (courts should generally let union discretion stand).

<sup>267</sup> Such an attempt would be analogous to the union's efforts to make the railroad exclusively white which was held unlawful in *Steele v. Louisville & Nashville Railroad*, 323 U.S. 192 (1944).

<sup>268</sup> *See supra* notes 213, 216, and accompanying text.

<sup>269</sup> *See supra* notes 278-83 and accompanying text.

<sup>270</sup> *See Local 12, United Rubber, Cork, Linoleum & Plastic Workers v. NLRB*, 368

Even if the union sincerely believes that the exclusion of women is necessary for fetal health, the union's DFR runs to its members, not to fetuses.<sup>271</sup> Consequently, union advocacy of mandatory expulsion of women from the workplace can only be explained as paternalistic social engineering by the union or as a maneuver to gain more jobs for male workers. The latter explanation is overt discrimination in violation of *Steele*. The paternalism rationale is similarly unacceptable.<sup>272</sup>

A more common issue is not the union's inability to propose a fetal protection policy, but its duty to negotiate against a protection policy which an employer wants to include in the collective bargaining agreement. This duty to negotiate arises if an employer attempts to introduce a fetal protection policy into the workplace in the middle of a contract term. Because health and safety and discrimination are mandatory bargaining subjects,<sup>273</sup> the employer has a duty to bargain over mid-term changes in these areas if they are covered by the contract.<sup>274</sup>

A union must consider the preferences of all of its members in negotiations.<sup>275</sup> In order to prove that it did consider the interests of all its members, a union may have to voice some opposition to the employer's fetal protection policy. The union may even be required to make counterproposals.<sup>276</sup> Even these requirements, however, do not guarantee the defeat of an employer's discriminatory proposal. Because the courts require the union only to bargain, not to win, a union can characterize its failure to defeat such a proposal as a concession made to secure broader benefits on a bread-and-butter issue.<sup>277</sup>

F.2d 12, 19 (5th Cir. 1966), *cert. denied*, 389 U.S. 837 (1967) (union opposition to employer's attempt to desegregate toilet facilities violated DFR).

<sup>271</sup> Cf. *Allied Chem. & Alkali Workers, Local 1 v. Pittsburgh Glass Co.*, 404 U.S. 1 (1971) (proper unit for union to represent is existing workers, not retirees).

<sup>272</sup> See *supra* notes 198-200 and accompanying text.

<sup>273</sup> See *International Union of Elec., Radio & Machine Workers v. NLRB*, 648 F.2d 18, 25 n.2 (D.C. Cir. 1980).

<sup>274</sup> This duty has been imposed through interpretations of sections 8(a)(5) and 8(d) of the National Labor Relations Act, 29 U.S.C. § 158(a)(5), (d) (1982). See generally R. GORMAN, *BASIC TEXT ON LABOR LAW, UNIONIZATION, AND COLLECTIVE BARGAINING* 463-66 (1976) (overview of duty to bargain over midterm modifications).

<sup>275</sup> *Steele v. Louisville & Nashville R.R.*, 323 U.S. 192, 204 (1944).

<sup>276</sup> *Emporium Capwell Co. v. Western Addition Community Org.*, 420 U.S. 50, 64 (1975); *Westinghouse Elec. Corp.*, 239 N.L.R.B. 106, 108 (1978), *modified on other grounds sub nom.*, *International Union of Elec., Radio, & Machine Workers v. NLRB*, 648 F.2d 18 (D.C. Cir. 1980).

<sup>277</sup> Cf. *Seep v. Commercial Motor Freight, Inc.*, 575 F. Supp. 1097 (S.D. Ohio 1983) (union did not breach DFR by signing a collective bargaining agreement in which female workers' desires were all compromised because benefits were obtained for the unit as a whole).

Despite the logic of this position, some courts have stated that unions are required by the DFR to fight discrimination to impasse. In *Macklin v. Spector Freight Systems, Inc.*,<sup>278</sup> Judge Skelly Wright stated that the DFR requires a union to refuse to sign a collective bargaining agreement containing discriminatory terms. The challenge in *Macklin* was to an obviously discriminatory hiring policy which the union supported.<sup>279</sup> A district court took a similar position in *Chrapiway v. Uniroyal, Inc.*,<sup>280</sup> a case involving discriminatory hiring, seniority, and bumping policies accepted purely on the basis of majority rule.<sup>281</sup> The facts of these cases, however, suggest that such a broad interpretation of the DFR was unnecessary. Both cases involved unions acting almost as co-conspirators in the discrimination, rather than as mere signatories to an employer-initiated discriminatory agreement. That conspiratorial conduct, not merely the failure to bargain to impasse, probably violated the DFR. Furthermore, Title VII might have provided a duty not to sign that the court mistakenly attributed to the DFR.<sup>282</sup>

Requiring a union to bargain to impasse over an employer's discriminatory fetal protection policy cannot be justified by the policies of the NLRA. The assumption that not all workers will achieve all their goals is inherent in collective bargaining.<sup>283</sup> If a union is required to refuse to sign a contract, it would effectively be required to risk a strike or a lock-out over a single issue affecting a minority of its members. Such a requirement does not promote industrial peace, a key goal of the NLRA.<sup>284</sup> Instead, it would unfairly force a union to pay for the employer's illegal conduct toward a minority of the workforce. Although elevation of minority interests could be undertaken voluntarily,<sup>285</sup> or may be required by another regulatory scheme, it is not a logical extension of the NLRA.

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<sup>278</sup> 478 F.2d 979, 989 (D.C. Cir. 1973).

<sup>279</sup> *Id.*

<sup>280</sup> 458 F. Supp. 252, 282 n.32 (N.D. Ind. 1977).

<sup>281</sup> *Id.* A decision made on the basis of numerical power traditionally violates the DFR. See *supra* note 264 and accompanying text.

<sup>282</sup> See *infra* text accompanying notes 306-14.

<sup>283</sup> See *Humphrey v. Moore*, 375 U.S. 335, 349-50 (1964).

<sup>284</sup> See National Labor Relations Act § 1, 29 U.S.C. § 151 (1982) (purposes of NLRA).

<sup>285</sup> A few Canadian unions have successfully negotiated reassignment rights for pregnant employees. See *Swinton*, *supra* note 6, at 68. The majority of unions, however, have not engaged in hard bargaining over the fetal protection issue. *Id.* This position is consistent with the tendency of unions generally to trade complex safety issues for gains in pay and benefits. See *O'Reilly*, *supra* note 250 at 313-15.

## 4. Union Obligations Beyond Contract

In *Conley v. Gibson* the Supreme Court extended the DFR to cover "resolution of new problems not covered by existing agreements" and to prohibit a union from tacitly consenting to employer discrimination.<sup>286</sup> *Conley* involved union acquiescence to an employer's abolition of forty-five jobs held by blacks and the hiring of forty-five whites to perform comparable duties.<sup>287</sup> In *Emporium Capwell Co. v. Western Addition Community Organization*, a case involving racially discriminatory job assignments and promotions,<sup>288</sup> the Supreme Court suggested a similar duty.<sup>289</sup> Both cases involved union action in the face of easily recognizable employment discrimination. Defining the scope of a union's affirmative duty when the case involves less obvious employment discrimination is more problematic.

Despite rhetoric emphasizing a union's duty to "seek out the existence of discriminatory schemes and . . . to eliminate them,"<sup>290</sup> an affirmative duty has only been enforced in cases of blatant discrimination in which the union participated.<sup>291</sup> These cases do not necessarily create similar duties in the context of fetal protection, as the programs in question are complex, costly to evaluate, and arguably legal. Reading an affirmative duty into the DFR, which was intended only to ensure that a union uses its power fairly, would transform the union's role from an instrument of industrial peace to a detective of discrimination. Such an alteration cannot be justified given the history and purpose of the DFR.

A second aspect of the union's duty under the DFR concerns the extent to which it is expected to fight once the discriminatory nature of the employer's plan is clear. Unions with no-strike clauses in their contracts cannot be required to strike over a discriminatory fetal protection policy.<sup>292</sup> An alternative would

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<sup>286</sup> *Conley v. Gibson*, 355 U.S. 41, 46 (1957).

<sup>287</sup> *Id.* at 43.

<sup>288</sup> *Emporium Capwell Co. v. Western Addition Community Org.*, 420 U.S. 50, 53 (1975).

<sup>289</sup> *Id.* at 64.

<sup>290</sup> *Westinghouse Elec. Corp.*, 239 N.L.R.B. 106, 117 (1978) (Murphy, member, dissenting), *modified on other grounds sub nom.*, *International Union of Elec., Radio & Machine Workers v. NLRB*, 648 F.2d 18 (D.C. Cir. 1980).

<sup>291</sup> See *supra* text accompanying notes 278-82.

<sup>292</sup> The contract in *Emporium Capwell* contained such a no-strike clause, and the union believed it was unable to strike legally over perceived discrimination. *Emporium Capwell*, 420 U.S. at 54. The Supreme Court did not suggest otherwise.



be to require the union to bring a Title VII lawsuit against the employer,<sup>293</sup> as an extension of the DFR. Although it is within a union's discretion to participate in such a suit,<sup>294</sup> there is no conceptual basis for requiring the initiation of litigation under the DFR. The DFR is based on exclusivity,<sup>295</sup> and the union does not have the exclusive power to litigate under Title VII. Instead, the EEOC, individual employees, or a class of employees could challenge the employer's action.<sup>296</sup> Furthermore, once the union actively pursues a Title VII suit, it may lose credibility as a negotiator. Although the union may choose to make such a trade-off in response to blatant discrimination, requiring union activism in the uncertain area of fetal protection is unsound. A flat requirement that a union initiate litigation is not defensible under current interpretations of the DFR, and should not be created given the history of that duty.

### C. A Union's Obligations Under Title VII

#### 1. Liability for Union-Initiated Discrimination

Title VII prohibits unions from discriminating on the basis of sex and from "caus[ing] or attempt[ing] to cause" an employer to discriminate on that basis.<sup>297</sup> The first prohibition regulates a union's behavior directly toward its members.<sup>298</sup> Courts have applied traditional Title VII disparate treatment and disparate impact analyses to this type of union violation.<sup>299</sup> For example, a union's refusal to process a grievance simply because the grievant is female violates this prohibition.<sup>300</sup> Refusing to admit

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<sup>293</sup> Such a requirement has been read into the NLRB's decision in *Westinghouse*. See *Westinghouse*, 239 N.L.R.B. at 119; Levine & Hollander, *supra* note 235, at 204.

<sup>294</sup> *Westinghouse*, 239 N.L.R.B. at 111.

<sup>295</sup> See *supra* text accompanying notes 220-24.

<sup>296</sup> See Title VII of Civil Rights Act of 1964 § 706(f)(1); 42 U.S.C. § 2000e-5(f)(1) (1982).

<sup>297</sup> *Id.* at § 703(c)(3), 42 U.S.C. § 2000e-2(c)(1).

<sup>298</sup> See *id.* at § 703(c)(1), 42 U.S.C. § 2000e-2(c)(1).

<sup>299</sup> See, e.g., *Hameed v. International Ass'n of Bridge, Structural and Ornamental Ironworkers, Local 396*, 637 F.2d 506, 512 (8th Cir. 1980) (statistical analysis demonstrates that selection criteria had a disproportionate impact on black applicants).

<sup>300</sup> Cf. *United States v. City of Buffalo*, 457 F. Supp. 612, 639 (W.D.N.Y. 1978) (refusal to administer blacks' grievances violates Title VII); *Bush v. Lone Star Steel Co.*, 373 F. Supp. 526, 536 (E.D. Tex. 1974) (refusal to administer blacks' grievances violates Title VII).

individuals to a union's apprentice program because they are female likewise violates Title VII.<sup>301</sup>

The analysis becomes more complex if a claimant argues that the union caused an employer to discriminate. Although the courts have read Title VII to cover causation by both commission and omission,<sup>302</sup> the easiest case involves affirmative union action. For example, union insistence on a scientifically unsupportable fetal protection program in order to transfer jobs from females to males violates the union's duty not to discriminate,<sup>303</sup> the union's duty not to cause discrimination,<sup>304</sup> and the DFR.<sup>305</sup> Fetal protection policies typically pose the more difficult case that arises when the union fails to challenge or unsuccessfully challenges an employer instituted policy.

## 2. Liability for a Discriminatory Collective Bargaining Agreement

A union might sign a contract that includes an employer-instituted fetal protection policy or a series of job classifications that are the outgrowth of such a policy. If the policy were discriminatory,<sup>306</sup> one could argue that the union's ratification of the policy caused the employer to discriminate in violation of Title VII. Courts have dealt with this reasoning in cases involving other forms of discrimination in three ways.

According to some courts of appeals, a union is strictly liable if the contract that it negotiates contains a discriminatory provision. These decisions suggest that a strike is required by Title VII if it is the only alternative to signing a discriminatory collective bargaining agreement.<sup>307</sup> Claims of union weakness are irrelevant under this standard.

<sup>301</sup> Title VII § 703(c)(2), 42 U.S.C. § 2000e-2(c)(2) (1982). *Cf.*, *Hameed*, 637 F.2d at 506 (racially discriminatory apprenticeship program); *Rios v. Enterprise Ass'n Steamfitters Local 638*, 501 F.2d 622 (2d Cir. 1974) (discrimination against blacks and hispanics).

<sup>302</sup> *Dickerson v. United States Steel Corp.*, 439 F. Supp. 55, 62 (E.D. Pa. 1977).

<sup>303</sup> Title VII § 703(c)(1), 42 U.S.C. § 2000e-2(c)(1) (1982).

<sup>304</sup> *Id.* § 703(c)(3), 42 U.S.C. § 2000e-2(c)(3).

<sup>305</sup> See *supra* text accompanying notes 267-72.

<sup>306</sup> See *supra* text accompanying notes 149-84.

<sup>307</sup> See, e.g., *Robinson v. Lorillard Corp.*, 444 F.2d 791, 799 (4th Cir.), *cert. dismissed*, 404 U.S. 1006 (1971). "Despite the fact that a strike over a contract provision may impose economic costs, if a discriminatory contract provision is acceded to, the bargainer as well as the bargainer will be held liable." *Id.* See also *Johnson v. Goodyear Tire & Rubber Co., Synthetic Rubber Plant*, 491 F.2d 1364, 1381-82 & n.57 (5th Cir. 1974); Comment, *Union as Plaintiff*, *supra* note 258, at 1409-10; Note, *Union Liability for Employer Discrimination*, 93 HARV. L. REV. 702, 707 & n.26 (1980) [hereinafter cited as Note, *Union Liability*].

These cases, however, have generally involved union activity bordering on a discriminatory conspiracy with the employer. This fact possibly explains the courts' impatience with union excuses. In *Johnson v. Goodyear Tire and Rubber Co.*, for example, the Court of Appeals for the Fifth Circuit wrote that "[d]espite the union's attempt to present itself in the posture of the helpless negotiator, we think the union deserves more credit for the misdeeds established" by the plaintiff.<sup>308</sup> Similarly, in *Robinson v. Lorillard Co.*, the Fourth Circuit found against a union, noting that the discriminatory seniority system in question was enacted under union pressure.<sup>309</sup> No cases have employed a strict liability standard in the face of a credible claim of union weakness.

A strict liability standard poses practical problems for unions. A union may have neither the funds nor the solidarity to strike over a fetal protection policy.<sup>310</sup> In reaction, courts have created a second standard, based on a "union function" defense. In *Myers v. Gilman Paper Corporation*,<sup>311</sup> a union attempted to use the "union function" defense in a Title VII action for backpay on the basis of racial discrimination in employment, promotion, and transfers. The union argued that the discriminatory agreement was signed out of "business necessity" because it did not have the power to reject the employer's discriminatory provisions. The Fifth Circuit termed the union's reasoning a "union function" defense, and discussed its implications at length.<sup>312</sup> The court found, however, that the defense was not relevant to the liability issue at hand.<sup>313</sup> It held that the defense, if supported by the facts, relates only to a union's backpay responsibility.<sup>314</sup>

Both of these standards pose serious problems if implemented in the case of fetal protection policies. The strict liability stan-

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<sup>308</sup> *Johnson*, 491 F.2d at 1381.

<sup>309</sup> *Robinson*, 444 F.2d at 799.

<sup>310</sup> See Comment, *Union as Plaintiff*, *supra* note 258, at 1410.

<sup>311</sup> *Myers v. Gilman Paper Co.*, 544 F.2d 837, 849 (5th Cir.), *rev'd in part, vacated in part, aff'd in part, and remanded on other grounds*, 556 F.2d 758 (5th Cir.) (per curiam), *cert. dismissed*, 434 U.S. 801 (1977).

<sup>312</sup> *Id.* at 849.

<sup>313</sup> *Id.*

<sup>314</sup> *Id.*; see also *Donnell v. General Motors Corp.*, 576 F.2d 1292, 1300 n.17 (8th Cir. 1978) (citing *Myers*). The court noted that "[a]n argument that a union successfully urged compliance with Title VII does not excuse the union from liability. It instead goes to whether the employer or the union should bear the primary responsibility." *Id.* See generally B. SCHLEI & P. GROSSMAN, *supra* note 119, at 633 (when apportioning liability between union and employer, a union can avoid backpay liability if it made efforts at change).

dard could result in a weak, underfunded union being held responsible for a fetal protection policy that it did not recognize as discriminatory, that it did not have the resources to fight, or that it fought bitterly but unsuccessfully. Application of this standard forces a union to strike to avoid liability. In addition to being painful for workers, a strike over as contentious an issue as fetal protection could open the union to a decertification challenge. Forcing a union to undertake these risks with respect to the fetal protection issue, which even the federal government has found intractable,<sup>315</sup> is unacceptable.

The "union function" standard poses similar problems. Although the union may be exonerated from backpay liability, it is still stigmatized as a Title VII violator for failing to stop employer discrimination. In that situation, a court could reach the odd conclusion that a union caused discrimination simply because the union was incapable of preventing the employer from discriminating.

Under a third standard, no Title VII liability is imposed if a union actively but unsuccessfully opposes an employer's discriminatory contract proposal.<sup>316</sup> In other contexts, courts have considered the negotiations themselves, alternatives the union could have proposed,<sup>317</sup> and union representation of minorities and women beyond specific negotiation decisions in determining Title VII liability.<sup>318</sup> Similarly, these factors could establish such an "active opposition" defense in the context of fetal protection.

This third framework best accommodates the intent of both Title VII and the NLRA. By recognizing a defense to the Title

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<sup>315</sup> See *supra* text accompanying notes 94–111 (agency inability to promulgate standards governing fetal protection).

<sup>316</sup> See, e.g., *Seep v. Commercial Motor Freight, Inc.*, 575 F. Supp. 1097, 1105 (S.D. Ohio 1983) (union sought to include a female clerical unit in collective bargaining agreement for dock workers but employer refused request); *Bennett v. Central Tel. Co.*, 545 F. Supp. 893, 895 (N.D. Ill. 1982) (union did not share responsibility for discriminatory provision in bargaining agreement where it had proposed a non-discriminatory alternative); see also Decision No. 71-1418, 3 Fair Empl. Prac. Cas. (BNA) 580, 588 (1971) (absence of evidence that labor organizations opposed discriminatory contract provisions and practices of employer meant that they themselves were in violation of Title VII).

<sup>317</sup> See, e.g., *Rodriguez v. East Tex. Motor Freight*, 505 F.2d 40, 61 (5th Cir. 1974), *vacated on other grounds*, 431 U.S. 395 (1977) (union could have proposed alternatives to seniority system whereby separate seniority rosters for city and road truck drivers meant that predominantly minority city drivers had to resign before being considered for more lucrative road positions).

<sup>318</sup> See, e.g., *Patterson v. American Tobacco Co.*, 535 F.2d 257, 270 (4th Cir.), *cert. denied*, 429 U.S. 920 (1976) (holding that a union may not bargain away minority employees' rights to equal treatment by acquiescing in discriminatory seniority system in exchange for union indemnity against claims of union members).

VII claim, the court properly acknowledges the complexity of the fetal protection issue and the difficulties it poses for unions. Critics argue that this third standard allows unions to escape liability by making a pretense of protest and by producing exonerating paper records.<sup>319</sup> They maintain that it recognizes a traditionally unacceptable good faith defense.<sup>320</sup> The standard, however, is actually more demanding than these critics suggest. A properly developed "active opposition" defense would require consideration of the union's motives, the bargaining alternatives, and the reasonableness of the union's position given the science, technology, and power relationships involved. This standard is as objective as a strict construction of the DFR.<sup>321</sup> The standard could be strengthened by putting the burden of proof on the union, as opposed to the DFR's requirement that the plaintiff prove the violation. Additionally, judicial inquiry beyond the minimalist scrutiny currently given DFR challenges could be required.<sup>322</sup>

Although some unions might successfully create paper smoke-screens, the damage caused by punishing already weak unions for something they could neither recognize nor prevent is more distressing than the alternative of letting a few guilty unions go unpunished. If the union's behavior is patently discriminatory, existing Title VII and DFR standards will be violated. Furthermore, the affected employee will receive relief regardless of the standard for union conduct. In order to reach the issue of a union's derivative liability, the court must already have concluded that the employer's policy was discriminatory. As between the employer, who implemented the fetal protection policy, and a union that was fulfilling its DFR but was too poor, divided, or preoccupied to fight that policy, the employer should be the primary source of employee relief.

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<sup>319</sup> See Note, *Union Liability*, *supra* note 307, at 706-07 (alternatives to strict liability permit union to engage in only rhetoric). *Cf.* *Bennett v. Central Tel. Co.*, 545 F. Supp. 893, 895 n.4 (N.D. Ill. 1982) (no hint that union merely created exonerating record).

<sup>320</sup> See *EEOC v. Enterprise Ass'n Steamfitters Local 638*, 542 F.2d 579, 587 (2d Cir. 1976), *cert. denied*, 430 U.S. 911 (1977) (good faith is not a defense in a Title VII case); *Patterson v. American Tobacco Co.*, 535 F.2d 257, 276 (4th Cir.), *cert. denied*, 429 U.S. 920 (1976) (Widener, J., concurring and dissenting).

<sup>321</sup> For a DFR case in which the court scrutinized a similar variety of factors in finding a violation, see *NAACP v. Detroit Police Officers' Ass'n*, 591 F. Supp. 1194, 1213-20 (E.D. Mich. 1984) (court compared past efforts of police officers' union on behalf of black and white officers respectively in finding union liable).

<sup>322</sup> In Comment, *Union as Plaintiff*, *supra* note 258, at 1412, a similar shift in the burden of proof was proposed. The Comment's proposal, however, involved a "best efforts" priority for anti-discrimination efforts. This Note criticizes that aspect of the Comment's scheme. See *infra* text accompanying notes 338-41.

### 3. Liability for Employer Discrimination Beyond the Collective Bargaining Agreement

Under section 703(c) of Title VII, a union could be held responsible for a sexually discriminatory fetal protection policy, even if that policy were instituted apart from the collective bargaining agreement. Unions have an affirmative duty not to acquiesce in an employer's discrimination.<sup>323</sup> Because the EEOC has not aggressively pursued unions that have breached this duty,<sup>324</sup> its outlines remain ill-defined.

The duty not to acquiesce should not be interpreted to require a union to prosecute all fetal protection grievances. Given the complex scientific and technological evidence that must be presented, a policy will most likely be evaluated in only one grievance proceeding. If a union is forced to challenge a policy when it is economically strapped, internally divided, or momentarily concerned with other matters, a valid challenge to a discriminatory policy could fail. Thus, the result of a forced challenge may ironically be the legitimation of a discriminatory policy. Restricting union discretion under Title VII beyond the limits of the DFR may therefore prove counterproductive.

A requirement forbidding acquiescence could be interpreted to mean that a union must propose a contractual prohibition on a discriminatory fetal protection policy that was independently adopted by the employer. Courts have used Title VII to require unions to propose such terms in other contexts.<sup>325</sup> Unions may be effectively required to make such proposals under the DFR as well.<sup>326</sup> Typically, a court will consider contractual proposals, grievance prosecutions, union attitudes toward minorities or

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<sup>323</sup> *Bonilla v. Oakland Scavenger Co.*, 697 F.2d 1297, 1304 (9th Cir. 1982), *cert. denied*, 104 S. Ct. 3533 (1984); *Gray v. Greyhound Lines East*, 545 F.2d 169, 174 n.15 (D.C. Cir. 1976); *Johnson v. Goodyear Tire & Rubber Co., Synthetic Rubber Plant*, 491 F.2d 1364, 1381 n.56 (5th Cir. 1974); *Macklin v. Spector Freight Systems, Inc.*, 478 F.2d 979, 989 (D.C. Cir. 1973); Decision No. 77-10, 19 Fair Empl. Prac. Cas. (BNA) 1147, 1149 (1977).

<sup>324</sup> See *EEOC Background Paper & Resolution to Encourage Voluntary Affirmative Action in Collective Bargaining*, DAILY LABOR REPORT (BNA) No. 65, at D-1 (Apr. 1, 1980) cited in B. SCHLEI & P. GROSSMAN, *supra* note 119, at 633-34.

<sup>325</sup> See *Macklin v. Spector Freight Sys., Inc.*, 478 F.2d 979, 989 (D.C. Cir. 1973); *Patterson v. American Tobacco Co.*, 535 F.2d 257, 270 (4th Cir.), *cert. denied*, 429 U.S. 920 (1976); *Dickerson v. United States Steel Corp.*, 472 F. Supp. 1304, 1353 (E.D. Pa. 1978), *vacated on other grounds sub nom.*, *Worthy v. United States Steel Corp.*, 616 F.2d 698 (3d Cir. 1980) (failure to negotiate for non-discriminatory contract term, or to protest discriminatory treatment, is itself discrimination); Decision No. 71-1477, 3 Fair Empl. Prac. Cas. (BNA) 494, 496 (1971).

<sup>326</sup> See *supra* text accompanying notes 273-77.

women, and the presence of minorities or women in the union hierarchy, to determine if the union has fulfilled its Title VII duty not to acquiesce in discrimination.<sup>327</sup>

The union's duty not to acquiesce attaches only if "a reasonable person might suspect [the policy] to be discriminatory."<sup>328</sup> When fetal protection policies were first introduced, unions might have been unaware of the Title VII problems with these plans. At that time, this qualification might have exempted them from responsibility. Today, however, the policies have probably received enough publicity to support the attachment of a Title VII duty,<sup>329</sup> particularly since only suspicions are required for the duty to attach.

Although some suggest that the union's duty includes an affirmative obligation to litigate,<sup>330</sup> courts faced with the issue have not imposed such a duty.<sup>331</sup> Furthermore, it is debatable whether a union can or should act as a Title VII class representative as opposed to an independent organizational representative.<sup>332</sup> Nonetheless, advocates of an affirmative duty to litigate clearly expect the union to champion the interests of its female members.<sup>333</sup>

<sup>327</sup> See, e.g., *Farmer v. ARA Serv., Inc.*, 660 F.2d 1096 (6th Cir. 1981) (insufficient negotiations and grievance prosecutions evidence of union breach); *Dickerson*, 472 F. Supp. at 1354 (E.D. Pa. 1978) (union exonerated because grievance prosecutions and gradual contractual changes yielded finding of "genuine concerted effort"); *United States v. City of Buffalo*, 457 F. Supp. 612, 639 (W.D.N.Y. 1978), *modified on other grounds*, 633 F.2d 643 (2d Cir. 1980) (union attitude, reputation and failure to prosecute grievances support finding of Title VII violation); Decision No. 74-56, 10 Fair Empl. Prac. Cas. (BNA) 280, 283 (1973) (some company concessions and grievance activity absolved union from liability).

<sup>328</sup> B. SCHLEI & P. GROSSMAN, *supra* note 119, at 636; see Decision No. 77-33, 21 Fair Empl. Prac. Case (BNA) 1801, 1803 (1977) (policy was not in collective bargaining agreement, no grievance had been filed, and no other means for union to know of problem existed, so union had no duty to challenge practice).

<sup>329</sup> See *supra* notes 8, 11.

<sup>330</sup> See *Westinghouse Elec. Corp.*, 239 N.L.R.B. 106, 117 (1978) (Murphy, member, dissenting), *modified on other grounds sub nom.* *International Union of Elec., Radio & Machine Workers v. NLRB*, 648 F.2d 18 (D.C. Cir. 1980); Levine & Hollander, *supra* note 235, at 204.

<sup>331</sup> See *Rosenfeld v. Southern Pac. Co.*, 293 F. Supp. 1219, 1229 (C.D. Cal. 1968), *aff'd*, 444 F.2d 1219 (9th Cir. 1971) (no duty to sue over discriminatory laws). Cf. *United States v. City of Buffalo*, 457 F. Supp. 612, 639 (W.D.N.Y. 1978) (no duty to challenge, presumably in court, discriminatory statutory hiring requirements). Even in *Macklin v. Spector Freight Systems, Inc.*, 478 F.2d 979, 989 (D.C. Cir. 1973), the court mentioned an employee's ability to litigate, but was silent on a union's duty to do so.

<sup>332</sup> The technicalities of that dispute are beyond the scope of this Note. For an overview of the debate, see Youngdahl, *Union Standing in Prosecution of Employment Discrimination Litigation: Questions of Class*, 38 ARK. L. REV. 24 (1984) (unions may be good Title VII class representatives); Note, *Reconsidering Union Class Representation in Title VII Suits*, 95 HARV. L. REV. 1627 (1982) (union can never be adequate Title VII class representative because of inherent conflicts among members).

<sup>333</sup> See *Westinghouse*, 239 N.L.R.B. at 117 (Murphy, member, dissenting).

Union participation in litigation, however, might not result in an absolutist advancement of female interests. In *Airline Stewards & Stewardesses Association, Local 550 v. American Airlines Inc.*, for example, some female employees desired to opt out of a union initiated Title VII suit because they believed they would fare better independently. The union-employer settlement in that case did not bind all concerned.<sup>334</sup> In *American Airlines*, the court did not imply that the union discriminated against females in the lawsuit. Rather, the court recognized that the union had to serve conflicting interests and that the concerns of some employees had to be sacrificed for the concerns of others.<sup>335</sup> The conflict between the full advancement of minority interests and the union's desire to assist all of its members was painfully evident in *Firefighter's Local 1784 v. Stotts*.<sup>336</sup> In *Stotts*, the union pursued the interests of the majority of its members by challenging a Title VII remedial scheme that satisfied the plaintiffs, the city, and the district court judge. The settlement did not satisfy the majority of union members, so the union appealed. Its subsequent "victory" marked the destruction of a plan that benefitted its minority members.<sup>337</sup>

One commentator argues that a union should be required to put its "best efforts," short of a strike or litigation, into fighting discrimination.<sup>338</sup> The best efforts obligation would require the union to make anti-discrimination bargaining its top priority. It would absolve the union of liability only if the employer's power were unilateral. If a weak, but not totally powerless, union chose to compromise an anti-discrimination goal to obtain much needed benefits for all workers on other issues, it presumably would still be liable under this standard.<sup>339</sup>

A best efforts standard is undesirable for several reasons. The employer could refuse the anti-discrimination demand, gambling that the union was raising it simply to achieve *pro forma* compliance with the best efforts requirement. Alternatively, the employer could use the fetal protection demand as a lever to gain

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<sup>334</sup> 490 F.2d 636, 641-42 (7th Cir. 1973), *cert. denied*, 416 U.S. 993 (1974).

<sup>335</sup> *Id.* at 642. The court noted that a union has no unique authority to compromise the rights of its members outside the area of collective bargaining.

<sup>336</sup> 104 S. Ct. 2576 (1984).

<sup>337</sup> *Id.* at 2581. For a discussion of the implications of *Stotts* for affirmative action generally, see Fallon & Weiler, *Firefighters v. Stotts: Conflicting Models of Racial Justice*, 1984 SUP. CT. REV. 1.

<sup>338</sup> Comment, *Union as Plaintiff*, *supra* note 258, at 1411-13.

<sup>339</sup> *Id.* at 1412.



concessions in other areas. Locking a union into a best efforts position invites an employer to play one group off against another. Increased union anti-discrimination vigilance may thus result in increased antipathy within the unit toward the minority.

A convincing reason has not been advanced for requiring best efforts or a similar level of union responsibility for policing employer initiated discrimination. The language and legislative history of Title VII do not clearly assert such a duty, and the Supreme Court has placed limits on the extent to which Title VII can undermine traditional collective bargaining systems. In *Emporium Capwell Co. v. Western Addition Community Organization*,<sup>340</sup> for example, the Supreme Court permitted the discharge of minority employees for engaging in concerted activity that was illegal under the NLRA. The court found that action undertaken independently by an interest group within the union on behalf of racial equality threatened union solidarity and authority.<sup>341</sup> Mandatory union devotion to the anti-discrimination fetal protection cause similarly threatens the union's flexibility and solidarity.

The female union members would not necessarily suffer if union liability for failure to fight a discriminatory fetal protection policy were limited. The EEOC was created to assist individual victims of discrimination. Even if the EEOC is not as vigilant as it could or should be, female employees may obtain a right-to-sue notice from the agency and proceed individually or as a class. Although the plaintiffs might have to acquire private representation, Title VII does provide for attorney's fees.<sup>342</sup> A difficult and important class action dealing with fetal protection might be an attractive pro bono project.<sup>343</sup> The American Civil Liberties Union has already devoted substantial resources to the fetal protection problem,<sup>344</sup> so at least one well-known source of support and referrals is available.

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<sup>340</sup> 420 U.S. 50 (1975).

<sup>341</sup> *Emporium Capwell*, 420 U.S. at 70. See generally Meltzer, *The National Labor Relations Act and Racial Discrimination: The More Remedies, the Better?* 42 U. CHI. L. REV. 1 (1974) (giving minority leverage at the expense of union solidarity threatens NLRA).

<sup>342</sup> Title VII § 706(k), 42 U.S.C. § 2000e-5(k) (1982).

<sup>343</sup> Cf. S. TISHER, L. BERNABEI, M. GREEN, *BRINGING THE BAR TO JUSTICE: A COMPARATIVE STUDY OF SIX BAR ASSOCIATIONS* 133 (1977) (favored pro bono cases present interesting legal issues and offer high visibility to firm).

<sup>344</sup> The ACLU's Woman's Rights Project filed amicus curiae briefs in all three leading fetal protection cases. See *Hayes v. Shelby Memorial Hosp.*, 726 F.2d 1543, 1545 (11th Cir. 1984); *Wright v. Olin Corp.*, 697 F.2d 1172, 1175 (4th Cir. 1982); *Zuniga v. Kleberg County Hosp.*, 692 F.2d 986, 987 (5th Cir. 1982).

With or without non-union assistance, a convincing rationale for forcing a labor union to become an EEOC-like advocate for female employees has not been offered. A union's expertise would not necessarily be lost to the cause if the union did not act as a direct advocate for female workers. The union could contribute its knowledge through depositions or by joinder of the union as an organizational representative.<sup>345</sup> In the absence of a specific congressional requirement of union advocacy, creating such a mandate out of the language of Title VII is inadvisable, particularly in light of the detrimental effects of such a requirement on union flexibility.

#### D. Incentives for Voluntary Union Involvement

Despite the limits of its legal duties, a union might voluntarily become involved in fetal protection policy issues,<sup>346</sup> either from a desire to further sexual equality or to fulfill Title VII duties.

A far-sighted union may welcome involvement in fetal protection decisionmaking because fetal protection policies strike at the heart of health, safety, and job placement, traditional areas of union concern. Union involvement in fetal protection decisions heightens union visibility and builds employee awareness.<sup>347</sup> It demonstrates that the union can assist workers in an area where federal regulation is inadequate or unavailable, proving that unions have a role even in a highly regulated society.<sup>348</sup> Voluntary union involvement also demonstrates an interest in women's rights in an era in which unions are struggling to attract female members.<sup>349</sup> Furthermore, because the chemical catalyst for a fetal protection program may harm male workers as well

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<sup>345</sup> See *supra* note 332 and accompanying text.

<sup>346</sup> Cf. *W.R. Grace & Co. v. Local Union 759, Int'l Union of the United Rubber, Cork, Linoleum, and Plastic Workers*, 461 U.S. 757 (1983) (union should desire to participate with employer in EEOC settlement discussions when interests mesh).

<sup>347</sup> Cf. Summers, *Individual Rights in Collective Agreements and Arbitrations*, 37 N.Y.U. L. REV. 362, 391-92 (1962) (exclusive union involvement in grievance settlement enhances union prestige, builds loyalty, and demonstrates union effectiveness).

<sup>348</sup> Charles Fried has argued that unions are no longer necessary in a market system with regulated minimum standards. See Fried, *Individual & Collective Rights in Work Relations: Reflections on the Current State of Labor Law and Its Prospects*, 51 U. CHI. L. REV. 1012, 1027-29 (1984).

<sup>349</sup> Cf. Donahue, *The Role of and Challenges Facing Unions in the 1940's and the 1980's—A Comparison*, 52 FORDHAM L. REV. 1062, 1068 (1984) (Secretary-Treasurer of the AFL-CIO on the need for unions to become progressive and to shift into new occupations); Gorov, *Are These Men out of Touch?* Boston Globe, Feb. 24, 1985, at 6, col. 3.

as female workers,<sup>350</sup> union vigilance could benefit the entire workforce.

Union participation is also desirable from the perspective of judicial economy and finality. Unions might be involved in evaluating the efficacy of proposed remedial schemes, and some Title VII remedies may be unenforceable if the union was not consulted in their formulation. A lack of union involvement was one reason behind the successful challenge to the Title VII remedial scheme in *Firefighters Local 1784 v. Stotts*.<sup>351</sup> Making the settlement binding at its outset might avoid lengthy, expensive challenges to the remedy after the fact. Because settlement of a fetal protection case might involve alteration of job transfer, job responsibility, or seniority provisions, union involvement might be crucial. More broadly, union involvement could be useful in providing another perspective and increased scrutiny in the highly complex area of fetal protection.

Nonetheless, although union involvement may be desirable if offered voluntarily, it should not be legally required. The union may be too preoccupied, underfunded, or overwhelmed to determine what position it should take, or simply too internally divided to take any position at all. Requiring such a union to become an advocate for female employees could completely undermine the unit. Such a result does not serve employee interests and should not be judicially countenanced.

## VI. CONCLUSION

Fetal hazards must be identified, researched, and regulated. In the absence of comprehensive regulation, employer-initiated fetal protection policies will continue to exclude women from many predominantly male industrial jobs. Title VII lawsuits are currently the only method available for affected employees to receive judicial scrutiny of the circumstances of that exclusion.

Three Courts of Appeals have struggled with the legitimacy of these policies. Each court has uniquely adapted traditional Title VII law in order to evaluate discrimination claims concerning fetal protection policies. No single framework is entirely

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<sup>350</sup> See *supra* notes 36–44 and accompanying text.

<sup>351</sup> *Firefighters' Local 1784 v. Stotts*, 104 S. Ct. 2576, 2586 (1984). The union did sign a separate memorandum with the city about seniority, but that agreement was not seen as relevant to deciding the case. *Id.* at 286 & n.7.

adequate. The shifting burdens and presumptions of *Hayes v. Shelby Memorial Hospital*, coupled with the tort-based business necessity defenses of *Wright v. Olin Corporation* and *Zuniga v. Kleberg County Hospital* do indicate that an equitable Title VII response is in the process of judicial development.

These cases also suggest that many currently existing fetal protection policies are unlawfully discriminatory. Labor unions must now respond to the discrimination in their workplaces. To date, however, unions have generally avoided this challenge.

Complete union avoidance of discriminatory fetal protection policies is unlawful under both the DFR and Title VII. The DFR imposes a responsibility for unions to investigate fetal protection grievances and to propose alternatives to discriminatory exclusion policies. Similar, though not identical, duties exist under Title VII.

Some courts and commentators argue that union responsibilities include striking, filing lawsuits, or extending best efforts short of these techniques to oppose employer discrimination. These arguments place an unwarranted burden on unions. Requiring such drastic action undermines needed union flexibility and undervalues the union's role as mediator between employee pressure groups and as negotiator between employers and employees.

If a union chooses to involve itself in the fetal protection dilemma, that choice should be honored and applauded. Union involvement would increase the flow of information about fetal protection and might raise workplace safety levels for all employees. Such involvement must not be legally mandated, however. No interests are served by holding a weak and ill-prepared union legally responsible for tackling an issue that has stymied the EEOC and confused the federal judiciary.

# NOTE

## REGULATION OF STATE NONMEMBER INSURED BANKS' SECURITIES ACTIVITIES: A MODEL FOR THE REPEAL OF GLASS-STEAGALL?

PETER B. SABA\*

*In the midst of the Great Depression Congress enacted the Glass-Steagall Act to separate the investment and commercial banking industries. This measure was a response to the perceived abuses by commercial banks and their securities affiliates which were seen as being associated with the stock market collapse and bank failures of that era.*

*As enacted, the Glass-Steagall Act included a number of inconsistencies and loopholes. Mr. Saba argues that since the passage of the Act, these loopholes, combined with market forces and technological advances, illustrate that the Act is little more than an economic impediment and is unsupported by its underlying policy rationales. After reviewing the justifications for and criticisms of the separation policy, Mr. Saba considers various regulatory and legislative proposals to permit bank involvement in securities activities, including the FDIC regulations for insured non-member banks. These restrict bank investments in securities to securities subsidiaries and affiliates and regulate their relations with their associated bank. Mr. Saba concludes that these regulations present the best model for replacing the antiquated Glass-Steagall Act.*

In response to actual or perceived abuses of the securities activities of commercial banks, which were seen as contributing to the Great Depression, the Glass-Steagall Act was enacted in 1933 to separate the businesses of investment and commercial banking.<sup>1</sup> Even as enacted, the wall separating the two industries had a number of gaping holes and inconsistencies.<sup>2</sup> Today,

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<sup>1</sup> The Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.), is popularly known as the Glass-Steagall Act. More frequently, however, the term "Glass-Steagall Act" is used to refer only to §§ 16, 20, 21, and 32 of the Banking Act of 1933, 12 U.S.C. §§ 24 (Seventh), 377, 378, 78 (1982 & Supp. II 1984). This paper adopts the latter convention.

<sup>2</sup> For example, the Glass-Steagall Act does not restrict affiliations between nonmember banks and securities firms, expressly permits banks to engage directly in a number of securities activities, and only restricts affiliations between member banks and firms "engaged principally" in the enumerated securities activities. In addition, securities firms have successfully exploited the "nonbank bank" loophole to avoid the restrictions of the Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841-50 (1982). *See, e.g., Note, Restrictions on Bank Underwriting of Corporate Securities: A Proposal for More Permissive Regulation*, 97 HARV. L. REV. 720, 725-27 (1984) [hereinafter cited as *Note, Underwriting Proposal*]; *see also infra* note 62 and accompanying text (discussing recent developments relating to the nonbank bank loophole); Perkins, *The Divorce of Com-*

as a result of technological advances and market forces,<sup>3</sup> the wall is but an anachronism manipulable by innovative lawyers seeking new ways to chip away at its foundation.

If the reasons for this separation remain valid today, then the wall should be fortified and any exceptions to this policy should be rationalized. On the other hand, if the whole concept of separating the functions of investment and commercial banking is counterproductive, then the wall should be dismantled, and the policy concerns that led to separation, to the extent they remain valid, should be addressed directly through regulation.

After reviewing the structure of the Glass-Steagall Act, Part I of this Note will examine one of its major gaps: the securities activities of affiliates of state nonmember banks. Through this gap in the Glass-Steagall Act, over 9000 banks, holding almost thirty percent of domestic deposits,<sup>4</sup> may be able to engage in securities activities through subsidiaries or affiliates. Part II of this Note will consider whether the Federal Reserve Board (Board) has authority under the Bank Holding Company Act to regulate holding company bank subsidiaries and the nonbank subsidiaries of those banks.

In Part III, this Note will examine the justifications for and criticisms of the separation policy. The Federal Deposit Insurance Company's (FDIC's) regulations covering the securities activities of subsidiaries and affiliates of insured nonmember banks will be considered in Part IV to determine whether they adequately address the policy concerns behind separation. Finally, these regulations will be compared to a number of recent legislative proposals to see which serves as the best model for replacing separation with regulation.

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*mercial and Investment Banking: A History*, 88 *BANKING L.J.* 483, 525 (1971). "[E]xtremely strong ties still remained between the two banking functions. Investment bankers continued to borrow much of their working capital from commercial banks. If the proponents of an alteration in the financial structure had as one of their goals the complete protection of commercial bank depositors from the risks of unsalable security issues, it was then only partially successful." *Id.*

<sup>3</sup> See, e.g., *Financial Services Industry—Oversight: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs* (part I), 98th Cong., 1st Sess. 53, 54–58 (1983) (statement of Paul Volcker, Chairman, Federal Reserve Board) [hereinafter cited as *Financial Services Oversight Hearings*]. "The accelerated pace of change in the structure of our financial system in recent years has reflected irreversible technological as well as market forces." *Id.* at 54.

<sup>4</sup> See C. GOLEMBE & D. HOLLAND, *FEDERAL REGULATION OF BANKING 1983–84*, at 215, 217 (1983) (Table 2, Table 4).

## I. THE GLASS-STEAGALL ACT

### A. *The Statutory Framework*

Actual or alleged abuses of commercial banks and their securities affiliates associated with the stock market collapse and the bank failures of the Great Depression were the subject of extensive congressional hearings in the early 1930's.<sup>5</sup> These hearings led Congress to adopt a policy of separating the commercial and investment banking industries.<sup>6</sup> This policy was implemented through sections 16, 20, 21, and 32 of the Banking Act of 1933.<sup>7</sup>

As the Supreme Court noted in *Board of Governors of the Federal Reserve System v. Investment Company Institute (ICI)*:<sup>8</sup>

Sections 16 and 21 of the Glass-Steagall Act approach the legislative goal of separating the securities business from the

<sup>5</sup> See, e.g., *Operation of the National and Federal Reserve Banking System, Subcommittee on S. Res. 71, Senate Comm. on Banking and Currency, 71st Cong., 3d Sess. (1931); S. REP. NO. 77, 73d Cong., 1st Sess. (1933)*. For a history of the events leading up to the passage of the Glass-Steagall Act, see GOLEMBE ASSOCIATES, INC., *COMMERCIAL BANKING AND THE GLASS-STEAGALL ACT 19-53 (1982)* (prepared for the American Bankers Ass'n); W. NELSON PEACH, *THE SECURITIES AFFILIATES OF NATIONAL BANKS (1941)*; Perkins, *supra* note 2. But see *Competitive Equity in the Financial Services Industry: Hearings before the Senate Comm. on Banking, Housing, and Urban Affairs (part III), 98th Cong., 2d Sess. 1274, 1278 (1984)* (statement of William Isaac, Chairman, FDIC) [hereinafter cited as *Competitive Equity Hearings*].

The Glass-Steagall Act prohibits member banks from affiliating with investment banking firms. The law was enacted in response to the collapse of the banking system of the 1930s. We do not believe it was an appropriate response. There were abuses by securities firms during that period, but there is no evidence those abuses were more prevalent among bank-affiliated securities firms than among securities firms generally. Neither is there evidence those abuses caused significant problems in the banking system.

The banking system collapsed during the 1930s primarily because of overly restrictive fiscal and monetary policies during the course of a major recession and because thousands of banks were not able to avail themselves of the discount window at the Federal Reserve. Since then, we have established a federal deposit insurance system to reassure depositors, created the SEC to regulate securities firms, strengthened bank examination and regulation, and through the Monetary Control Act of 1980, made the discount window available to all depository institutions.

*Id.* at 1278.

<sup>6</sup> See GOLEMBE ASSOCIATES, INC., *supra* note 5, at 49-53; Perkins, *supra* note 2, at 505-15.

<sup>7</sup> 12 U.S.C. §§ 24 (Seventh), 377, 378, 78 (1982 & Supp. II 1984).

<sup>8</sup> 450 U.S. 46 (1981) (Board determination to allow bank holding companies and their nonbanking subsidiaries to perform investment advisory services for closed-end investment companies is within its statutory authority and did not violate the Glass-Steagall Act or the Bank Holding Company Act). See also *infra* note 34. For a discussion of the differences between closed-end and open-end investment companies, see *infra* note 278.

banking business from different directions. The former places a limit on the power of a bank to engage in securities transactions; the latter prohibits a securities firm from engaging in the banking business.<sup>9</sup>

Section 16 has been described as "the foundation for the wall separating commercial and investment banking."<sup>10</sup> This section prohibits a national bank from underwriting any issue of securities or from purchasing and selling securities for its own account.<sup>11</sup> Section 16, however, specifically permits national banks to purchase and sell "securities and stock without recourse, solely upon the order, and for the account of, customers;" to purchase for its own account "investment securities" (defined as marketable debt obligations and not stock) under regulations prescribed by the Comptroller of the Currency (Comptroller); and to deal in, underwrite and purchase for its own account obligations of the United States, general obligations of states and their political subdivisions, and obligations of other enumerated government entities.<sup>12</sup> The limitations of section 16 are also applicable to state-chartered banks that are members of the Federal Reserve System (state member banks).<sup>13</sup>

This restriction is reinforced by sections 20 and 32.<sup>14</sup> Section 20 forbids any member bank from being affiliated with any organization "engaged principally in the issue, flotation, under-

<sup>9</sup> 450 U.S. at 62.

<sup>10</sup> Karmel, *Glass-Steagall: Some Critical Reflections*, 97 *BANKING L.J.* 631, 633 (1980).

<sup>11</sup> 12 U.S.C. § 24 (Seventh) (Supp. II 1984).

<sup>12</sup> *Id.*

<sup>13</sup> Banking Act of 1933, § 5(c), 12 U.S.C. § 335 (1982). National banks are chartered by the Comptroller of the Currency and are required to be members of the Federal Reserve System. *See id.* § 222. State-chartered banks have the option of becoming members or not. *See id.* § 321. All member banks are required to have their deposits insured by the FDIC. *See id.* § 1814. State nonmember banks may also be eligible for FDIC insurance. *See id.* § 1815. *See also* C. GOLEMBE & D. HOLLAND, *supra* note 4, at 6-9 (discussion of dual bank chartering and regulation). Since the Depository Institutions Deregulatory Act of 1980, Pub. L. No. 96-221, 94 Stat. 142 (1980) (codified at 12 U.S.C. §§ 3501-3509 (1982)), no advantages except possibly prestige attach to Federal Reserve System membership and there actually may be some disadvantages to membership. *See FDIC Securities Proposal and Related Issues: Hearings Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce*, 98th Cong., 1st Sess. 69 (statement of Bevis Longstreth, Commissioner, SEC) [hereinafter cited as *House Hearings on FDIC Proposal*]. For a general discussion of the dual banking system, see Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 *STAN. L. REV.* 1 (1977).

This paper will use the term "insured bank" to refer to FDIC-insured banks, unless otherwise stated.

<sup>14</sup> *See* GOLEMBE ASSOCIATES, INC., *supra* note 5, at 54. "The remaining two sections [*i.e.*, §§ 20, 32] are essentially supportive or complementary to Section 16." *Id.*



writing, public sale, or distribution [of securities]."<sup>15</sup> In addition, section 32 prohibits an officer, director, or manager of a member bank from being an officer, director, or manager of an entity primarily engaged in certain securities activities.<sup>16</sup>

Section 21, on the other hand, prohibits securities firms from engaging in banking.<sup>17</sup> This section makes it unlawful for any person or organization "engaged in the business of issuing, underwriting, selling, or distributing . . . stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of [receiving deposits]."<sup>18</sup> A securities company can be linked to a bank without violating section 21, as long as the company does not itself make deposits.<sup>19</sup>

In sum, sections 16, 20, and 32 restrict the activities and affiliations of member banks and their personnel. These restrictions by their terms do not apply to nonmember banks. In addition, section 21 prohibits the same entity from both engaging in certain securities activities and receiving deposits. By its terms, however, section 21 is a "single-entity" restriction and

<sup>15</sup> 12 U.S.C. § 377 (1982). The term "affiliate" is defined at 12 U.S.C. § 221a(b) (1982). While this definition of "affiliate" includes a subsidiary controlled by a bank, this paper will refer to subsidiaries and affiliates when it is important to distinguish between subsidiary affiliations on the one hand, and parent or sister affiliations on the other.

<sup>16</sup> *Id.* § 78. For an analysis of the distinctions among the standards of "engaged," "primarily engaged," and "engaged principally," see *Board of Governors v. Agnew*, 329 U.S. 441, 446-49 (1947).

<sup>17</sup> See *ICI*, 450 U.S. at 62; see also *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys. (Becker)*, 104 S. Ct. 2979 (1984). "Section 21 also separates investment and commercial banks, but does so from the perspective of investment banks." *Id.* at 2986. Cf. *Golembe & Holland, Expansion Possibilities for Nonmember Banks*, BANKING EXPANSION REP., Jan. 15, 1982, at 1, 9.

Although seemingly aimed at firms principally in the investment banking business that also might want to accept deposits, the wording of Section 21 is sufficiently broad to cover firms principally in the deposit-taking business—that is, banks—that might want to engage in the proscribed investment banking activities. There is no language that could be construed as exempting organizations only peripherally engaged in the securities business. Any organization engaging, however minutely, in any of the listed activities would be in the investment banking business and thus prohibited from taking deposits.

*Id.*

<sup>18</sup> 12 U.S.C. § 378 (1982). Section 21 was amended in 1935 to clarify that it did not limit the ability of any bank to engage in the securities activities permitted to national banks under § 16. Banking Act of 1935, ch. 614, § 303, 49 Stat. 684, 707 (codified as amended at 12 U.S.C. § 378(a)(1) (1982)). See S. REP. NO. 1007, 74th Cong., 1st Sess. 15 (1935); H.R. REP. NO. 742, 74th Cong., 1st Sess. 16 (1935). Section 16 also was amended to make it clear that a member bank could purchase and sell stock for the account of customers, but not for its own account. Banking Act of 1935, ch. 614, § 308, 49 Stat. 684, 709 (codified as amended at 12 U.S.C. § 24 (Seventh) (Supp. II 1984)). See S. REP. NO. 1007, *supra*, at 16-17; H.R. REP. NO. 742, *supra*, at 18.

<sup>19</sup> See *infra* notes 33-44 and accompanying text.

does not address the activities of subsidiaries or affiliates. Thus, the subsidiaries and affiliates of nonmember banks are unaffected by the statutory framework of separation erected by the Glass-Steagall Act.<sup>20</sup>

### B. Member Bank Restrictions

While a literal reading of the statute supports the conclusion that the Glass-Steagall Act prohibitions on member banks in sections 16, 20, and 32 do not extend to nonmember banks, such a reading has been questioned as inconsistent with the intent of Congress to divorce commercial and investment banking.<sup>21</sup> This, however, is "a law which was written with great particularity so as to address specific abuses which Congress believed led to the Depression of the 1930's."<sup>22</sup> Thus, despite broad pronouncements of congressional intent, the clear language of the statute should control.<sup>23</sup> Moreover, as previously

<sup>20</sup> See Statement of Policy on Applicability of Glass-Steagall Act to Securities Activities of Insured Nonmember Banks, 47 Fed. Reg. 38,984 (1982) [hereinafter cited as FDIC Policy Statement]; C. GOLEMBE & D. HOLLAND, *supra* note 4, at 82; Note, *Underwriting Proposal*, *supra* note 2, at 725; Note, *Avoiding the Glass-Steagall and Bank Holding Company Acts: An Option for Bank Product Expansion*, 59 IND. L.J. 89, 95-105 (1983) [hereinafter cited as Note, *Product Expansion Option*]; Golembe & Holland, *supra* note 17, at 1, 9.

<sup>21</sup> See, e.g., *Investment Company Inst. v. FDIC*, 606 F. Supp. 683, 684-85 (D.D.C. 1985) (plaintiff's argument); Comment Letter of the Investment Company Inst. to Hoyle L. Robinson, Executive Secretary, FDIC (July 18, 1983) (on file at the FDIC) [hereinafter cited as Comment Letter of the Investment Company Inst.].

<sup>22</sup> Karmel, *supra* note 10, at 633 (citing the great particularity in drafting as the cause of many ambiguities that result when Glass-Steagall is applied in a changed environment).

<sup>23</sup> See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976) (private cause of action for damages will not lie under § 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 in the absence of any allegation of "scienter," i.e., intent to deceive, manipulate, or defraud). Justice Powell noted that "the language of the statute controls when sufficiently clear in its context." *Id.* (cited in Note, *Product Expansion Option*, *supra* note 20, at 96, in support of the proposition that §§ 16, 20, 32 do not apply to nonmember banks); see also 2A N. SINGER, SUTHERLAND STATUTORY CONSTRUCTION § 46.04 (1984 Revision) (when meaning is unambiguous, courts should give effect to that meaning without looking at intent); cf. *United States v. American Trucking Ass'n*, 310 U.S. 534, 543 (1940).

There is, of course, no more persuasive evidence of the purpose of a statute than the words by which the legislature undertook to give expression to its wishes. Often these words are sufficient in and of themselves to determine the purpose of the legislation. In such cases we have followed their plain meaning. When that meaning has led to absurd or futile results, however, this Court has looked beyond the words to the purpose of the act. Frequently, however, even when the plain meaning did not produce absurd results but merely an unreasonable one 'plainly at variance with the policy of the legislation as a whole' this Court has followed that purpose, rather than the literal words.

*Id.* (footnotes omitted). It would be inappropriate, however, to disregard actual words in a statute in order to give effect to broad legislative intent when this would deny effect to the more specific intent of the enacting Congress.

noted, the Glass-Steagall Act does not contemplate a complete separation of the commercial and investment banking industries.<sup>24</sup>

While the conventional wisdom holds that the omission of nonmember banks from the prohibitions of the Glass-Steagall Act was purely inadvertent,<sup>25</sup> a closer examination of the legislative history reveals that the omission reflects Congress's restrictive view of its constitutional authority to regulate nonmember banks.<sup>26</sup> The Senate Report accompanying the Senate bill that ultimately became the Banking Act of 1933 evidences Congress's preoccupation with national and member banks<sup>27</sup> and Congress's narrow view of its Commerce Clause powers.<sup>28</sup> This restrictive interpretation of the Commerce Clause power resulted in the separate treatment of state-organized bank holding companies.<sup>29</sup> Even Senator Glass expressed doubts as to the

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<sup>24</sup> See *supra* note 2 and accompanying text.

<sup>25</sup> See *House Hearings on FDIC Proposal*, *supra* note 13, at 40 (testimony of Lee Spencer, Director of Corp. Fin., SEC); GOLEMBE ASSOCIATES, INC., *supra* note 5, at 56; Golembe & Holland, *supra* note 17, at 9-10.

The Banking Act of 1933 provided that after July 1, 1936 only member banks could be insured by the newly established FDIC. Subsequent Congresses extended the date, and this eligibility requirement was completely repealed in 1939. These changes were made for reasons unrelated to the restrictions on securities activities of banks. See *id.*; Comment Letter of the American Bankers Ass'n to Hoyle L. Robinson, Executive Secretary, FDIC (May 31, 1984) (on file at the FDIC) [hereinafter cited as Comment Letter of the American Bankers Ass'n].

<sup>26</sup> See Comment Letter of the American Bankers Ass'n., *supra* note 25.

<sup>27</sup> See, e.g., S. REP. NO. 77, *supra* note 5, at 10 (stating that the proposed legislation is aimed at separating "as far as possible national and member banks from affiliates of all kinds").

See also *Investment Co. Inst. v. Camp (Camp)*, 401 U.S. 617, 629-30 (1971) ("Moreover, Congress was concerned that commercial banks in general and member banks of the Federal Reserve System in particular had both aggravated and been damaged by stock market decline partly because of their direct and indirect involvement in the trading and ownership of speculative securities." *Id.* (footnote omitted)).

<sup>28</sup> See, e.g., S. REP. NO. 77, *supra* note 5, at 2.

[I]t seems to be the consensus of opinion among banking authorities that the United States will never have a complete and strong system until such time as it shall succeed in fully harmonizing and adjusting State and Federal laws on banking questions. This might involve a constitutional amendment or some equally far-reaching measure necessitating a long postponement of action.

*Id.*

<sup>29</sup> See *Investment Co. Inst. v. Board of Governors of the Fed. Reserve Sys.*, 606 F.2d 1004, 1015-16 (D.C. Cir. 1979), *rev'd*, 450 U.S. 46 (1981); Bock, *The Glass-Steagall Act and the Acquisition of Member Banks by Unregulated Bank Holding Companies*, 100 BANKING L.J. 484, 496-97 (1983). The Senate Report accompanying the bill stated that:

Since the companies are State corporations, Congress has no control over them, except that which may be voluntarily granted. However, since the staple of their ownership or holdings is the stock of National and State member banks, it would seem that Congress may control the conditions under which such stocks may be owned and particularly voted.

constitutionality of the one provision that placed restrictions on both member and nonmember banks.<sup>30</sup> Furthermore, the congressional debate on the scope of the provision restricting bank affiliates unequivocally indicates Congress's restrictive view of its jurisdiction over state banks.<sup>31</sup> Thus, to expand the coverage of the restrictions on member banks to encompass nonmember banks would be to disregard not only the unambiguous language of the statute, but also Congress's intent to omit nonmember banks from these prohibitions.<sup>32</sup>

### C. Section 21

Section 21 has not been interpreted to reach affiliates or subsidiaries.<sup>33</sup> Rather, in *ICI*, the Supreme Court affirmed the view

S. REP. NO. 77, *supra* note 5, at 10–11. This explanation of the provision that ultimately became § 19(e) leads to the conclusion that:

The authors of the report clearly had a much narrower view of Congress's constitutional authority to regulate state-chartered companies than is almost universally accepted today, fifty years later, and it consequently appears that Congress did not intend to regulate the subsidiaries of holding companies by means of Section 20 *because it did not believe it had the authority to do so.*

Bock, *supra*, at 497 (emphasis in original).

<sup>30</sup>

[The constitutionality of section 21] was very doubtful according to the best legal advice that we could get, but so intent were we upon curing the abuses that have been developed since 1927 up to the preliminary revelations of this committee, which have been greatly accentuated by subsequent disclosures before this committee—so intent were we upon doing that, that we risked the validity of that restrictive legislation.

*Stock Exchange Practices: Hearings on S. Res. 84 and S. Res. 56 Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess. 4030 (1933); see also Bock, supra note 29, at 497 n.24.* "This suggests that Congress's view of its authority was consistent, but that the bill's proponents were nevertheless willing to take a risk regarding the constitutionality of § 21 because they perceived the problem dealt with by that section as particularly critical." *Id.*

<sup>31</sup> *See, e.g.,* 75 CONG. REC. 9905 (May 10, 1932) (remarks of Sen. Walcott) (congressional debate on S. 4412, a predecessor to the bill that became the Glass-Steagall Act).

Mr. FESS. The provision [restricting bank affiliations] does not attempt to go beyond the Federal reserve system.

Mr. WALCOTT. It does not control state banking, and the reason for that is obvious: The Federal Government has no jurisdiction over State banks.

*Id.*

<sup>32</sup> In the context of the applicability of section 20 to the regulation of subsidiaries of holding companies, one commentator has stated:

This leaves an intriguing issue of statutory construction: whether a court must respect an obsolete view by Congress of its own authority in enacting a statute when, years later, the court must construe that statute. This history provides a strong argument that to construe the statute broadly (i.e., not literally) would violate Congress's stated intent, even if in retrospect that intent was limited by self-imposed constraints now viewed as incorrect.

Bock, *supra* note 29, at 497.

It might still be argued that Congress intended these prohibitions to apply to all FDIC-insured banks and that subsequent events led to the statutory gap. *See supra* note 25 and accompanying text. This argument, however, disregards the fact that the statute differentiates among banks by their status as members of the Federal Reserve System.

<sup>33</sup> *See* FDIC Policy Statement, *supra* note 20, at 38,984–85; Note, *Product Expansion Option, supra* note 20, at 104.

that section 21 is a single-entity restriction and "cannot be read to include within its prohibition separate organizations related by ownership with a bank, which does receive deposits."<sup>34</sup> The Court then quoted from the legislative debates to indicate that "the drafters of the bill agreed with this construction."<sup>35</sup> Absent justifications for disregarding separate corporate personalities, such as fraud or inadequate capitalization,<sup>36</sup> section 21 should not be applied to the affiliates or subsidiaries of banks.<sup>37</sup>

While the activities of subsidiaries have been attributed to their parents, and affiliates have been treated as single entities in order to analyze affiliations and management interlocks under sections 20 and 32,<sup>38</sup> this would be inappropriate in the context

<sup>34</sup> *ICI*, 450 U.S. at 58 n.24. *ICI* involved the legality of permitting nonbanking subsidiaries of bank holding companies (i.e., sister affiliates of banks) to offer investment advisory services, and the quoted language arose in the context of the Court's refusal to treat the bank and its parent holding company as a single entity for purposes of sections 16 and 21. *See id.* This interpretation is equally applicable to the present situation. *See* FDIC Policy Statement, *supra* note 20, at 38,985. "Although the Supreme Court in *Board of Governors v. ICI* did not consider section 21 in the context of a bank and its subsidiary, we are of the opinion that the Court's conclusion regarding section 21 and holding company affiliates is equally applicable in this instance." *Id. Cf. Bock, supra* note 29, at 486 & n.4. It "appears settled that Section 21 does not limit the banking activities of a *subsidiary* of an entity engaged in the enumerated securities activities. [But, it is] more controversial . . . whether under this same footnote, a bank may establish a subsidiary to engage in securities activities of a type in which the bank could not itself engage under § 21." *Id.* (emphasis in original).

<sup>35</sup> *ICI*, 450 U.S. at 58 n.24 (citing 77 CONG. REC. 3730 (1933)).

Mr. GLASS. . . . Here [§ 21] we prohibit the large private banks whose chief business is investment business, from receiving deposits. We separate them from the deposit business.

. . . .

Mr. ROBINSON of Arkansas. That means that if they wish to receive deposits they must have separate institutions for that purpose?

Mr. GLASS. Yes.

*Id.*

<sup>36</sup> *See, e.g., Minton v. Cavaney*, 56 Cal. 2d 576, 579, 364 P.2d 473, 475, 15 Cal. Rptr. 641, 643 (1961) (corporate officer is not personally liable for judgment against the corporation when not a party to the suit and not in control of the litigation). "The figurative terminology 'alter ego' and 'disregard of the corporate entity' is generally used to refer to the various situations that are an abuse of the corporate privilege." *Id.* (citations omitted). *See also* 12 C.F.R. § 570.10 (1985) (separate corporate existence of a service corporation); Note, *The Demise of the Bank/Nonbank Distinction: An Argument for Deregulating the Activities of Bank Holding Companies*, 98 HARV. L. REV. 650, 661-63 (1985) [hereinafter cited as Note, *BHC Argument*]. "Courts are especially unlikely to pierce the corporate veil in the banking context." *Id.* at 661. *See infra* notes 130 & 134-36 and accompanying text.

<sup>37</sup> *Cf.* Comment Letter of the Investment Company Inst., *supra* note 21, at 9 n.\*\*\*\*\* (arguing that alter ego liability is appropriate because nonmember banks would be utilizing the corporate form to evade a statute). This argument, however, should fail because the structure of the statute itself contemplates different treatment of single-entities and affiliates.

<sup>38</sup> *See OCC Approves National Bank Charter for Bank Owned by Mutual Fund Advisor*, [1982-1983 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 99,464 (Feb. 18, 1983) (approval of application to charter Dreyfus National Bank & Trust Co.; applying "single-entity" theory in section 20 context); *see also* Bock, *supra* note 29, at 507-11

of section 21. Aggregation in the context of section 21 would render section 20 superfluous by failing to give effect to the fact that section 20 only restricts affiliations between member banks and entities "engaged principally" in the enumerated securities activities.<sup>39</sup> "Thus, the structure of the Act reveals a congressional intent to treat banks separately from their affiliates."<sup>40</sup>

This analysis of section 21 was upheld recently in court. In *Securities Industry Association v. Federal Home Loan Bank Board*,<sup>41</sup> a federal district court denied a challenge to the approval of applications permitting the formation of service corporation subsidiaries of federal savings and loans in order to conduct limited brokerage and investment advisory services.<sup>42</sup> Even assuming that the Glass-Steagall Act's prohibitions applied to savings and loan associations, the court rejected the argument that section 21 prohibited the securities activities.<sup>43</sup> The court reasoned that such activities would take place in separate organizations which would not and could not receive deposits and concluded that section 21 was inapplicable.<sup>44</sup>

#### D. Regulatory Developments

The issue of the indirect involvement of nonmember banks in securities activities was first raised in an application before the FDIC in 1969.<sup>45</sup> At that time, the FDIC found that the Glass-Steagall Act did not prohibit a state nonmember bank from being

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(discussion of precedents for treating two or more affiliates as a single entity for purposes of §§ 20 and 32 and for attributing securities activities of a subsidiary to its parent corporation).

<sup>39</sup> Aggregation in the context of section 16 would be similarly inappropriate. In addition, it would be improper to expand the member bank restrictions of section 16 to encompass nonmember banks, *see supra* notes 21-32 and accompanying text.

<sup>40</sup> *ICI*, 450 U.S. at 59 n.24. "Moreover, bank affiliates may be authorized to engage in certain activities that are prohibited to banks themselves." *Id.* at 60 (footnote omitted).

<sup>41</sup> 588 F. Supp. 749 (D.D.C. 1984).

<sup>42</sup> *Id.* at 764.

<sup>43</sup> *Id.* at 763. *See also* *Stock Brokerage Activities for Existing, Acquired, or Newly Established Service Corporations*, [Current] FED. BANKING L. REP. (CCH) ¶ 83,013 at 61,034 n.22 (March 3, 1983); *Establishment of Third-Tier Service Corporation to Conduct Certain Brokerage Activities*, *id.* ¶ 83,011 at 61,027 n.33 (May 1982) (arguing that the Glass-Steagall Act might not be applicable to savings and loan associations since at the time of its passage all such associations were share institutions and were not engaged in the business of accepting deposits).

<sup>44</sup> 588 F. Supp. at 762-63.

<sup>45</sup> *See* Letter from William Isaac, Chairman, FDIC, to Sen. Jake Garn (R-Utah) (May 25, 1983), reprinted in *House Hearings on FDIC Proposal*, *supra* note 13, at 150 [hereinafter cited as Isaac Letter].

affiliated with a company engaged in securities activities and granted deposit insurance to a new bank, Investors Bank and Trust Company, Boston, Massachusetts, which was affiliated with Eaton and Howard, Inc., a securities firm.<sup>46</sup> "Between September 1969 and September 1984, [the] FDIC . . . approved sixteen affiliations between insured nonmember banks and securities firms."<sup>47</sup> In approving these applications for deposit insurance and changes in bank control, the FDIC imposed or obtained conditions designed to protect the safety and soundness of the insured banks.<sup>48</sup>

In response to an inquiry by the SEC regarding a proposal by the Boston Five Cents Savings Bank, a nonmember bank, to establish two wholly-owned subsidiaries that would advise and distribute shares of a mutual fund, the FDIC issued a policy statement on the Glass-Steagall Act.<sup>49</sup> The statement set forth the FDIC's opinion that the Glass-Steagall Act "does not, by its terms, prohibit an insured nonmember bank from establishing an affiliate relationship with, or organizing or acquiring, a subsidiary corporation that engages in [securities activities]."<sup>50</sup> In order to address the safety and soundness concerns associated with bank involvement in securities activities, the FDIC subsequently adopted final regulations to establish safeguards in this area.<sup>51</sup>

The validity of the FDIC's regulations was recently sustained by a federal district court.<sup>52</sup> In rejecting a challenge by the Investment Company Institute, the court refused to extend the section 21 prohibitions to the activities of bank subsidiaries and affiliates.<sup>53</sup> The court reasoned that section 21 was a criminal

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<sup>46</sup> *Id.*

<sup>47</sup> Jones, *The Glass-Steagall Act and Nonmember Banks—Views of the FDIC with Respect to Glass-Steagall*, in THE GLASS-STEAGALL ACT: BANKS AND THE SECURITIES BUSINESS (1984 PLI) 65, 72 [hereinafter cited as 1984 PLI]. See Isaac Letter, *supra* note 45. See also Letter from Margaret Egginton, Deputy to the Chairman, FDIC, to Rep. Timothy Wirth (D-Colo.) (Aug. 4, 1983), reprinted in *House Hearings on FDIC Proposal*, *supra* note 13, at 153 (list of approved and pending applications as of Aug. 4, 1983).

<sup>48</sup> See Jones, *supra* note 47, at 73; Isaac Letter, *supra* note 45. For examples of conditions imposed, see Order in re: E.F. Hutton Bank (Sept. 26., 1983) reprinted in 1984 PLI, *supra* note 47, at 573; Order in re: Vanguard Fiduciary Trust Co., reprinted in 1984 PLI, *supra* note 47, at 571.

<sup>49</sup> See FDIC Policy Statement, *supra* note 20, at 38,984; Isaac Letter, *supra* note 45.

<sup>50</sup> FDIC Policy Statement, *supra* note 20, at 38,984.

<sup>51</sup> See 49 Fed. Reg. 46,709 (1984); *FDIC Release*, [1984-1985 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 86,118 (Nov. 23, 1984).

<sup>52</sup> *Investment Company Inst. v. FDIC*, 606 F. Supp. 683 (D.D.C. 1985).

<sup>53</sup> *Id.* at 685-86.

statute which must be strictly construed and that plaintiffs' interpretation of section 21 would violate rules of statutory construction by rendering section 20 unnecessary and contradictory.<sup>54</sup> In addition, the court noted that:

legislative history squarely indicates that Congress intended to place controls on the affiliations only of banks belonging to the Federal Reserve System and did not intend to restrict affiliations of state non-member banks because at time of enactment 50 years ago it doubted Congress could exercise federal authority over state-chartered banks not within the Federal Reserve System.<sup>55</sup>

In conclusion, the court found that "section 21 was not intended to bar securities activities by subsidiaries or affiliates of insured non-member state banks."<sup>56</sup>

## II. THE BANK HOLDING COMPANY ACT

Before taking advantage of the gap in the statutory framework of the Glass-Steagall Act to enter the investment banking business through an affiliate or a subsidiary, nonmember banks that are part of a holding company structure must also consider the restrictions imposed by the Bank Holding Company Act of 1956.<sup>57</sup> In addition, if a member bank is part of the holding company structure, then any investment banking affiliate or

<sup>54</sup> *Id.* at 685.

<sup>55</sup> *Id.* at 685-86 (citations omitted).

<sup>56</sup> *Id.* at 686.

<sup>57</sup> 12 U.S.C. §§ 1841-1850 (1982). See FDIC Policy Statement, *supra* note 20, at 38,984 n.1. "[I]nsured nonmember banks that are members of a bank holding company system will also need to take into consideration the restrictions of sections 4(a) and 4(c)(8) of the Bank Holding Company Act (12 U.S.C. §§ 1843(a), 1843(c)(8)) and Federal Reserve Board regulations before entering into securities activities through subsidiaries." *Id.* Because banks normally have a limited-purpose charter, see Clark, *The Regulation of Financial Holding Companies*, 92 HARV. L. REV. 787, 795-96 (1979), as compared to other corporations which may be organized under the general corporate law "to conduct or promote any lawful business or purposes," see, e.g., DEL. CODE ANN. tit. 8, § 101(b) (1983), state laws also need to be examined to determine whether a particular state grants its state-chartered banks the power to engage in securities activities. See, e.g., CAL. FIN. CODE § 1338 (West Supp. 1985) (commercial bank may sponsor, control, and underwrite investment companies); MASS. GEN. LAWS ANN. ch. 167F, § 3 (Law. Cop. Supp. 1985) (depository institution may invest up to 4% of deposits in stock of any corporation); see also Golembe & Holland, *supra* note 17, at 10. In addition, state legislatures may have adopted "mini-Glass-Steagalls" which may further restrict a bank's ability to conduct or be affiliated with an organization conducting securities activities. Finally, state bank holding company laws may limit the activities of bank holding companies and their bank and nonbank subsidiaries. The language and intent of each state's laws would need to be considered to determine the scope of its limitations.



subsidiary of the nonmember bank could be an affiliate of the member bank and thereby fall within Glass-Steagall's section 20 restrictions.<sup>58</sup> If the nonmember bank is part of a "bank holding company" as defined by the Bank Holding Company Act, its product expansion possibilities may be severely limited.

### A. *Unregulated Holding Companies: The Nonbank Bank Loophole*

A "bank holding company" is defined as "any company which has control over any bank or over any company that is or becomes a bank holding company,"<sup>59</sup> and a "bank" is defined as any entity that both "(1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans."<sup>60</sup> Thus, a holding company may be able to avoid the restrictions of the Bank Holding Company Act by voluntarily precluding the chartered bank from either accepting demand deposits or making commercial loans so that it does not meet the Act's two-part definition of a "bank."<sup>61</sup> A holding company that contains only nonmember "nonbank" banks is not constrained by either the Glass-Steagall Act or the Bank Holding Company Act—it is a truly unregulated holding company. Such a holding company can therefore be established with the securities activities located in a separate sister affiliate, in the parent holding company, or in a subsidiary of the nonmember nonbank bank.

While Congress has failed to close the nonbank bank loophole, recent judicial decisions have brought into question the legitimacy of using this loophole to avoid regulation under the Bank Holding Company Act.<sup>62</sup> Definitive resolution of the non-

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<sup>58</sup> Cf. Bock, *supra* note 29 (discussing a possible approach to structuring holding companies so as to avoid the section 20 restrictions).

<sup>59</sup> Bank Holding Company Act of 1956, § 2(a)(1), 12 U.S.C. § 1841(a)(1) (1982).

<sup>60</sup> *Id.* § 2(c), 12 U.S.C. § 1841(c) (1982).

<sup>61</sup> See Wilmarth, *The Federal Reserve Board's Nonbank Bank Dilemma*, in PROCEEDINGS OF A CONFERENCE ON BANK STRUCTURE AND COMPETITION 231 (Fed. Reserve Bank of Chicago 1984) [hereinafter cited as 1984 PROCEEDINGS]; Note, *BHC Argument*, *supra* note 36, at 653-55.

<sup>62</sup> In February 1985, a federal district court issued a preliminary injunction restraining the Comptroller from granting final approvals of national bank charters for nonbank banks. *Independent Bankers Ass'n. of Am. v. Conover*, [1984-1985 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 86,178, at 90,528, 90,539 (M.D. Fla. Feb. 15, 1985). This decision, however, did not enjoin the Comptroller from issuing preliminary approvals of national bank charters. *Id.* As a result of this decision, the Board announced in March 1985 that it was suspending further processing of applications from bank

bank bank issue must await congressional or Supreme Court action.

### B. Regulation of the Parent Holding Company and Nonbanking Subsidiaries

If a holding company is a bank holding company under the Bank Holding Company Act, then section 4 of this Act will clearly apply to restrict the activities of a bank affiliate, whether this affiliate is the parent holding company itself or a nonbanking subsidiary of the parent holding company. Unless such an affiliate falls within one of the exceptions to section 4, it will be prohibited from engaging in any activities other than banking.<sup>63</sup> The only significant possible exception is section 4(c)(8), which provides that section 4 will not apply to a company whose activities the Board has determined are "closely related" to banking and are likely to produce net public benefits.<sup>64</sup>

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holding companies to acquire nonbank banks. *FRB Suspends Processing of BHC Applications to Acquire Nonbank Banks*, [1984-1985 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 86,193 (Mar. 15, 1985).

In May 1985, the Eleventh Circuit overturned the Board's approval of a nonbank bank. *Florida Dep't of Banking and Fin. v. Board of Governors of the Fed. Reserve Sys.*, 760 F.2d 1135, 1144 (11th Cir. 1985), *petition for cert. filed sub nom. U.S. Trust Corp. v. Board of Governors of the Fed. Reserve Sys.*, 54 U.S.L.W. 3100 (U.S. Aug. 5, 1985) (No. 85-193). The Eleventh Circuit held that the Board should have used its power under section 5(b) of the Bank Holding Company Act to prevent evasion of the Act and deny the nonbank bank application. *Id.* at 1143-44.

On the other hand, the Tenth Circuit has at a minimum condoned the nonbank bank loophole. *See* *Dimension Fin. Corp. v. Board of Governors of the Fed. Reserve Sys.*, 744 F.2d 1402 (10th Cir. 1984), *cert. granted*, 105 S. Ct. 2137 (1985) (invalidating Board's attempt to expand the definition of "commercial loan"). "The Act itself with the clearly expressed definition permitted the development of the non-bank banks." 744 F.2d at 1407. *See also* *Oklahoma Bankers Ass'n v. Federal Reserve Bd.*, 766 F.2d 1446 (10th Cir. 1985) (affirming Board order permitting the acquisition of an inactive state trust company charter by an out-of-state bank holding company, enabling the holding company to offer industrial banking services through a subsidiary in the state; the court found that thrift certificates which limited the depositor's right to withdraw by private contractual agreement are not "demand deposits"); *First Bancorporation v. Board of Governors of the Fed. Reserve Sys. (Beehive)*, 728 F.2d 434 (10th Cir. 1984) (setting aside Board order placing conditions on acquisition of industrial loan companies by a bank holding company; the court found that negotiable order of withdrawal (NOW) accounts are not demand deposits because state regulations required the industrial loan companies to reserve the right to require 30 days' notice from the account holder before making a withdrawal). *But cf. Wilshire Oil Co. v. Board of Governors of the Fed. Reserve Sys.*, 668 F.2d. 732 (3d Cir. 1981), *cert. denied*, 457 U.S. 1132 (1982) (affirming Board order, under its power to prevent evasions of the Act, finding parent to be in violation of the Bank Holding Company Act; the subsidiary bank had sent a letter to its depositors reserving the right to require notice of withdrawal, but also stating that it had no intention to exercise this reserved right).

<sup>63</sup> *See* 12 U.S.C. § 1843(a) (1982).

<sup>64</sup> *Id.* § 1843(c)(8).

The Board has consistently indicated its intention to apply the "spirit and purpose" of the Glass-Steagall Act in its determinations under section 4(c)(8),<sup>65</sup> and it is highly unlikely to allow bank holding companies to engage in general investment banking in the near future.<sup>66</sup> Thus, the Board probably would not permit a bank holding company to engage in general investment banking through the parent holding company or a sister affiliate of the bank. It is less clear whether the Board has authority under the Bank Holding Company Act to regulate the activities of subsidiaries of holding company banks.<sup>67</sup>

### C. Regulation of Holding Company Banks and Their Subsidiaries

#### 1. Holding Company Banks

In response to concerns about increasing concentration of economic resources,<sup>68</sup> the Bank Holding Company Act was enacted in 1956 to rectify the ineffectiveness of the existing regulation of bank holding companies.<sup>69</sup> The structure of the Bank Holding Company Act evidences Congress's intent to grant the Board authority over parent bank holding companies and their nonbanking subsidiaries, but to reserve the supervision of banks to the banks' primary regulators.<sup>70</sup> Section 3 governs the acqui-

<sup>65</sup> See, e.g., *Banco di Roma* [1966-1973 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 95,782 (Sept. 28, 1972) (denial of application of foreign-based bank holding company to retain one-third ownership interest in a domestic broker-dealer substantially engaged in underwriting). "The Federal Reserve Board has consistently applied the policies of the Glass-Steagall Act to all bank holding companies registered under the Bank Holding Company Act irrespective of whether they have subsidiaries that are member banks." *Id.*

<sup>66</sup> See Golembe & Holland, *supra* note 17, at 10.

<sup>67</sup> See *id.*; Note, *Product Expansion Option*, *supra* note 20, at 105-09.

<sup>68</sup> See Note, *BHC Argument*, *supra* note 36, at 656-67. "Fear of excessive economic concentration was largely responsible for the enactment of the Bank Holding Company Act of 1956 . . . [d]espite concessions at the time that there was no evidence of excessive concentration or abuse . . ." *Id.* at 656 (footnote omitted).

<sup>69</sup> See Board of Governors of Fed. Reserve Sys. v. Investment Co. Inst., 450 U.S. 46, 68-71 (1981).

<sup>70</sup> See TASK GROUP ON REGULATION OF FINANCIAL SERVICES, BLUEPRINT FOR REFORM: THE REPORT OF THE TASK GROUP ON REGULATION OF FINANCIAL SERVICES 20 (July 2, 1984), reprinted in FED. BANKING L. REP. (CCH), Special Report No. 1050 (part II), at 20 (Nov. 16, 1984).

Regulation of banks is, however, only one of two layers of federal supervision, as federal controls also exist for the parent holding companies of banks . . . Under current law the [Board] regulates all bank holding companies in the United States, even though in most cases it does not regulate the subsidiary bank or banks of such firms.

*Id.* at 20 (footnote omitted).

sition of banks by a bank holding company,<sup>71</sup> section 4 governs the nonbanking activities of a bank holding company and its nonbanking subsidiaries,<sup>72</sup> and section 7 provides for the reservation of certain powers to the states.<sup>73</sup> Thus, one set of commentators has concluded that “[t]he Board’s responsibilities under the Act are to regulate companies that control banks and the nonbank activities of such companies. The Act does not give the Board authority to regulate the activities of banks themselves.”<sup>74</sup> Subsequent Congresses have explicitly confirmed that the “concept of the [Act] was to regulate bank holding companies and not their subsidiary banks.”<sup>75</sup>

Even the Federal Reserve Board has taken this position. In *Cameron Financial Corporation v. Board of Governors of the Federal Reserve System*,<sup>76</sup> the Fourth Circuit held that “subsidiary” in section 4(a)(2) of the Bank Holding Company Act, which extended grandfather privileges to “subsidiaries” of bank holding companies, did not refer to banking subsidiaries.<sup>77</sup> The Board had argued that “since Congress recognized that banking subsidiaries were already regulated by agencies other than the Federal Reserve, *i.e.*, Comptroller of the Currency, Federal Deposit Insurance Corporation, and state authorities, Congress intended to grant to the Federal Reserve Board authority to regulate only the previously unregulated nonbanking subsidiaries . . . .”<sup>78</sup> More recently, in discussing whether the Board’s regulations authorized banks as well as bank holding companies and nonbank subsidiaries to act as investment advisors, the Supreme

<sup>71</sup> 12 U.S.C. § 1842 (1982).

<sup>72</sup> *Id.* § 1843.

<sup>73</sup> *Id.* § 1846.

<sup>74</sup> Golembe & Holland, *supra* note 17, at 10.

<sup>75</sup> H.R. REP. NO. 387, 91st Cong., 1st Sess. 15 (1969).

<sup>76</sup> 497 F.2d 841 (4th Cir. 1974).

<sup>77</sup> *Id.* at 848.

<sup>78</sup> *Id.* at 845. In its brief, the Board stated that:

Congress did not intend to give the Board regulatory control over the activities of subsidiary banks when it gave it authority to regulate the activities of bank holding companies.

. . . .

. . . The Board has adhered strictly to the legislative intent, and, in regulating holding companies, has not interfered with the internal activities of subsidiary banks. The banks’ activities are regulated by the Comptroller of the Currency with respect to national banks, the Federal Deposit Insurance Corporation with respect to Federally insured state banks, and state authorities in the case of other state-chartered banks, under applicable banking laws—not by the Board.

Brief for the Federal Reserve Board, *cited in* Comment Letter of the Ass’n. of Bank Holding Companies to William W. Wiles, Secretary, Bd. of Governors of the Fed. Reserve Sys. (Jan. 11, 1985) (on file at the Board).

Court in *ICI* stated that "the Board does not have the power to confer such authorization on banks."<sup>79</sup> Thus, both the Supreme Court and the Board seem to have recognized that the Bank Holding Company Act does not authorize the Board to regulate the activities of bank subsidiaries of bank holding companies.<sup>80</sup>

## 2. Nonbank Subsidiaries of Holding Company Banks

The structure of the Bank Holding Company Act and long-standing regulatory practice also suggest that the Board's authority under the Bank Holding Company Act does not extend to the subsidiaries of banks. Congress has excluded both banks and subsidiaries of banks from the Board's enforcement powers.<sup>81</sup> In addition, under the Comptroller's regulations, operating subsidiaries of national banks are regulated, supervised, and examined in the same manner as their parent banks.<sup>82</sup>

In regulating nonbanking activities and acquisitions by bank holding companies, the Board has implemented its position of noninterference in the activities of subsidiary banks.<sup>83</sup> Section 225.22(d) of the Board's regulations provides that:

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<sup>79</sup> 450 U.S. at 59 n.25. The Court proceeded to cite approvingly from the Board's opinion in the case that "[t]he authority of national banks or state member banks to furnish investment advisory services does not derive from the Board's regulation; such authority would exist independently of the Board's regulation and its scope is to be determined by a particular bank's primary supervisory agency." *Id.* (citing App. to Pet. for Cert. 61a). The Court concluded that the "regulation only applies to bank holding companies." *Id.* at 60 n.29.

<sup>80</sup> See Golembe & Holland, *supra* note 17, at 10; Note, *Product Expansion Option*, *supra* note 20, at 108-09.

<sup>81</sup> See, e.g., 12 U.S.C. § 1844(e) (1982) (termination of activities or ownership or control of nonbank subsidiaries constituting serious risk); *id.* (termination of status as insured bank, cease and desist proceedings).

<sup>82</sup> See 12 C.F.R. § 5.34 (1985). For a general discussion of the regulation of subsidiaries of national banks, see Glidden, *The Regulation of National Banks' Subsidiaries*, 40 Bus. LAW. 1299 (1985).

In 1968, the Board reversed its earlier interpretation of the "incidental powers" clause, see 52 FED. RESERVE BULL. 1157 (1966) (superseded by 12 C.F.R. § 250.141 (1985)), and explicitly authorized member banks to establish operating subsidiaries. See 12 C.F.R. § 250.141 (1985).

<sup>83</sup> See *Financial Services Oversight Hearings* (part I), *supra* note 3, at 60 (statement of Paul Volcker).

The Federal Reserve, in administering the Bank Holding Company Act, has for some years maintained a policy of permitting state-chartered bank affiliates of bank holding companies to engage in any activity such a bank is permitted to engage in under its state charter. This policy has been premised upon the view that a certain degree of experimentation and difference in approach among the states is a legitimate and desirable aspect of our dual banking system, and that differences in powers allowed by states would be acceptable to the extent they would not dominate established Congressional policy.

*Id.*

A state-chartered bank or its subsidiary may, insofar as Federal law is concerned and without the Board's prior approval under this subpart:

• • • • •  
 (ii) Acquire or retain all (but, except for directors' qualifying shares, not less than all) of the securities of a company that engages solely in activities in which the parent bank may engage, at locations at which the bank may engage in the activity, and subject to the same limitations as if the bank were engaging in the activity directly.<sup>84</sup>

This section also provides that national and state banks or their subsidiaries do not need the Board's approval to acquire or retain securities on the basis of section 4(c)(5) of the Bank Holding Company Act.<sup>85</sup> Section 4(c)(5) of the Bank Holding Company Act exempts "shares which are of the kinds and amounts eligible for investment by national banking associations under the provisions of section 24 of [title 12 U.S.C.]."<sup>86</sup> The Board has consistently applied this regulation in approving several section 3 applications involving the formation of bank holding companies through the acquisition of state-chartered banks that owned subsidiaries engaged in insurance activities.<sup>87</sup>

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<sup>84</sup> 12 C.F.R. § 225.22(d)(2) (1985).

<sup>85</sup> *Id.* § 225.22(d)(1), (2).

<sup>86</sup> 12 U.S.C. § 1843(c)(5) (1982).

<sup>87</sup> In *Piedmont Carolina Fin. Servs., Inc.*, 59 FED. RESERVE BULL. 766 (1973), the bank engaged "through a wholly-owned subsidiary in general insurance agency activities at off-premise locations including one office in a community where Bank does not operate any branches. It appears that Bank itself could directly perform these activities at those locations." *Id.* at 767. The Board, citing section 4(c)(5) of the Bank Holding Company Act and section 225.4(e) (the predecessor of section 225.22(d)) of Regulation Y, ruled that because the subsidiary would have been considered an operations subsidiary of the bank if the bank had been a state member bank, the activities of the subsidiary did not require the approval of the Board. *Id.* at 767-68. In a footnote, however, the Board stated that if "State law did not authorize Bank to perform the activities directly, but rather only authorized the investment in shares of the insurance agency, such agency would not be permissible on the basis of § 4(c)(5) and § 225.4(e)." *Id.* at 768 n.2.

In *American Bancorp, Inc.*, 39 Fed. Reg. 22,468 (1974), the Board mechanically applied its *Piedmont* rationale and approved the section 3 application. In that case, the bank owned a title insurance subsidiary which operated offices in three states and maintained agents in six other states and the District of Columbia. *See id.* The bank also owned two nonbanking subsidiaries that engaged in commercial finance activities and held bank premises and properties acquired by the bank as a result of loan defaults. As to these two subsidiaries, the Board ruled that under sections 4(c)(5) and 4(c)(1)(A) and (D) of the Bank Holding Company Act, it was not required to approve of their "indirect acquisition" by the bank holding company. *Id.*

The Board also has adhered to this position in interpretations concerning subsidiaries of banks that engage in insurance underwriting, *see, e.g., Insurance Underwriting—By Subsidiary State Member Bank*, 1 FED. RESERVE REGULATORY SERV. (FED. RESERVE SYS.) 4-599 (Sept. 1984), and in insurance brokerage, *see, e.g., Insurance Agent or Broker—Federal Regulation of Rates*, 1 FED. RESERVE REGULATORY SERVICE (FED. RESERVE SYS.) 4-591 (Nov. 1982).

The question of the treatment of subsidiaries of banks has emerged in the context of the applicability of section 23A of the Federal Reserve Act<sup>88</sup> to transactions between a member state bank and its operating subsidiary. The Board has stated that “[s]ince an operations subsidiary is in effect a part of, and subject to the same restrictions as, its parent bank, there appears to be no reason to limit transactions between the bank and such subsidiary any more than transactions between departments of a bank.”<sup>89</sup> This interpretation of section 23A was codified by amendment to the Federal Reserve Act in 1982.<sup>90</sup> Section 23A now explicitly exempts subsidiaries, other than a subsidiary bank, of banks from its definition of affiliates<sup>91</sup> and treats loans and other transactions by a subsidiary of a bank to an affiliate of the bank as a transaction between the bank and the affiliate.<sup>92</sup>

The issue of the Board’s authority over subsidiaries of banks under the Bank Holding Company Act arose recently in connection with the real estate activities of bank holding companies and their bank and nonbank subsidiaries. In January 1985, the Board issued a notice soliciting comments on the permissibility of real estate investment for bank holding companies and their direct and indirect nonbank subsidiaries.<sup>93</sup> The Board specifically sought comment on whether it should amend section 225.22(d) of Regulation Y.<sup>94</sup>

The Board revealed its position on its regulatory authority over subsidiaries of holding company banks in its statement soliciting public comments. In a footnote, the Board stated that:

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<sup>88</sup> 12 U.S.C. § 371c (1982).

<sup>89</sup> 12 C.F.R. § 250.240 (1985).

<sup>90</sup> See Banking Affiliates Act of 1982, Pub. L. No. 97-320, § 410(b), 96 Stat. 1469, 1516-17 (1982) (codified at 12 U.S.C. § 371c(b)(2)(A) (1982)).

<sup>91</sup> See 12 U.S.C. § 371c(b)(2)(A) (1982).

<sup>92</sup> See *id.* § 371c(c).

<sup>93</sup> See 50 Fed. Reg. 4519 (1985). This notice was prompted by recent developments, see *id.* at 4519-20; *Can Fed-FDIC Real Estate Conflict be Avoided?*, BANKING EXPANSION REP., Feb. 4, 1985, at 3, 3 [hereinafter cited as *FED-FDIC Real Estate Conflict*], most notably an increase in new state legislation authorizing banks chartered in those states to engage in real estate investment, see e.g., S.D. CODIFIED LAWS ANN. § 51-18-30 (Supp. 1984). “A bank is expressly empowered, directly or through subsidiaries, to engage in all facets of the insurance business.” *Id.* Other such developments include notices of proposed rulemaking by the FHLBB, see 49 Fed. Reg. 48,743 (1984), and the FDIC, see *id.* at 48,552. The FDIC proposal would prohibit insured banks from directly engaging, inter alia, in certain insurance and real estate activities and would require that such activities be conducted only through a “bona fide subsidiary” of the bank. See *id.* Subsequently, the FDIC issued for further comment a revised Notice of Proposed Rulemaking that would permit insured banks to conduct certain limited insurance and real estate activities within the bank. See 50 Fed. Reg. 23,964 (1985).

<sup>94</sup> See 50 Fed. Reg. 4519, 4521-22 (1985).

By encompassing indirect as well as direct ownership interests, [section 4] of the Act prohibits a holding company subsidiary *bank* as well as the holding company itself from owning more than 5 percent of the voting shares of any company engaged in impermissible nonbank activities such as real estate investment and development. The board has since enactment of the Act held this view.<sup>95</sup>

In the Board's view section 225.22(d)(2) contains a "regulatory exemption" from the nonbanking prohibitions of the Bank Holding Company Act and could be amended to apply limitations on nonbanking activities to the subsidiaries of holding company banks.<sup>96</sup> The Board also emphasized that since "the premise for the adoption by the Board of section 225.22(d) was that a subsidiary of a bank was equivalent to a department or division, . . . a 'bona fide subsidiary' would clearly not be the type of subsidiary that was intended to be authorized under section 225.22(d)(2) of Regulation Y."<sup>97</sup>

Where the parent bank may not engage directly in the nonbanking activities, the terms of section 225.22(d)(2) are not met.<sup>98</sup> Thus, according to the Board, if the nonbanking activity is not exempt under the Bank Holding Company Act, and a bank is prohibited from engaging directly in the activity, then holding companies and their direct and indirect subsidiaries—including their banking subsidiaries and subsidiaries of holding company banks—may not engage in the activities.<sup>99</sup> In such a situation, "only nonmember banks that are not in holding company systems would be permitted to engage in these activities through subsidiaries of those banks."<sup>100</sup>

<sup>95</sup> *Id.* at 4522 n.3 (emphasis in original).

<sup>96</sup> *See id.* at 4521.

<sup>97</sup> *Id.* at 4522 n.4.

<sup>98</sup> *See* 12 C.F.R. § 225.22(d)(2) (1985).

<sup>99</sup> *See* 50 Fed. Reg. 4519, 4522 (1985). The Board has recently implemented its view in an order denying the application of Citicorp, a bank holding company, to acquire a South Dakota bank and to engage in insurance activities through the bank. *See Order Denying the Acquisition of a Bank*, 71 FED. RESERVE BULL. 789 (1985). The Board concluded that:

the acquisition of Bank is in reality an acquisition for the purpose of permitting Citicorp to engage in insurance activities prohibited for bank holding companies under section 4 of the BHC Act and that Bank is simply a device to accomplish this objective. Accordingly, the Board has determined that the proposal constitutes an evasion of section 4 of the Act and section 225.22(d)(2) of Regulation Y and that Board approval is therefore precluded.

*Id.* at 791 (footnote omitted).

<sup>100</sup> 50 Fed. Reg. 4519, 4522 (1985). The Board also has indicated that it might use its authority under the Bank Holding Company Act to impose special capital requirements on bank holding companies that own a bank engaged in certain activities. *See id.*



In evaluating the ramifications of the Board's position for the securities activities of nonmember banks, it should be remembered that while the Glass-Steagall Act does not regulate the affiliations of nonmember banks with securities firms, section 21 of the Glass-Steagall Act prohibits nonmember banks from engaging directly in the enumerated securities activities.<sup>101</sup> If the Board's interpretation of its authority under the Bank Holding Company Act is affirmed, then only nonmember banks that are not in holding company systems may be permitted to engage in securities activities and then only through subsidiaries. Therefore, under the present statutory framework, there might be incentives for banks not only to convert from national to state charters or relinquish their status as member banks, but also to dismantle their holding company systems.<sup>102</sup>

"The Board's authority under the Bank Holding Company Act over subsidiaries of banks that are in turn subsidiaries of holding companies is clear mostly to itself. Large segments of the banking industry, and the other federal banking regulators, probably have a different opinion."<sup>103</sup> The Board would contend that it was simply utilizing its authority to regulate "indirect ownership or control"<sup>104</sup> and implementing the intent of Congress by preventing evasion of the Bank Holding Company Act's restrictions and by enforcing the purpose of the Glass-Steagall Act to separate commercial and investment banking. As previously noted, however, Congress did not intend to grant regulatory authority over the activities of banks to the Board under

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<sup>101</sup> See *supra* notes 17-18 and accompanying text.

<sup>102</sup> See, e.g., *House Hearings on FDIC Proposal*, *supra* note 13, at 9 (statement of John Shad, Chairman, SEC) (noting the incentive for national banks to convert to state charters and for member banks to withdraw from Federal Reserve membership); *id.* at 66-67 (SEC Reply to Written Questions) (citing FDIC proposal and recent amendments to the Bank Service Corporation Act as reasons why a holding company might choose to dissolve the holding company). The disincentives to dissolving a holding company are less for one-bank holding companies, especially where state law would permit the present operations of the nonbanking subsidiaries of the holding company to be conducted directly by the bank or by a subsidiary of the bank. In 1981, 3093 of the 3500 bank holding companies were one-bank holding companies. See C. GOLEMBE AND D. HOLLAND, *supra* note 4, at 226 (Table 13). In recent testimony before Congress, Board Chairman Paul Volcker stated that the vast number of bank holding companies—more than 5000 out of the total of about 6100—were one-bank holding companies in which "the parent company is essentially a shell with no significant nonbanking operations of its own." *Hearings before the Subcomm. on Commerce, Consumer and Monetary Affairs of the House Comm. on Government Operations*, 99th Cong., 1st Sess. (Mar. 27, 1985) (testimony of Paul Volcker).

<sup>103</sup> *FED-FDIC Real Estate Conflict*, *supra* note 93, at 4.

<sup>104</sup> See Bank Holding Company Act of 1956, § 4(a), 12 U.S.C. § 1843(a) (1982).

the Bank Holding Company Act<sup>105</sup> or to prohibit the securities affiliations of nonmember banks under the Glass-Steagall Act.<sup>106</sup> One could still counter that recent changes in state laws granting broader powers to banks, the repudiation of the restrictive view of Congress's Commerce Clause powers, and a greater federal interest in the soundness of the financial system require such regulation to prevent evasion of Congress's more general intent to separate the commercial and investment banking industries. This, however, is an argument for legislative action by Congress, not for abdicating legislative authority to an unelected judiciary or administrative agency.<sup>107</sup> Moreover, such action should take place only after a thorough assessment of the continuing efficacy of the separation policy.

### III. THE POLICY OF SEPARATION: JUSTIFICATIONS AND CRITIQUE

In often quoted language, the Supreme Court declared in *Investment Company Institute v. Camp* that:

The Glass-Steagall Act reflected a determination that policies of competition, convenience, or expertise which might otherwise support the entry of commercial banks into the investment banking business were outweighed by the "hazards" and "financial dangers" that arise when commercial banks engage in the activities proscribed by the Act.

The hazards that Congress had in mind were not limited to the obvious danger that a bank might invest its own assets in frozen or otherwise imprudent stock or security investments . . . . The legislative history of the Glass-Steagall Act shows that Congress also had in mind and repeatedly focused on the more subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business either directly or by establishing an affiliate to hold and sell particular investments. This course places new promotional and other pressures on the bank which in turn create new temptations.<sup>108</sup>

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<sup>105</sup> See *supra* notes 70–75 and accompanying text.

<sup>106</sup> See *supra* notes 21–32 and accompanying text.

<sup>107</sup> See Fein, *Regulating the Interception and Disclosure of Wire, Radio, and Oral Communications: A Case Study of Federal Statutory Antiquation*, 22 HARV. J. ON LEGIS. 47, 48–49 (1985).

<sup>108</sup> 401 U.S. 617, 630–31 (1971) (footnotes omitted).

Because of these hazards, "Congress rejected a regulatory approach when it drafted the statute"<sup>109</sup> and instead enacted a prophylactic measure.<sup>110</sup>

Yet, the separation mandated by the statute was incomplete. Developments over the past fifty years have further eroded this separation, raising questions about the policy rationales behind it. Senator Glass, as early as 1935, had "retreated somewhat from his views regarding a complete separation of investment and commercial banking . . . [and] attempted to amend the Act to allow commercial banks to underwrite and sell bonds, debentures, and notes."<sup>111</sup> Since then, commentators have urged reform to permit varying degrees of bank involvement in securities activities,<sup>112</sup> and recently a number of legislative proposals have been introduced in Congress.<sup>113</sup>

These proposals should be considered with the goals behind the regulation of financial intermediaries in mind. These goals include: promoting a strong and stable banking system; increasing efficiency in the allocation of capital and credit and minimizing cost in order to benefit consumers; enhancing fair competition in the provision of financial services; avoiding undue concentration of economic resources; and protecting consumers, depositors, investors, and others against discrimination, conflicts of interest, and other potential abuses.<sup>114</sup> Trade-offs among these goals may be necessary in determining the optimal degree of regulation or deregulation of financial intermedi-

<sup>109</sup> *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.* (Becker), 104 S.Ct. 2979, 2988 (1984).

<sup>110</sup> See Note, *A Conduct-Oriented Approach to the Glass-Steagall Act*, 91 YALE L.J. 102, 107-08 (1981). See generally GOLEMBE ASSOCIATES, INC., *supra* note 5, at 49-53. "Regulation of security affiliates and, more generally, of the investment banking activities of commercial banks was an alternative to divorcement and, indeed, seemed the more likely reform until shortly before passage in 1933 of the Glass-Steagall Act." *Id.* at 50. See also Perkins, *supra* note 2. "In fact, after reflecting upon the eventual changes in the legislative as well as the executive branch as a result of the Democratic victory [in November 1932], Glass saw himself in a position where for the first time he could realistically anticipate keeping the divorce provision in the final version of the bill." *Id.* at 519-20.

<sup>111</sup> Nichols, *Legislative History of the Glass-Steagall Act*, in 1984 PLI, *supra* note 47, at 34.

<sup>112</sup> See, e.g., Note, *BHC Argument*, *supra* note 36; Note, *Underwriting Proposal*, *supra* note 2.

<sup>113</sup> See *infra* Part V.

<sup>114</sup> See *How the Financial System Can Best Be Shaped to Meet the Needs of the American People. Financial Deregulation: Hearings Before the House Comm. on Banking, Finance and Urban Affairs*, 98th Cong., 2d Sess. 1680 (1984) (statement of Paul Volcker) [hereinafter cited as *Financial Deregulation Hearings*]; *Financial Services Oversight Hearings* (part I), *supra* note 3, at 60 (statement of Paul Volcker).

aries.<sup>115</sup> Protecting the safety and soundness of banks is often cited as the preeminent goal.<sup>116</sup> Based on this concern for bank soundness, it is argued that bank holding companies should be regulated to ensure that the holding company will serve as a "source of strength" for its subsidiary bank and to avoid abuses.<sup>117</sup> Concern for bank safety, however, is only one of the goals and the others should not be disregarded in setting a balance. To do so ultimately would be detrimental to the goal of promoting a strong banking system.<sup>118</sup>

### A. Bank Safety and Soundness

Two justifications commonly cited for prohibiting commercial banks from engaging in investment banking are that such activities are too risky and that the income stream from such activ-

<sup>115</sup> This list is not intended to be exhaustive, nor are the categorizations definitive. Some of the goals are quite complementary, and the distinctions between them blur. For example, avoiding conflicts of interest by preventing interaffiliate abuses also plays a large role in promoting bank soundness. Cf. Fischer, Gram, Kaufman & Mote, *The Securities Activities of Commercial Banks: A Legal and Economic Analysis*, 51 TENN. L. REV. 467, 506-07 (1984) [hereinafter cited as Fischer]. "Thus, the issue [of conflicts of interest] is at its heart one of fairness, though efficiency and bank safety may be affected as well." *Id.*

<sup>116</sup> See, e.g., Corrigan, *Are Banks Special?*, in FEDERAL RESERVE BANK OF MINNEAPOLIS, ANNUAL REPORT 2 (1982); Note, *Underwriting Proposal*, *supra* note 2, at 733. In testimony before Congress, Chairman Volcker has stated that:

Public Policy has long recognized the importance of protecting the safety and soundness of banks and depository institutions generally: they perform a unique and critical role in the financial system as operators of the payments system, as custodians of the bulk of liquid savings, as unbiased suppliers of short-term credit, and as the critical link between monetary policy and the economy. In our judgment, those concerns remain central today in any consideration of banking legislation.

*Financial Deregulation Hearings*, *supra* note 92, at 1681 (statement of Paul Volcker). See also, Clark, *supra* note 57, at 815 (1985) ("[O]ne may perceive the most basic reason for the separation theme: absent countervailing considerations, intermediary businesses ought to be kept separate from other lines of business in order to facilitate the regulators' task of achieving soundness.").

<sup>117</sup> See Note, *BHC Argument*, *supra* note 36, at 656-58; Note, *Underwriting Proposal*, *supra* note 2, at 721-22. See also Board of Governors v. First Lincolnwood Corp., 439 U.S. 234, 253 (1978). There the Court held that the Board was "entitled to conclude that respondent [applicant to become a bank holding company] would not be a sufficient source of financial and managerial strength to its subsidiary bank." *Id.*

<sup>118</sup> See *Financial Services Oversight Hearings* (part I), *supra* note 3, at 65 (statement of Paul Volcker) "In seeking an overall balance of protections and restrictions for banks, we can, and should, avoid competitive disadvantage to the depository institutions themselves; to do otherwise is to erode the vitality and strength of the very sector of the financial system deemed of special importance." *Id.* See also Note, *BHC Argument*, *supra* note 36, at 658-60 (arguing that activities regulation of bank holding companies by limiting their ability to compete has hindered their ability to serve as a source of strength to their banks).

ities would be cyclical and unstable.<sup>119</sup> The critical question is whether the risks involved in investment banking are so qualitatively or quantitatively different from the risks involved in commercial banking that banks should be prohibited from engaging in those activities.<sup>120</sup> Some commentators have concluded that the risks associated with securities activities, such as the underwriting of corporate securities, are no different from or greater than the risks associated with activities in which banks presently engage, such as municipal general obligation bond underwriting, foreign securities underwriting under the Edge Act,<sup>121</sup> and foreign exchange trading. These commentators also note that investment bankers can and do limit the risks involved in underwriting.<sup>122</sup>

In addition, the extent of risk to the bank from the alleged instability of revenues from securities activities will depend not only on the degree of instability of such revenue, but also on the proportion of total bank income that such revenue represents, and the covariance of such revenue with other bank income.<sup>123</sup> If the two sources of income display a negative or weak positive covariance, banks can actually increase their financial stability through diversification.<sup>124</sup> While the evidence is mixed, some commentators claim that a decrease in risk would result from geographic and activities deregulation.<sup>125</sup>

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<sup>119</sup> Cf. Note, *Underwriting Proposal*, *supra* note 2, at 727-29 (discussing the flaws in both of these arguments).

<sup>120</sup> The special problem of the "salesman's stake" that arises from combining the two activities will be considered below. See *infra* notes 148-88 and accompanying text.

<sup>121</sup> See 12 U.S.C. § 615 (1982); 12 C.F.R. § 211.5(d)(13) (1985) (Edge Act corporation may underwrite foreign securities in an amount equal to the lesser of \$2 million per issue or 20% of the issuer's voting stock).

<sup>122</sup> See, e.g., Edwards, *Banks and Securities Activities: Legal and Economic Perspectives on the Glass-Steagall Act* in *THE DEREGULATION OF THE BANKING AND SECURITIES INDUSTRY* 273, 281 (L. Goldberg & L. White eds. 1979); Giddy, *Underwriting Risks for Commercial Banks: An Empirical Study*, in 1984 PROCEEDINGS, *supra* note 61, at 211; Saunders, *An Economic Perspective on Bank Uniqueness and Corporate Securities Activities*, in *id.*, at 199; Saulsbury, *Bank Securities Activities and Corporate Securities Underwriting*, in *RECENT LEGISLATIVE AND OTHER DEVELOPMENTS IMPACTING DEPOSITORY INSTITUTIONS*, May 1984, at 1, 4-6 (FDIC Division of Research and Strategic Planning); Note, *Underwriting Proposal*, *supra* note 2, at 726-28.

<sup>123</sup> See Note, *Underwriting Proposal*, *supra* note 2, at 728-29.

<sup>124</sup> See *id.*; Note, *BHC Argument*, *supra* note 36, at 659-61.

<sup>125</sup> See Saunders, *supra* note 122, at 200; Note, *BHC Argument*, *supra* note 36, at 659-661; Note, *Underwriting Proposal*, *supra* note 2, at 729. Cf. Clark, *supra* note 57, at 823-24 (discussing diversification as an ambiguous reason for holding company formation); Fischer, *supra* note 115, at 505-06 (suggesting little diversification benefit from combining commercial and investment banking).

Moreover, with FDIC insurance of deposits up to \$100,000 and *de facto* insurance of all deposits at FDIC-insured banks,<sup>126</sup> any increase in risk would be borne by the FDIC and bank shareholders, rather than by depositors. One way to address any increase in risk is to vary the premiums paid for deposit insurance to reflect the increase.<sup>127</sup> Furthermore, the risk of loss to the FDIC is not so much the risk of bank insolvency, but rather the risk of failing to detect a potential insolvency in time to intervene.<sup>128</sup> Thus, it even has been suggested that this risk can be ameliorated by engaging in securities activities because such activities involve investment in marketable assets which are more easily and accurately valued than typical banking assets, such as commercial loans.<sup>129</sup>

Risks to the bank from product expansion may be limited by requiring that some or all of the securities activities be conducted through a separately incorporated organization. Assuming that management meets the legal requirements for establishing and maintaining corporate separateness, limited shareholder liability resulting from the corporate form confines the risk of the bank.<sup>130</sup> If the securities affiliate is a subsidiary of the bank, this risk is limited to the bank's investment in the affiliate.<sup>131</sup> In

<sup>126</sup> See FEDERAL DEPOSIT INS. CORP., DEPOSIT INSURANCE IN A CHANGING ENVIRONMENT: A STUDY OF THE CURRENT SYSTEM OF DEPOSIT INSURANCE xv-xvii (1983); Wall, *Deposit Insurance Reform: The Insuring Agencies' Proposals*, ECON. REV. (Fed. Reserve Bank of Atlanta), Jan. 1984, at 43, 49-50; see also *FDIC Requests Comments on Risk-Related Deposit Insurance Proposal*, [Current] FED. BANKING L. REP. (CCH) ¶ 86,409 (Sept. 20, 1985) (FDIC discussion paper on risk-related insurance); Market Discipline for FDIC-Insured Banks, 50 Fed. Reg. 19,088 (1985) (request for comments on modified payoff procedure and increased capital requirements as two approaches to imposing market discipline on the risk-taking activities of banks).

<sup>127</sup> See Clark, *supra* note 57, at 847-48, 852; Saunders, *supra* note 122, at 200-01. The problems of the current system of flat-rate premium deposit insurance and a discussion of the various proposals for reform are beyond the scope of this Note. See, e.g., sources cited *supra* note 126.

<sup>128</sup> See Horvitz, *A Reconsideration of the Role of Bank Examination*, 12 J. MONEY, CREDIT AND BANKING 654, 655 (1980). "Protection of the insurance fund does not require *prevention* of failure; all it requires is prompt *detection* of bank insolvency." *Id.* (emphasis in original).

<sup>129</sup> See Giddy, *supra* note 122, at 228.

<sup>130</sup> See Clark, *supra* note 57, at 825; McFadyen, *Corporate Separateness and Bank Regulation* in RECENT LEGISLATIVE AND OTHER DEVELOPMENTS IMPACTING DEPOSITORY INSTITUTIONS, Mar. 1984, at 1, 3-4 (FDIC Division of Research and Strategic Planning).

<sup>131</sup> Under normal circumstances, the bank's loss as a shareholder would be limited to its investment in the capital stock of the corporation, plus any unpaid balance of the consideration for which such shares were issued. See, e.g., DEL. CODE ANN. tit. 8, § 162 (1983) (liability of stockholder or subscriber for stock not paid in full). In extreme circumstances, such as gross mismanagement by the parent bank, the loans of the parent might be subordinated to the claims of other creditors or shareholders. See, e.g.,

the case of sister affiliates, the bank's risk is more indirect. If the bank is not a shareholder of the affiliate, harm to the bank would only arise from reducing the ability of its bank holding company to act as a "source of strength."<sup>132</sup> Thus, "the riskiness of a subsidiary will affect more surely the soundness of an intermediary than will the riskiness of any of its other affiliates."<sup>133</sup>

Several commentators have convincingly refuted the argument that banks should be prohibited from being affiliated with firms engaged in securities activities because courts might "pierce the corporate veil"<sup>134</sup> of a troubled securities affiliate in order to reach the assets of the bank.<sup>135</sup> The possibility that the corporate form will be disregarded can be substantially reduced through regulation of the establishment of bank affiliates and of transactions between banks and their affiliates.<sup>136</sup> Furthermore, in a sister affiliate situation, if corporate separateness is compromised, "courts are more likely to extend liability upward to the parent company than laterally to another subsidiary."<sup>137</sup>

Other regulatory approaches could be utilized to mitigate the risks associated with bank involvement in securities activities.

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*Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939) (in reorganization of subsidiary, the parent holding company's claims as a creditor were subordinated to claims of other creditors and preferred shareholders of the subsidiary; case involved inadequate capitalization of the subsidiary and gross mismanagement of the subsidiary for the benefit of the parent). See also Clark, *supra* note 57, at 834. "[B]oth existing legal doctrine about fraudulent conveyances and veil piercing and an appreciation of the weight legal policy gives to protection of depositors and policyholders indicate that an affiliate's creditors will rarely be given priority over, or even parity with, the intermediary's public creditors." *Id.*

<sup>132</sup> See Note, *Underwriting Proposal*, *supra* note 2, at 721-22; see also *supra* note 117 and accompanying text.

<sup>133</sup> Clark, *supra* note 57, at 808. In both subsidiary and sister affiliate situations, risks beyond legal liability may exist. For example, the desire to prevent erosion of public confidence in the bank creates an incentive to utilize bank resources to assist a distressed affiliate. See, e.g., Note, *Underwriting Proposal*, *supra* note 2, at 722; Note, *BHC Argument*, *supra* note 36, at 657-58. This leads to general concern with controlling conflicts of interest. See *infra* notes 148-88 and accompanying text.

For a discussion of a parent bank's risk of control person liability for securities law violations by its securities subsidiary, see *infra* note 216.

<sup>134</sup> "Piercing the corporate veil" refers to the situation in which the corporate entity is disregarded and the equitable owner of a corporation is held liable for the corporation's actions because there has been abuse of corporate privilege. A detailed discussion of the topic can be found in 1 C. VAN SWEARINGEN, *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* §§ 41-46 (rev. perm. ed. 1983).

<sup>135</sup> See, e.g., Clark, *supra* note 57, at 834 (calling danger purely speculative); McFadyen, *supra* note 130, at 3 (instances of veil piercing have almost exclusively involved nonbanking organizations); Note, *BHC Argument*, *supra* note 36, at 661-62. "Courts are especially unlikely to pierce the corporate veil in the banking context." *Id.* at 661.

<sup>136</sup> See McFadyen, *supra* note 130, at 5-6; Note, *BHC Argument*, *supra* note 36, at 661.

<sup>137</sup> McFadyen, *supra* note 130, at 4.

One commentator, considered three regulatory approaches to limit the danger that unsuccessful underwriting issues might deplete the capital of bank holding companies.<sup>138</sup> The first approach would restrict bank affiliates to underwriting issues that involve little risk.

The risk limitation approach, however, has several flaws. First, quality restrictions would prevent small and medium sized corporations from taking advantage of bank underwriting and would thereby defeat one of the chief aims of bank underwriting: to remedy the current inability of such firms to obtain underwriting services from investment banks. Second, quality ratings only imperfectly reflect risk, and external factors such as interest rate increases are at least as determinative of underwriting risk as is the "quality" of the issue. Finally, quality ratings measure the risk of holding securities as investments rather than the risk of underwriting the securities.<sup>139</sup>

The second approach would limit the exposure of a bank holding company's capital on a per-issue basis. This would encourage bank affiliates to diversify their underwriting, but also could result in placing commercial banks at a competitive disadvantage vis-a-vis investment banks not subject to such limits.<sup>140</sup> The commentator concludes that the best regulatory approach is one that would limit the proportion of a bank holding company's equity that could be invested in a securities affiliate. While this might prevent some small banks from engaging in securities activities, it would allow bank affiliates to compete on an equal basis with investment houses and would "still protect the soundness of bank holding companies."<sup>141</sup>

Even if the risks and legal liability of banks affiliated with securities firms can be limited, the financial difficulties of an affiliate may engender a loss of public confidence in the bank.<sup>142</sup>

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<sup>138</sup> See Note, *Underwriting Proposal*, *supra* note 2, at 734-35.

<sup>139</sup> *Id.* at 734.

<sup>140</sup> See *id.* at 734-35. The extent of diversification should be based on management's judgment rather than on a fixed formula that is unrelated to the actual risk of the issue being underwritten. Investment banking firms generally limit their exposure on a per-issue basis through syndication of large or risky issues. See L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 84-89 (1983). A per-issue capital limit, depending on the amount at which it was set, could have the undesirable effect of preventing further involvement in an underwriting with little risk. A per-issue capital limit also could have a disproportionate impact on smaller and medium size banks.

<sup>141</sup> Note, *Underwriting Proposal*, *supra* note 2, at 735.

<sup>142</sup> See, e.g., *Investment Co. Inst. v. Camp (Camp)*, 401 U.S. 617, 631 (1971). "[P]ressures are created because the bank and the affiliate are closely associated in the public mind, and should the affiliate fare badly, public confidence in the bank might be impaired." *Id.* Cf. Note, *BHC Argument*, *supra* note 36, at 657-58 (stating that such arguments do not provide a persuasive basis for activities regulation).



This is crucial as maintaining the confidence of its customers is a bank's "first and most important line of defense."<sup>143</sup> The extent to which legal separateness is ignored by the public is disputed.<sup>144</sup> Public confidence in the safety of deposits is, however, best preserved through deposit insurance and access to the discount window rather than through activities regulation and prohibitions on affiliations.<sup>145</sup> Concern about maintaining public confidence should be directed toward preserving the perceived soundness of the insurance system. Since confidence is based on the soundness of the system as a whole rather than any component part or affiliate of a component, the financial difficulties of one securities affiliate or even one bank would probably only tangentially influence public confidence.<sup>146</sup> Lingering concerns could be addressed through prohibitions on common

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<sup>143</sup> *Financial Services Oversight Hearings* (part I), *supra* note 3, at 64 (statement of Paul Volcker).

<sup>144</sup> *Compare id.* at 66 ("The holding companies themselves, the securities markets, and the general public look upon these organizations as consolidated units.") with Note, *BHC Argument*, *supra* note 36, at 665 ("Yet major financial rating agencies and professional lenders have already demonstrated their respect for the principle of limited liability by relying upon it in rating banks and bank holding companies and in making loans. Some segments of the public are less discriminating . . . ." (footnotes omitted)). See also *Securities Indus. Ass'n v. Federal Home Loan Bank Bd.*, 588 F. Supp. 749, 764 (1984) (stating, in the context of saving and loan associations' subsidiaries performing limited brokerage and investment advisory services, that because the service corporations "will be separate corporations, the risk that S & Ls will lose the good will of their customers will be minimized.")

Both sides in the dispute over this issue have argued that recent events support their position. See *McFadyen*, *supra* note 130, at 5-6 (citing Beverly Hills National Bank and Peoples Trust Bank as examples supporting both arguments). In both situations, the parent holding companies were experiencing severe financial problems that adversely affected the subsidiary banks due to a loss of public confidence. "In both . . . cases, however, it can be argued that corporate separateness was a significant factor in preventing the bank's closing." *Id.* at 6. Compare Schotland, *Bank Holding Companies and Public Policy Today*, in STAFF OF HOUSE COMM. ON BANKING, CURRENCY AND HOUSING, 94TH CONG., 2D SESS., FINANCIAL INSTITUTIONS AND THE NATION'S ECONOMY (FINE), COMPENDIUM OF PAPERS PREPARED FOR THE FINE STUDY 233, 270-77 (Comm. Print 1976) (problems associated with Real Estate Investment Trusts) (REITs) with *GOLEMBE ASSOCIATES, INC.*, *supra* note 5, at 85-86 (banks involved in REIT problems "survived nicely" despite considerable publicity).

<sup>145</sup> See Note, *BHC Argument*, *supra* note 36, at 665; see also *GOLEMBE ASSOCIATES, INC.*, *supra* note 5, at 85. "[As] to the issue of public confidence and bank product expansion. It is, in 1982, largely irrelevant." *Id.* at 85 (citing deposit insurance and access to the discount window as major reasons).

<sup>146</sup> The recent crisis among privately insured state thrifts in Ohio resulted from a loss of confidence in the insurance system itself when its reserves were reduced to zero by the failure of one institution. As soon as it was possible to arrange for the affected institutions to obtain federal insurance, the crisis was over. See *Most Ohio Thrifts Restore Some Service; 18 Qualify for U.S. Deposit Insurance*, *Wall St. J.*, Mar. 23, 1985, at 5, col. 1.

names and logos, restrictions on advertising, and by a generally more effective bank regulatory and supervisory system.<sup>147</sup>

### B. Conflicts of Interest

Given the premise that conflicts of interest exist everywhere in our society,<sup>148</sup> the question is whether there exists something so unique about the "salesman's stake" in the success of any investment banking venture or in the mixing of investment and commercial banking activities to warrant separating the two industries.<sup>149</sup> Many observers have convincingly argued that the concerns associated with "promotional interests" can be adequately addressed through regulation.<sup>150</sup>

Conflicts may arise as a result of bank managers having access to "insider information." In *Camp*, the Supreme Court noted its concern that a "bank might exploit its confidential relationship with its commercial and industrial creditors for the benefit of the [mutual] fund."<sup>151</sup> It is unlikely, however, that the potential for abuse would be any greater than that which presently exists as a result of the extensive trust department activities of many commercial banks or that any increase in this potential cannot be adequately controlled through regulation.<sup>152</sup> At present the use of material inside information in connection with stock trading is prohibited by the federal securities laws,<sup>153</sup> and conflicts

<sup>147</sup> See GOLEMBE ASSOCIATES, INC., *supra* note 5, at 86-87; McFadyen, *supra* note 130, at 6; Note, *BHC Argument*, *supra* note 36, at 665; see also Clark, *supra* note 57, at 838 (suggesting a prohibition on using similar names, but permitting disclosure-type advertising to retain benefits of publicizing the relationship).

<sup>148</sup> See, e.g., Edwards, *supra* note 122, at 282.

<sup>149</sup> See, e.g., *id.*; GOLEMBE ASSOCIATES, INC., *supra* note 5, at 83.

<sup>150</sup> See, e.g., Clark, *supra* note 57, at 838-48; GOLEMBE ASSOCIATES, INC., *supra* note 5, at 79-83, 87-92; Note, *BHC Argument*, *supra* note 36, at 662-64; Note, *Underwriting Proposal*, *supra* note 2, at 729-30; cf. Edwards, *supra* note 122, at 282-89 (arguing that conflicts of interest are quite similar to those that already exist and for which special regulations have been adopted, but that the use of separate affiliates exacerbates the problem). *But see* Karmel, *supra* note 10, at 640.

The prohibition of conflicts of interest perceived by Congress as improper is basic to the Glass-Steagall Act. Functional segregation of investment and commercial banking is a respectable regulatory mechanism for preventing conflicts of interest. Although in other areas federal law had resolved conflicts of interest by disclosure, the elimination of possible conflict situations is obviously more effective.

*Id.*

<sup>151</sup> 401 U.S. at 637-38.

<sup>152</sup> See Edwards, *supra* note 122, at 283-84; Note, *Underwriting Proposal*, *supra* note 2, at 729-30.

<sup>153</sup> Securities Exchange Act of 1934, § 10, 15 U.S.C. § 78j (1982); Rule 10b-5, 17 C.F.R. § 240.10b-5 (1985).

arising out of bank's trust department activities are controlled through use of the "Chinese Wall."<sup>154</sup> Similarly, the establishment of separate securities affiliates with separate personnel and records could mitigate the potential for abuse of "insider information."

Another subtle hazard cited by the Court in *Camp* was that:

the pressure to sell a particular investment and to make the affiliate successful might create a risk that the bank would make its credit facilities more freely available to those companies in whose stock or securities the affiliate has invested or become otherwise involved. Congress [had] feared that banks might even go so far as to make unsound loans to such companies.<sup>155</sup>

Similar incentives to make unsound loans to distressed borrowers already exist in the banking industry.<sup>156</sup> This danger is presently regulated through limits on a bank's ability to extend loans to a particular borrower.<sup>157</sup> In addition, prohibitions or other restrictions could be placed on a bank's ability to make loans, during a period prior to and after an underwriting, to an organization whose securities are being underwritten by the bank or its securities affiliate. Similar steps could be taken with respect to loans to organizations for whose securities the bank, or its securities affiliate, acts as a market maker, or in which it has a substantial position as a principal.<sup>158</sup> Section 23A restrictions on interaffiliate loans and other transactions<sup>159</sup> could be extended to cover transactions between banks and their underwriting customers or customers of their securities affiliates. Section 23A of the Federal Reserve Act presently defines "affiliate" to include companies in control of and in certain contractual relationships with a bank and its affiliates. The Board is authorized to include

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<sup>154</sup> See GOLEMBE ASSOCIATES, INC., *supra* note 5, at 89; Note, *Underwriting Proposal*, *supra* note 2, at 729-30. The term "Chinese Wall" refers to written internal procedures established "to assure that material inside information which may come into the possession of the commercial, bond or other departments of the bank is not transferred to personnel in the trust department with investment responsibility for publicly traded securities." Herzel & Colling, *The Chinese Wall and Conflict of Interest in Banks*, 34 BUS. LAW. 73, 74 (1978).

<sup>155</sup> 401 U.S. at 631 (footnote omitted).

<sup>156</sup> See GOLEMBE ASSOCIATES, INC., *supra* note 5, at 84.

<sup>157</sup> See, e.g., 12 U.S.C. § 84 (1982); C. GOLEMBE & D. HOLLAND, *supra* note 4, at 87-88.

<sup>158</sup> Cf. 49 Fed. Reg. 46,709, 46,715-17 (1984) (FDIC discussion of lending restriction provision of its final rule). See *infra* text accompanying note 260.

<sup>159</sup> 12 U.S.C. § 371c (1982). See also 12 C.F.R. § 337.3 (1985) (limits on extensions of credit to executive officers, directors, and principal shareholders of insured nonmember banks).

in this definition any company that the Board determines to have a relationship with the bank or its affiliate that may adversely affect the bank or its affiliate.<sup>160</sup> This definition could be expanded to explicitly include relationships with underwriting customers. Such restrictions would adequately minimize these conflicts of interest dangers.

The Supreme Court noted in *Camp* that Congress also was concerned "that bank depositors might suffer losses on investments that they purchased in reliance on the relationship between the bank and its affiliate. This loss of customer good will might 'become an important handicap to a bank during a major period of security market deflation.'"<sup>161</sup> In its worst manifestation, this hazard could result in a bank dumping poor quality issues on its banking customers<sup>162</sup> or engaging in securities transactions with banking customers in order to assist a distressed issuer to repay its commercial loans.<sup>163</sup> As one commentator has noted, however, "this potential conflict already exists for banks whose trust departments have extensive holdings. . . . [and] manipulation of securities holdings for the benefit of loan customers has been rare."<sup>164</sup> The fiduciary duties of banks to their customers are extensively regulated.<sup>165</sup> More general claims of incompatibility between "the promotional interest of the investment banker and the obligation of the commercial banker to render disinterested investment advice"<sup>166</sup> have been countered by the simple observation that in providing fiduciary and commercial services bankers also face basic promotional incentives.<sup>167</sup> It is far from clear that these concerns require strict separation of functions and cannot be handled by disclosure regulation and the normal marketplace incentives for main-

<sup>160</sup> 12 U.S.C. § 371c(b) (1982).

<sup>161</sup> 401 U.S. at 631 (quoting 1931 Senate Hearings) (footnotes omitted).

<sup>162</sup> See *id.* at 633. "Congress had before it evidence that securities affiliates might be driven to unload excessive holdings through the trust department of the sponsor bank." *Id.* (footnote omitted).

<sup>163</sup> See Note, *Underwriting Proposal*, *supra* note 2, at 730. "Because commercial departments bring in much more revenue than do securities and trust departments, a commercial bank's temptation to use securities transactions to help an ailing commercial loan customer might be immense." *Id.* (footnote omitted).

<sup>164</sup> *Id.* (footnotes omitted).

<sup>165</sup> See, e.g., 12 C.F.R. §§ 9.1-22 (regulation of fiduciary powers of national banks); see also GOLEMBE ASSOCIATES, INC., *supra* note 5, at 87-89; Note, *Underwriting Proposal*, *supra* note 2, at 730.

<sup>166</sup> *Investment Co. Inst. v. Camp (Camp)*, 401 U.S. 617, 633 (1971).

<sup>167</sup> See Edwards, *supra* note 122, at 285 (citing, for support, Justice Blackmun's dissent in *Camp*, 410 U.S. at 643-44 (Blackmun, J., dissenting)).

taining customer goodwill. Any temptation "to make loans to customers with the expectation that the loan would facilitate the purchase of stocks and securities,"<sup>168</sup> could be controlled through margin requirements or by prohibiting loans for the purchase of securities currently issued, underwritten, or distributed by a bank or its securities affiliate.<sup>169</sup>

As previously noted, requiring banks to conduct their securities activities through separate affiliates can limit the bank's risk exposure<sup>170</sup> and can minimize the potential for abuse of "insider information."<sup>171</sup> Segregating the activities into separate organizations facilitates the task and reduces the cost of regulating soundness.<sup>172</sup> This segregation of activities, however, entails additional costs, such as those incurred in defining the boundaries of permissible activities.<sup>173</sup> Moreover, the use of separate affiliates by banks to conduct securities activities may exacerbate conflicts of interest problems,<sup>174</sup> because affiliates may have different capital and ownership structures than banks,<sup>175</sup> or because the controlling managements' compensation may be tied to the performance of a particular affiliate.<sup>176</sup>

<sup>168</sup> *Camp*, 410 U.S. at 632 (footnote omitted).

<sup>169</sup> The FDIC's regulations governing the securities activities of insured nonmember banks contain just such a restriction of loans in order to mitigate this potential abuse. See *infra* text accompanying notes 250-51.

<sup>170</sup> See *supra* notes 130-32 and accompanying text.

<sup>171</sup> See *supra* note 154 and accompanying text.

<sup>172</sup> See Clark, *supra* note 57, at 814-15; see also *Financial Services Oversight Hearings* (part I), *supra* note 3, at 67 (statement of Paul Volcker). "[S]egregation may well make it easier to assure consistency and equity in the application of those regulations appropriate to particular activities conducted in either the bank or an affiliate." *Id.*

<sup>173</sup> See Clark, *supra* note 57, at 815, 851-53.

<sup>174</sup> See Edwards, *supra* note 122, at 285-87; Fischer, *supra* note 115, at 508-10; see also Clark, *supra* note 57, at 828-33.

In summary, an incentive for unfair self-dealing is present whenever controlling persons have different interests in different parts of a holding company system. Because holding company systems can serve as smokescreens or as ways of externalizing services, the dangers of fraud and unfair self-dealing in such systems can be great. In addition, there is a danger that holding companies will extract excessive dividends from some of their subsidiaries. In financial holding companies, these dangers tend to fall on the intermediary subsidiary and thus threaten the dominant goal of insuring the soundness of intermediaries. This is the major real problem posed by financial holding companies. It should be the focus of regulation.

*Id.* at 833.

<sup>175</sup> See Clark, *supra* note 57, at 829; Edwards, *supra* note 122, at 286-87.

<sup>176</sup> See Clark, *supra* note 57, at 829 n.173. The term "controlling management" is not used in the sense of ownership or management control of a corporation through the proxy machinery. Rather, the term describes that set of decisionmakers who are in a position to control relevant decisions—i.e., decisions involving potential conflict of interest problems, such as the terms of transactions between a bank and its securities affiliate. This set of decisionmakers will vary depending on the organization's structure

Requiring disclosure of and supervising interaffiliate transactions, however, can aid in preventing potential abuse.<sup>177</sup>

Other dangers of an affiliate system are that excessive dividends may be extracted from the bank<sup>178</sup> and that the bank's resources may be utilized to assist a troubled affiliate.<sup>179</sup> The distribution of bank dividends, however, is regulated by federal<sup>180</sup> and state law,<sup>181</sup> and section 23A of the Federal Reserve Act restricts transactions between member banks and their affiliates.<sup>182</sup> This section is made applicable to federally insured nonmember banks through section 18(j) of the Federal Deposit Insurance Act.<sup>183</sup>

Reforming current regulation of interaffiliate transactions,<sup>184</sup> bank dividends,<sup>185</sup> and other potential abuses,<sup>186</sup> as well as considering limits on capital and ownership structures,<sup>187</sup> may be necessary if banks are permitted to expand their securities activities through affiliates. There is no reason to believe, how-

and on the transaction involved. This group or individual will not necessarily be at the top of the organizational chart.

<sup>177</sup> See Note, *BHC Argument*, *supra* note 36, at 662-64; Note, *Underwriting Proposal*, *supra* note 2, at 735-36.

<sup>178</sup> See, e.g., Clark, *supra* note 57, at 829-30, 833.

<sup>179</sup> In *Camp*, the Court stated "since public confidence is essential to the solvency of a bank, there might exist a natural temptation to shore up [a distressed] affiliate through unsound loans or other aid." 401 U.S. at 631 (footnote omitted). See also *Financial Services Oversight Hearings* (part I), *supra* note 3, at 67 (statement of Paul Volcker); McFadyen, *supra* note 130, at 4-5.

<sup>180</sup> See 12 U.S.C. §§ 56, 60, 324 (1982).

<sup>181</sup> See, e.g., CAL. FIN. CODE §§ 640-646 (West Supp. 1985); MASS. GEN. LAWS ANN. ch. 172, § 28 (Law. Co-op. Supp. 1985); N.Y. BANKING LAW § 112 (McKinney Supp. 1984-85); OHIO REV. CODE ANN. §§ 1117.02-.05 (Page 1968). See generally Clark, *supra* note 57, at 802 (discussing regulation of bank dividends).

<sup>182</sup> See 12 U.S.C. § 371c (1982). Section 23A was substantially overhauled in 1982. Banking Affiliates Act of 1982, Pub. L. No. 97-320, § 410(b), 96 Stat. 1469, 1516-17 (codified at 12 U.S.C. § 371c (1982)). For a discussion of the "new" § 23A, see Rose & Talley, *The Banking Affiliates Act of 1982: Amendments to Section 23A*, 68 FED. RESERVE BULL. 693 (1982).

<sup>183</sup> 12 U.S.C. § 1828(j) (1982).

<sup>184</sup> See, e.g., Clark, *supra* note 57, at 839-45 (proposing a prohibition on interaffiliate transactions with limited exceptions, including an administrative exemption scheme for transactions that are "more than fair").

<sup>185</sup> See, e.g., *id.* at 845-48.

<sup>186</sup> See, e.g., Note, *BHC Argument*, *supra* note 36, at 663-64 (citing the following areas for potential reform: management fees and service charges, prepayment of debt owed by a bank, transfer of operations to or from a bank, transfers through the payments system, and certain unregulated bank management and director interlocks); see also, Letter from Prof. Hal Scott, Harvard Law School, to Rep. Steve Bartlett (R-Tex.) (Aug. 2, 1984) (proposing an amendment to prohibit any institution with access to the payment systems from accepting deposits from or processing payments for any unregulated affiliate) (on file at the HARV. J. ON LEGIS.).

<sup>187</sup> Cf. Clark, *supra* note 57, at 839 (rejecting approach of regulating the structure of financial holding companies).

ever, that such regulation will not effectively address the potential conflicts of interest abuses allegedly associated with bank product expansion. Of course, even improvements in regulation, supervision, and enforcement and increases in penalties cannot prevent all abuses caused by either disregard of the law or gross mismanagement. But bank managers willing to disregard the law and abuse their position to the detriment of bank safety and soundness will do so whether or not their banks engage in securities activities.<sup>188</sup> Since any increase in potential abuse can be adequately restrained by regulation, the policy of prohibition cannot be justified by claims that complete separation is necessary to prevent conflicts of interest.

### C. Antitrust Considerations

Much ink has already been spilled on the antitrust considerations of bank involvement in securities activities.<sup>189</sup> Reasons often cited and equally often rejected for separating the two industries include unfair competitive advantages,<sup>190</sup> voluntary and involuntary tie-ins,<sup>191</sup> concentration in individual markets,<sup>192</sup>

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<sup>188</sup> See McFadyen, *supra* note 130, at 5-7.

<sup>189</sup> See Clark, *supra* note 57, at 826 (citing the extensive analysis in the antitrust literature on anticompetitive effects of financial holding companies and stating that "[m]any expert commentators think that the dangers posed by these practices are often overstated or that for other reasons harsh legal rules about them are not in order"); Fischer, *supra* note 115, at 511-13 (reviewing the literature on aggregate concentration and concluding that though "[i]t probably has more direct and serious implications for the political process than for the functioning of the economic system, . . . available data do not suggest that the problem it poses is currently a serious one or that it is growing rapidly." *Id.* at 513).

<sup>190</sup> See, e.g., GOLEMBE ASSOCIATES, INC., *supra* note 5, at 108-21; Edwards, *supra* note 122, at 275; Note, *Underwriting Proposal*, *supra* note 2, at 731-32. To the extent that banks do derive benefits from special regulations, regulatory exemptions, or tax breaks, modification of these laws may be required. See Edwards, *supra* note 122, at 275. One recent example of just such a modification is the adoption by the SEC of Rule 3b-9 requiring a bank to conduct certain securities activities through a broker-dealer registered under the Securities Exchange Act of 1934. See *Applicability of Broker-Dealer Registration to Banks*, 50 Fed. Reg. 28,385 (1985) (to be codified at 17 C.F.R. § 240.3b-9). Placing the two industries in an equivalent regulatory status while preserving the policies supporting special treatment of banks can be achieved by requiring banks to engage in securities activities through separate organizations. See *infra* note 208 and accompanying text.

<sup>191</sup> See, e.g., GOLEMBE ASSOCIATES, INC., *supra* note 5, at 114-16; Clark, *supra* note 57, at 826-28.

<sup>192</sup> See, e.g., Fischer, *supra* note 115, at 510. "Concentration in the individual markets would be likely to decline as a consequence of bank entry into a wider range of securities activities, particularly if that entry were accompanied by the entry of securities firms into traditional banking activities." *Id.* Cf. Karmel, *supra* note 10, at 639.

and undue consolidation of economic resources in the aggregate economy.<sup>193</sup> While the extent of such dangers is debatable, it seems clear that they could be contained through the use of antitrust laws and do not require the separation of the two industries.<sup>194</sup> Even if it is argued that anticompetitive effects are increased by banks engaging in securities activities or that there are special anticompetitive concerns because banks operate in a uniquely regulated market, these arguments only support stricter or specially tailored antitrust regulation.<sup>195</sup> Just as conflicts of interest and safety and soundness concerns do not justify the policy of separation, “[t]hese competitive fears . . . also do not support a policy of total prohibition.”<sup>196</sup>

#### D. Benefits of Deregulation

Two basic benefits can be expected from permitting bank product expansion into securities activities. First, deregulation should lead to increased competition in the securities markets with the attendant benefits of decreased cost and product innovation.<sup>197</sup> Second, product expansion “would strengthen the

Regulation of the securities industry must necessarily be concerned about the impact upon that industry which could be caused by the expansion of the securities activities of commercial banks (e.g., bank entry into the revenue bond market)—the public will not be well served by a further contraction of the securities industry.

*Id.*

<sup>193</sup> See, e.g., GOLEMBE ASSOCIATES, INC., *supra* note 5, at 95–105; Fischer, *supra* note 115, at 511–13; see also Clark, *supra* note 57, at 835–36 (“The United States is far from being a *zaibatsu* system.” *Id.* at 836. *Zaibatsu* were “large financial and industrial conglomerates which ruled the Japanese economy.” *Id.* at 835 n.193.)

<sup>194</sup> See Clark, *supra* note 57, at 836–38; Edwards, *supra* note 122, at 287–88; cf. Karmel, *supra* note 10, at 639. “It probably can be argued that the separation of commercial and investment banking mandated by the Glass-Steagall Act has proven a better regulator than the antitrust and other laws for curbing the excessive aggregation of banking power in only a few financial institutions.” *Id.*

<sup>195</sup> But cf. Clark, *supra* note 57, at 828 (concluding that “the case for going beyond regular antitrust law in dealing with possible anticompetitive practices of financial holding companies has not been proven”).

<sup>196</sup> Edwards, *supra* note 122, at 288.

<sup>197</sup> See, e.g., *Competitive Equity Hearings* (part III), *supra* note 5, at 1276 (statement of William Isaac). “First, it would be procompetitive. The American public—including consumers, small businesses and farmers—would be given a broader range of financial products at more competitive prices.” *Id.*; *Id.* at 1718–19 (statement of Donald Regan, Secretary of the Treasury). “[C]onsumers will benefit from a wider variety of services at lower prices and the convenience and efficiency of one-stop shopping.” *Id.* See also *id.* at 1279 (statement of William Isaac).

While the issue of broader powers for banks is sometimes characterized as a “big bank” issue, we could not disagree more. This issue should be of concern to banks of all sizes and their customers. For example, since permitted to do



banking system by allowing banks to be more competitive in the financial marketplace and [to] develop new sources of income to help offset the cost of liability deregulation."<sup>198</sup> Product expansion would allow banks to benefit from diversification of risk,<sup>199</sup> and would facilitate their efforts to raise capital.<sup>200</sup> In

so in 1982, some 1,200 banks have begun offering the public discount brokerage services at commissions ranging from 40 to 60 percent lower than those available at full-service brokers. Similar benefits have been realized by life insurance purchasers in New England and New York where savings banks profitably underwrite and sell life policies at rates among the lowest available anywhere. Small banks without the managerial or financial resources to enter these new businesses alone are often able to do so through joint ventures or the purchase of packages assembled by others.

*Id.*

Decreased costs are likely to result from a direct increase in competition due to new entry and from efficiencies involved in combining products. In addition, underwriting by depository institutions could lower the cost of raising capital for corporations. Because banks have potential securities customers not reached by securities firms, one result of underwriting by banks might be to increase demand for securities, which would tend to reduce interest rates for debt issues or raise prices for equity issues. Significant empirical work supports this hypothesis.

Note, *Underwriting Proposal*, *supra* note 2, at 732 (footnote omitted); *cf.* Fischer, *supra* note 115, at 515.

Although arguments for allowing expanded bank securities activities are founded on efficiency, there is little support for them in the available evidence from empirical studies. Rather, these arguments must rest on the general presumption that firms do not willingly enter into new activities if they expect to suffer an efficiency disadvantage and that free entry is generally conducive to more intense competition.

*Id.*

<sup>198</sup> *Competitive Equity Hearings* (part III), *supra* note 5, at 1276 (statement of William Isaac). See also Kurucz, *Current Bank Brokerage Initiatives*, in 1984 PLI, *supra* note 47, at 106 ("Brokerage represents a new source of much needed fee income for banks."); Note, *Underwriting Proposal*, *supra* note 2, at 738.

Competition from other financial institutions has reduced the interest income of commercial banks and savings and loan associations and forced them to seek new forms of income. Securities activity by affiliates of depository institutions can provide this needed income, and bank soundness can be ensured through limitations on the amount of bank capital that securities affiliates may place at risk.

*Id.*

Reregulation presents one alternative for addressing the fear that bank safety may be prejudiced by a reduction in bank competitiveness in the financial marketplace. Reregulation, however, is unlikely to be effective in the face of rapid market and technological changes, see Note, *BHC Argument*, *supra* note 36, at 666, and would result in the loss of the efficiency benefits discussed in *supra* note 197 and accompanying text.

Similarly, "the fact that Glass-Steagall can be penetrated is not an argument for not changing it. The current methods of engaging in 'prohibited' activities are costly and inefficient and are likely to discriminate against small and less aggressive banks." Kaufman, *The Securities Activities of Banks: What Has Been Done and What Could Have Been Done*, in 1984 PROCEEDINGS, *supra* note 61, at 202, 208.

<sup>199</sup> See *supra* notes 123-25 and accompanying text.

<sup>200</sup> See J.P. MORGAN & CO., *RETHINKING GLASS—STEAGALL 22* (Dec. 1984) (on file at the HARV. J. ON LEGIS.); see also Clark, *supra* note 57, at 819 (citing economies of scale in raising capital as a benefit of the conglomerate form of organization).

addition, it would lead to advantages of conglomerate organization such as the coordination and uncertainty-reducing benefits of vertical integration and the ability to redeploy capital without incurring the transaction and information costs associated with the capital markets.<sup>201</sup> Because potential harms can be adequately addressed through regulation while benefits can be realized by permitting bank product expansion, the present policy of separation is unjustified.<sup>202</sup>

### E. Policy Prescription

Thus far this Note has only concluded that the present policy of separation should be discarded in favor of one permitting bank product expansion into securities activities. The question remains what organizational form this expansion should take. This issue must be considered in light of the policy objectives of financial institutions regulation.<sup>203</sup>

Based on conclusions that investment banking risks do not differ significantly from commercial banking risks and that affiliate systems may actually aggravate conflicts of interest hazards,<sup>204</sup> some consideration has been given to the possibility of allowing banks to engage in securities activities directly.<sup>205</sup> Most proposals, however, would require that at least some of the securities activities take place in a separate organization.<sup>206</sup>

<sup>201</sup> See Clark, *supra* note 57, at 819–22, 844–45; cf. Fischer, *supra* note 115, at 514–15. “However, just as little concrete evidence has been found of the detrimental effects of conglomerate mergers, similarly little evidence has been found of their vaunted synergies.” *Id.* at 514.

<sup>202</sup> See GOLEMBE ASSOCIATES, INC., *supra* note 5, at 122. They argue that the “underlying assumption is that the public is best served by maximizing competition among financial institutions, and that only the most compelling considerations of public policy should be permitted to limit the attainment of that objective . . . [The conclusion reached here is that] the case for change in the [Glass-Steagall] Act has been made.” *Id.*; Rosenblum, *Banks and Nonbanks: Who’s in Control?*, BANKERS MAG., Sept.-Oct. 1984, at 10. After reviewing the effect on banks of increased competition by nonbank firms, Rosenblum concluded that “[t]he economic and historical record would suggest that careful and orderly expansion of bank product lines would increase both the safety and competitiveness of the banking system.” *Id.* at 20.

<sup>203</sup> See *supra* notes 114–18 and accompanying text.

<sup>204</sup> See *supra* notes 119–25, 174–79 and accompanying text.

<sup>205</sup> See, e.g., Edwards, *supra* note 122, at 288–89; see also Fischer, *supra* note 115, at 509–10. “It may be more straightforward and more effective to allow the bank to engage in the activities directly subject to administrative safeguards like those designed to limit abuses by bank trust departments.” *Id.*

<sup>206</sup> See, e.g., *Competitive Equity Hearings* (part III), *supra* note 5, at 1276–78 (statement of William Isaac); GOLEMBE ASSOCIATES, INC., *supra* note 5, at 137–44, 147–48. See also *infra* Parts IV & V. For a general discussion of whether banks conducting securities activities should be required to do so through affiliates, see *Glass-Steagall and the Affiliate Issue*, GOLEMBE REPORTS, Apr. 5, 1982 (on file at the HARV. J. ON LEGIS.).

Given the preeminence of bank safety and soundness, as well as the inadequacy of the information on which these policy decisions are based,<sup>207</sup> it is preferable to adopt a proposal that limits bank exposure to risk by segregating activities into different legal entities. Mandating separate securities subsidiaries or affiliates facilitates administration of soundness regulation and permits the creation of a "level playing field."<sup>208</sup> Through reporting and monitoring of transactions, segregation mitigates the potential danger of certain types of conflicts of interest, such as insider trading.<sup>209</sup>

Any aggravation of conflicts of interest problems resulting from affiliate systems can be adequately addressed through regulation. The analysis presented earlier suggests that the major potential conflicts of interest associated with affiliation would arise from different ownership and control structures and from management compensation agreements.<sup>210</sup> These conflicts can be minimized by requiring that segregation be accomplished through one specific form of organization: wholly-owned subsidiary relationships. This would remove negative incentives created by divergent ownership interests.<sup>211</sup> Conflicts of interest resulting from performance compensation agreements could be regulated directly. For example, in a parent bank/securities subsidiary situation, prohibitions on the tying of bank management's salary to the performance of the securities subsidiary would remove the incentive provided by compensation agreements to make unsound loans to the subsidiary or its customers.

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<sup>207</sup> See GENERAL ACCOUNTING OFFICE, REPORT TO THE CHAIRMAN FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL: INFORMATION ABOUT DEPOSITORY INSTITUTIONS' ANCILLARY ACTIVITIES IS NOT ADEQUATE FOR POLICY PURPOSES (1982); Fischer, *supra* note 115, at 517.

<sup>208</sup> See *supra* notes 172-77 and accompanying text.

[T]he holding company framework permits the creation of the infamous level playing field. Competition between bank holding company subsidiaries and nonbank institutions could be conducted under the same ground rules. If a holding company subsidiary provides commodities services, it would be regulated by the Commodities Futures Trading Commission. Subsidiaries providing securities services would come under the jurisdiction of the Securities and Exchange Commission. None of the subsidiaries would be able to take advantage of the competitive edge banks enjoy as a result of deposit insurance. By the same token, subsidiaries would not be bound by banking restrictions.

Remarks by C.T. Conover, Comptroller of the Currency, before the Association of Bank Holding Companies, Washington, D.C. (Nov. 19, 1982), *reprinted in* QUARTERLY J., March 1983, at 50, 53.

<sup>209</sup> See *supra* notes 154 & 177 and accompanying text.

<sup>210</sup> See *supra* notes 174-76 and accompanying text.

<sup>211</sup> *But cf.* Clark, *supra* note 57, at 839 (rejecting the regulation of the structure of financial holding companies as an approach to controlling conflicts of interest).

The major remaining source of conflicts of interest resulting from the affiliate system would be differences in the capital structure of the parent and subsidiary. Because benefits from this conflict exist only in the event of bankruptcy,<sup>212</sup> it can be assumed that the danger of abuse is not great during normal operations and can be adequately addressed by monitoring the transactions and financial condition of affiliates.

By mitigating the conflicts of interest associated with affiliate systems, wholly-owned subsidiary relationships would require fewer restrictions on interaffiliate relationships than would be required if the transactions involved other affiliates. Thus, the parent-subsidiary form may be better able to achieve organizational efficiencies.<sup>213</sup> The bank, of course, should always be sure to conduct activities so as to preclude any risk of "veil piercing."<sup>214</sup>

Placing the securities activities in a bank subsidiary would "provide adequate protection to the bank while permitting the bank and its customers to directly benefit from the profits and capital base generated from the new activities. Moreover, it would allow [owners] . . . to avoid the expense and inconvenience of forming a holding company."<sup>215</sup> While the bank's investment in its subsidiary is directly at risk, this risk can be limited by restricting the proportion of a bank's capital that can be invested in a securities subsidiary.<sup>216</sup> Prohibitions on the

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<sup>212</sup> See Edwards, *supra* note 122, at 287. Depending on the bank's capital structure relative to that of its affiliate, this conflict of interest may operate to the benefit or detriment of the banking entity. *Id.*

<sup>213</sup> See Clark, *supra* note 57, at 844-45 (discussing whether proposal of prohibitory rules and exemption procedures regulating interaffiliate transactions would be consistent with the achievement of organizational efficiencies by financial holding companies).

<sup>214</sup> See *supra* notes 135-36 and accompanying text.

<sup>215</sup> *Competitive Equity Hearings* (part III), *supra* note 5, at 1277 (statement of William Isaac).

<sup>216</sup> See *supra* notes 130-41 and accompanying text. In a parent-subsidiary relationship, the bank will run a risk of control person liability for securities law violations. See Securities Act of 1933, § 15, 15 U.S.C. § 77o (1982); Securities Exchange Act of 1934, § 20, 15 U.S.C. § 78t(a) (1982). The risk of control person liability, however, is greatly reduced if the organizations are required to, and in practice do, maintain separate management. The bank would then be likely to avoid liability because it could prove that it "had no knowledge of or reasonable grounds to believe in the existence of the facts" on which liability is predicated, see 15 U.S.C. § 77o (1982), or that it "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation," see *id.* § 78t(a). See also 49 Fed. Reg. 46,709, 46,711 (1984). "The FDIC therefore concluded that it is possible to structure the relationship between a parent bank and its subsidiary to avoid or lessen the bank's exposure under the securities laws for the acts of the subsidiary." *Id.*

sharing of common names and logos and restrictions on advertising are also appropriate.<sup>217</sup>

Even though the direct subsidiary approach has some advantages over other forms of organization, practical realities dictate that the subsidiary approach should not be the only permissible form of organization for banks engaging in securities activities. Large securities firms acquiring or establishing small banks would be unwilling to structure themselves as subsidiaries of the banks. Requiring these firms to directly operate the bank as a subsidiary of the securities firm would also create practical difficulties in the case of holding companies that have a number of securities subsidiaries. Holding companies structured so that all of the bank and nonbank subsidiaries are wholly-owned by the parent company would similarly not exhibit the conflict of interest incentives created by divergent ownership interests. Holding company structures with divergent ownership interests, however, would produce negative incentives and would require stricter regulation of interaffiliate transactions.<sup>218</sup> In either of these holding company contexts, it is likely that the compensation of the control group would be more closely related to the performance of the securities firm and that the management would feel that it could take advantage of the present level-premium insurance system to take more risks at the bank level to benefit the parent or sister securities firm.<sup>219</sup> Thus, increased regulation of interaffiliate transactions would be appropriate whenever the securities activities take place in an affiliate that is not a wholly-owned subsidiary of the bank. This increased regulation would serve as an incentive to adopt the preferred

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<sup>217</sup> See *supra* note 147 and accompanying text; see also *infra* notes 254–56 and accompanying text (discussing appropriateness of FDIC's regulation in this area).

<sup>218</sup> Some commentators have suggested that divergent ownership interests may result due to the prohibitive cost of acquiring complete ownership of a bank and due to the ability to obtain effective control of a bank through a smaller interest. See Clark, *supra* note 57, at 829; Note, *Underwriting Proposal*, *supra* note 2, at 736.

<sup>219</sup> Under the present level-premium insurance system, bank managers have an artificial incentive to undertake more than the socially optimal level of risk. This "moral hazard" results because the level-premium system severs the link between bank portfolio risk and the cost of extra riskiness to managers, stockholders, and depositors. See Flannery, *Deposit Insurance Creates a Need for Bank Regulation*, BUS. REV. (Fed. Reserve Bank of Philadelphia), Jan.-Feb. 1982, at 17. For a discussion of various proposals for reform of the level-premium insurance system, see *id.* at 23–24 and sources cited *supra* note 126. Because the controlling management in a holding company context is likely to be further removed from the costs associated with extra bank riskiness, the "moral hazard" is even greater in this context and less amenable to correction through reform of the insurance system.

structure whereby the bank engages in securities activities through a direct subsidiary.

The determination of which activities the depository institution should be permitted to perform directly and which could be undertaken only by an affiliate should depend on several factors: the inherent risks of the activity; the efficiencies of permitting such an activity to be conducted in conjunction with existing bank activities; and the ease of administering regulations, including soundness and conflicts of interest regulations.<sup>220</sup> The costs incurred in defining and policing any definition of permissible activities<sup>221</sup> can be minimized by requiring that all securities activities take place in the separate organization except for a few well defined and limited exceptions. A statute could make it clear that new products and other product variations would fall outside the exception, unless specifically included by regulation or order. While this kind of statutory and administrative scheme would not reduce all of the definitional costs, it should tend to decrease the amount of litigation.

In sum, the policy prescription suggested here is to authorize bank product expansion into securities activities. Depending on a functional analysis of the particular product, this expansion may be limited to engagement in such activities only through an affiliate in order to assure that the public interest in the safety and soundness of depository institutions is not being compromised. The wholly-owned subsidiary approach is preferable and should be encouraged since, with appropriate safeguards, it will reduce risks and provide other benefits of an affiliate relationship while limiting detrimental conflicts of interest with minimal regulation. Moreover, conducting such activities through a wholly-owned subsidiary will more directly provide the benefits of increased profits and an expanded capital base to the bank. Within an appropriate regulatory framework, however, the final decision as to which affiliate structure is best suited for a particular bank should be left to management. With this conclusion in mind, this Note will now examine various regulatory and legislative proposals to permit banks to engage in investment banking activities.

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<sup>220</sup> Cf. *Competitive Equity Hearings* (part III), *supra* note 5, at 1276-77 (statement of William Isaac) (suggesting a division based on whether the financial services are "offered in an agency capacity" or "offered by a bank as principal").

<sup>221</sup> See *supra* note 173 and accompanying text.

## IV. THE FDIC'S REGULATIONS

## A. Format

As previously noted, the FDIC had placed ad hoc conditions on the approval of deposit insurance and change in bank control applications involving insured nonmember banks affiliated with securities firms.<sup>222</sup> Anticipating an increase in the number of such applications, the FDIC instituted a formal rulemaking procedure to address the problems of safety and soundness, conflicts of interest, and tying arrangements associated with such affiliations.<sup>223</sup> The FDIC's final rule, adopted in November 1984,<sup>224</sup> does not authorize any bank to engage in securities activities. Instead, it attempts to regulate insured nonmember banks' state authorized participation in such activities under the FDIC's authority to control "unsafe and unsound" banking practices.<sup>225</sup> The rule: (1) restricts insured nonmember banks' investment in securities subsidiaries to "bona fide subsidiaries" and limits the permissible securities activities of such subsidiaries;<sup>226</sup> (2) requires a notice of intent to invest in such subsidiaries;<sup>227</sup> (3) places limited restrictions on securities affiliates of insured nonmember banks;<sup>228</sup> (4) restricts transactions between

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<sup>222</sup> See *supra* note 48 and accompanying text.

<sup>223</sup> See *House Hearings on FDIC Proposal*, *supra* note 13, at 139 (statement of William Isaac). The FDIC adopted a Notice of Proposed Rulemaking in September 1982, see Advanced Notice of Proposed Rulemaking, 47 Fed. Reg. 42,121 (1982), and issued proposed regulations for comment in May 1983, see 48 Fed. Reg. 22,155 (1983), and in May 1984, see 49 Fed. Reg. 18,497 (1984). The FDIC held a one-day public hearing on the proposed regulations on June 17, 1983, see Oral Discussion for the Proposed Rule to Govern Securities Activities of FDIC Supervised Banks, June 17, 1983 (on file with the FDIC) (testimony of Mathew Fink, Vice President and General Counsel of the Investment Company Institute, and of Lawrence Connell, President, Washington Mutual Savings Bank). The Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Committee on Energy and Commerce also considered the FDIC's proposals in hearings in June 1983, see *House Hearings on FDIC Proposal*, *supra* note 13.

<sup>224</sup> See 49 Fed. Reg. 46,709 (1984) (to be codified at 12 C.F.R. § 337.4).

<sup>225</sup> See *id.* at 46,709-10, 46,722-23; *House Hearings on FDIC Proposal*, *supra* note 13, at 139-41 (statement of William Isaac); see also 49 Fed. Reg. 46,709, 46,721 (1984). "We wish to stress that the final regulation does *not* authorize any insured nonmember bank to either directly, or indirectly through a subsidiary, conduct any securities activity. An insured nonmember bank must derive that authority, if at all, from some other source, such as state law." *Id.* It seems clear, however, that the FDIC was acting within its authority. See 49 Fed. Reg. 46,709, 46,710 (1984) *But see* National Council of Sav. Insts. v. FDIC, No. 85-1451 (D.D.C. filed May 7, 1985) (challenging the FDIC's authority to promulgate the regulations as they apply to FDIC insured federal savings banks).

<sup>226</sup> 12 C.F.R. § 337.4(b) (1985).

<sup>227</sup> *Id.* § 337.4(d).

<sup>228</sup> *Id.* § 337.4(c).

insured nonmember banks and their securities subsidiaries or affiliates;<sup>229</sup> and (5) prohibits certain tying arrangements between banks and their securities subsidiaries or affiliates.<sup>230</sup> No "grandfather" clause exempts insured nonmember banks that had established securities subsidiaries or affiliates prior to the rule's effective date. Rather, compliance is phased in, with complete compliance mandated within two years of the effective date.<sup>231</sup> Foreign banks and insured branches of foreign banks are specifically exempted.<sup>232</sup>

Unless an insured nonmember bank's securities subsidiary engages solely in securities activities which the bank may engage in directly under the Glass-Steagall Act, the securities subsidiary must be a bona fide subsidiary.<sup>233</sup> The regulations define "bona fide subsidiary" in order to ensure the corporate separateness of the bank and the securities subsidiary.<sup>234</sup> To be "bona fide" a subsidiary must be adequately capitalized and physically separate in its operation. In addition, it cannot share a common name or logo with the bank, must maintain separate corporate records, and must observe separate corporate formalities.<sup>235</sup> The definition also restricts personnel interlocks.<sup>236</sup> The subsidiary must have separate employees who are compensated by the subsidiary, share no officers with the bank, and a majority of its board of directors cannot be directors or officers of the bank.<sup>237</sup> Bank employees may perform "back office" functions for the subsidiary that do not directly involve customer contact, but they must be contracted for at arm's length.<sup>238</sup> Finally, the subsidiary must conduct business pursuant to independent policies and procedures.<sup>239</sup> Substantially similar requirements apply to securities affiliates of insured nonmember banks.<sup>240</sup>

A securities subsidiary's underwriting activities are limited to the underwriting of investment quality debt and equity issues and the underwriting of certain investment companies and

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<sup>229</sup> *Id.* § 337.4(e).

<sup>230</sup> *Id.* § 337.4(e)(8).

<sup>231</sup> *Id.* § 337.4(h); *see also* 49 Fed. Reg. 46,709, 46,720-21 (1984).

<sup>232</sup> 12 C.F.R. § 337.4(a)(6) (1985); *see also* 49 Fed. Reg. 46,709, 46,721 (1984).

<sup>233</sup> 12 C.F.R. § 337.4(b)(1)(ii) (1985).

<sup>234</sup> *See* 49 Fed. Reg. 46,709, 46,710-13 (1984).

<sup>235</sup> 12 C.F.R. § 337.4(a)(2)(i)-(v) (1985).

<sup>236</sup> *Id.* § 337.4(a)(2)(vi)-(viii).

<sup>237</sup> *Id.*

<sup>238</sup> *Id.* § 337.4(a)(2)(vi) n.6.

<sup>239</sup> *Id.* § 337.4(a)(2)(ix).

<sup>240</sup> *Id.* § 337.4(c).



money market funds.<sup>241</sup> If, however, the subsidiary is a “qualified underwriter,” basically a National Association of Securities Dealers member that has been in continuous operation for more than five years, there are essentially no restrictions on its underwriting activity.<sup>242</sup> The bank’s investment in a securities subsidiary is not counted toward the bank’s capital.<sup>243</sup> There are no restrictions on the activities conducted by a securities affiliate of an insured nonmember bank.<sup>244</sup>

The FDIC’s regulations extend the restrictions of section 23A of the Federal Reserve Act<sup>245</sup> to any loan or extension of credit to subsidiaries or affiliates engaged in securities activities and to any investment company for which the bank’s subsidiary or affiliate acts as an investment adviser.<sup>246</sup> The regulations also prohibit a bank’s making any loan or extending credit to any company whose securities are currently underwritten or distributed by the subsidiary or affiliate of the bank unless such securities are investment quality debt or equity securities.<sup>247</sup>

Paragraph (e)(4) of the FDIC’s rule prohibits, without exception, any loan or extension of credit to investment companies whose shares are currently underwritten or distributed by a subsidiary or affiliate of the bank.<sup>248</sup> This stricter prohibition was adopted because the FDIC felt that the risk of unsound loans to such companies was greater, because their credit needs are most likely to arise when they are facing liquidity problems.<sup>249</sup> The regulations also prohibit banks from making loans or extending credit for the purpose of acquiring securities currently issued, underwritten, or distributed by their securities subsidiary or affiliate.<sup>250</sup> This rule also applies where the credit or loan is extended to purchase securities currently issued by an investment company advised by such subsidiary or affiliate.<sup>251</sup> In addition, the regulations forbid the conditioning of any loans or credits on the purchase of any security currently underwritten or distributed by the bank’s subsidiary or affiliate, or

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<sup>241</sup> *Id.* § 337.4(b)(1).

<sup>242</sup> *Id.* § 337.4(b)(2).

<sup>243</sup> *Id.* § 337.4(b)(3).

<sup>244</sup> See 49 Fed. Reg. 46,709, 46,714 (1984). See also 12 C.F.R. § 337.4(c) (1985).

<sup>245</sup> 12 U.S.C. § 371c (1982).

<sup>246</sup> 12 C.F.R. § 337.4(e)(6), (7) (1985).

<sup>247</sup> *Id.* § 337.4(e)(3).

<sup>248</sup> *Id.* § 337.4(e)(4).

<sup>249</sup> See 49 Fed. Reg. 46,709, 46,716 (1984).

<sup>250</sup> 12 C.F.R. § 337.4(e)(5) (1985).

<sup>251</sup> *Id.*

on the requirement that a company use the subsidiary or affiliate to underwrite or distribute the company's securities.<sup>252</sup> Trust department transactions are also restricted.<sup>253</sup>

### B. Critique

A number of the comment letters opposed the specific requirements for separating a bank from its subsidiary or affiliate, particularly the prohibition on sharing a common name or logo.<sup>254</sup> These provisions, however, serve a number of purposes: they limit the possibility that a court may pierce the corporate veil, reduce the risk of erosion of public confidence in the bank because of the financial difficulties of an affiliate, and reduce the risk of public confusion over the identities of the entities and over which products are federally insured.<sup>255</sup> Moreover, the regulations contemplate that a securities subsidiary or affiliate may advertise or otherwise disclose its relationship to the insured nonmember bank.<sup>256</sup> In light of these factors, the regulations are appropriate.

On the other hand, the limits on the permissible securities activities of subsidiaries should be discarded. As previously noted, the risk limitation approach is flawed because it restricts the ability of small and medium-sized firms to take advantage of such services, because quality ratings only imperfectly reflect risk, and because it places the securities subsidiaries of banks at a competitive disadvantage.<sup>257</sup>

The FDIC took an important step toward not restricting product options when it adopted the "qualified underwriter" exception in its final rule. Yet the condition that the qualified underwriter must have been in continuous operation for five years is unnecessarily restrictive and forces an insured nonmember bank

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<sup>252</sup> *Id.* § 337.4(e)(8).

<sup>253</sup> *Id.* § 337.4(e)(1),(2).

<sup>254</sup> See, e.g., Comment Letter of the American Bankers Ass'n, *supra* note 25; Comment Letter of the California Bankers Ass'n to Hoyle L. Robinson, Executive Secretary, FDIC (May 29, 1984) (on file with the FDIC).

<sup>255</sup> See 49 Fed. Reg. 46,700, 46,712-13 (1984). "Although proper disclosures can go a long way in avoiding such customer confusion, disclosure *plus* other measures will more effectively separate the identities of the players." *Id.* at 46,712.

<sup>256</sup> See 12 C.F.R. § 337.4(a)(2) n.5, (c) n.8 (1985).

<sup>257</sup> See *supra* note 139 and accompanying text. *But see* 49 Fed. Reg. 46,709, 46,714-15 (1984) (retaining basic concept of product restrictions in cases of de novo entrance into securities underwriting through a subsidiary despite problems with trying to objectively define "investment quality equity security").

to acquire an underwriter or establish an affiliate relationship if it wants to avoid product restrictions. Moreover, the FDIC has adopted a form of capital limitation by excluding the bank's investment in the subsidiary from the bank's capital. This exclusion led the FDIC to eliminate as unnecessary the investment limitation it had previously proposed.<sup>258</sup> If a risk limitation regulation is deemed necessary, an investment ceiling for de novo subsidiary entrants would be preferable to product restrictions.<sup>259</sup>

The FDIC's regulations generally seem adequately designed to address conflicts of interest dangers associated with banks engaging in securities activities. In order to control the possibility of a bank making imprudent loans to companies whose securities are underwritten by the bank's securities subsidiary or affiliate, the regulations prohibit such loans during the underwriting or distribution of securities when the securities are not investment quality debt or equity securities.<sup>260</sup> This prohibition, however, only applies to loans during the period when such securities are being "currently" underwritten or distributed. This provision can be easily circumvented by extending the loans or making the commitments immediately before or after the prohibited period. Thus, the prohibition, or alternatively section 23A-type restrictions, should be imposed over a longer period commencing at the start of negotiations or other comparable contact between the affiliate or subsidiary and the issuing company, and ending at some set number of days after the underwriting or distribution has been completed. The lending restrictions also should explicitly cover any agreement to extend credit. In addition, lending restrictions should apply whenever the subsidiary or affiliate is acting as a market maker or has a substantial position as a principal in non-investment quality securities of a corporation.

When the bank engages in securities activities through a wholly-owned subsidiary, consideration should be given to replacing these prohibitions and some of the other interaffiliate restrictions with a system of reporting and monitoring in order to preserve organizational efficiencies and because the dangers of interaffiliate abuse are minimized in the case of wholly-owned

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<sup>258</sup> See 49 Fed. Reg. 46,709, 46,718 (1984).

<sup>259</sup> See *supra* notes 138-141 and accompanying text.

<sup>260</sup> See 12 C.F.R. § 337.4(e)(3) (1985).

subsidiaries. While the present regulations provide an incentive to organize in the form of sister affiliates, the recommendations for eliminating product restrictions and easing restrictions on interaffiliate transactions would provide incentives to establish securities subsidiaries. Within this proposed regulatory framework, bank managers could then decide which structure would provide the maximum benefits of bank product expansion.

## V. LEGISLATIVE PROPOSALS

In testimony before Congress, Paul Volcker stated that:

The banking and financial system will evolve in new directions. The only question is whether that evolution will proceed within a framework established by the Congress, with full consideration and a balancing of the public interests involved, or whether it will proceed entirely under the impetus of market forces pushing around, and over, a legislative structure set in quite different circumstances years ago.<sup>261</sup>

This concern has spawned a number of legislative proposals which vary in the way they address the nonbank and nonmember bank loopholes, the degree of activities regulation, conflicts of interest issues, and countless other banking and financial system questions. One thing all have in common, however, is that none of them have been enacted into law. Moreover, the outlook for significant Congressional action in 1985–1986 is bleak.<sup>262</sup> The following sections will analyze the extent that banks could engage in securities activities under three proposals—the 1982 Treasury proposal;<sup>263</sup> the Financial Services Com-

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<sup>261</sup> *Financial Deregulation Hearings*, *supra* note 114, at 1679 (statement of Paul Volcker).

<sup>262</sup> See *Banking Legislation in 1984—What Happened?*, GOLEMBE REPORTS, Oct. 24, 1984, at 9–12 [hereinafter cited as *1984 Legislation*]. As of November 1985, the only legislative proposal impacting on the securities activities of banks to receive significant consideration by the first session of the 99th Congress was H.R. 20. H.R. 20, 99th Cong., 1st Sess. (1985). H.R. 20, reported out of committee by the House Banking Committee on June 12, 1985, only addresses the nonbank bank loophole. See H.R. REP. NO. 175, 99th Cong., 1st Sess. 8–9 (1985) (to accompany H.R. 20). The bill would redefine a bank to be any institution that is insured by the FDIC or any state or federally chartered institution that makes commercial loans and that also accepts demand deposits or “deposits that the depositor may withdraw by check or similar means for payment to third parties or others.” See H.R. 20, *supra*, § 2. The bill would grandfather activities engaged in by nonbank banks prior to or on May 24, 1984 if such bank had been given final regulatory approval by May 9, 1984. See *id.* §§ 2(b), 3. The bill also addresses loopholes in the statutes regulating savings and loan holding companies. See *id.* § 4.

<sup>263</sup> S. 2490, 97th Cong., 2d. Sess. (1982).

petitive Equity Act,<sup>264</sup> which passed the Senate in September 1984;<sup>265</sup> and the Financial Institutions Equity Act of 1984,<sup>266</sup> which was reported out of committee by the House Committee on Banking, Finance and Urban Affairs (House Banking Committee) in June 1984.<sup>267</sup>

### A. *The Treasury Proposal*

The Treasury Department under Secretary Regan began work on a proposal in 1981 and had the third draft of its proposal introduced as the "Bank Holding Company Deregulation Act of 1982."<sup>268</sup> This bill would have amended the Glass-Steagall Act to permit affiliations and interlocks between banks and "bank securities affiliates."<sup>269</sup> These "bank securities affiliates" would have been required to be subsidiaries of the bank holding company rather than of the bank, except that banks with less than \$100 million in assets and which were not controlled by a bank holding company ("eligible associations") could have directly owned securities subsidiaries.<sup>270</sup>

A "bank securities affiliate" would have been authorized to conduct all of the securities activities that banks could engage in under present law; to underwrite municipal revenue bonds, except industrial development bonds; to sponsor, manage, and underwrite investment companies; to advise investment companies that it sponsors; and to deal in and distribute commercial paper and other instruments of certain affiliated entities.<sup>271</sup> The bill would have required any bank associated with a bank securities affiliate to transfer to that affiliate certain securities activities, including dealing in and underwriting of United States government and municipal general obligations and engaging in securities brokerage transactions.<sup>272</sup> The affiliated bank also

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<sup>264</sup> S. 2851, 98th Cong., 2d Sess. (1984).

<sup>265</sup> See 130 CONG. REC. S11,162 (daily ed. Sept. 13, 1984) (Senate passage of S. 2851).

<sup>266</sup> H.R. 5916, 98th Cong., 2d Sess. (1984).

<sup>267</sup> See H.R. REP. NO. 889, 98th Cong., 2d Sess. (1984) (to accompany H.R. 5916).

<sup>268</sup> S. 2490, *supra* note 263. See also 1984 Legislation, *supra* note 262, at 3-4; *Third Draft of Treasury's BHC Deregulation Act Sent to Congress*, BANKING EXPANSION REP., May 3, 1982, at 2; *Financial Services Oversight Hearings* (part I), *supra* note 3, at 3 (statement of Donald Regan, Secretary of the Treasury). For a section-by-section analysis of S. 2490, see Wallison, *The Administration Has Four Long-Term Objectives for Financial Deregulation*, in FINANCIAL SERVICES INSTITUTE 283, 319-37 (PLI 1983).

<sup>269</sup> S. 2490, *supra* note 263, §§ 2, 4.

<sup>270</sup> *Id.* §§ 3, 7, 10.

<sup>271</sup> *Id.* § 10.

<sup>272</sup> *Id.* §§ 3, 10.

would have been prohibited from advising an investment company sponsored by its affiliate.<sup>273</sup> In addition, the proposal would have expanded the permissible non-securities activities of non-bank subsidiaries of holding companies to include certain real estate and insurance activities, as well as other activities the Board determined to be of a "financial nature," and would have eased the regulatory procedures for approval for engaging in such activities.<sup>274</sup>

While the Treasury bill proposed a measure of bank product expansion, the extent of deregulation would have been incomplete, and the range of permissible activities would have failed to include a major sector of the financial services industry. Under this approach, bank securities affiliates and nonbank subsidiaries of bank holding companies would still have been prohibited from engaging in the underwriting of corporate debt and equity securities. This partial deregulation would have denied to banks and bank holding companies the opportunity to develop new sources of revenue. Concomitantly, consumers of these financial services would have been denied the benefits of decreased costs and product innovation resulting from the increased competition due to bank entry into this sector.

In mandating that banks associated with bank securities affiliates transfer certain securities activities to that affiliate, this

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<sup>273</sup> *Id.*

<sup>274</sup> *Id.* §§ 8, 9, 11, 12. Section 9 of the proposed bill would have required the Board to promulgate regulations permitting bank holding companies to engage in activities of a financial nature. It was intended that the Board define the term "expansively and in such a manner as to enable bank holding companies to offer a range of service which will compete with other companies not regulated to the same extent as banks and bank holding companies." Wallison, *supra* note 268, at 326 (section-by-section analysis). The bill specified that:

Such activities shall include (i) making or acquiring extensions of credit, (ii) operating an industrial bank, Morris Plan bank or industrial loan company as authorized under State law, (iii) servicing loans or extensions of credit for any person, (iv) acting as an investment or financial advisor, (v) leasing personal or real property, (vi) selling money orders, travelers checks, and U.S. savings bonds, and (vii) such additional activities of a financial nature as will maximize competition between bank holding companies and other firms engaging in such activities. In defining an activity of a financial nature, the Board shall give primary consideration to securing for the public the benefits of increased competition between bank holding companies and other firms engaged in activities of a financial nature. The Board shall from time to time revise its regulations under this section in order to promote the expansion of such competition.

S. 2490, *supra* note 263, § 9. The Board, however, would have been prohibited from including in its regulations activities which bank securities affiliates would have been permitted to conduct; real estate and insurance activities which bank holding companies could have engaged in under sections 11 and 12 of the bill; and activities prohibited under sections 16 and 20 of the Glass-Steagall Act, as amended by the bill. *Id.*

proposal would have undermined the goal of increasing the stability of the banking system. By placing these activities in a sister affiliate, the bank would no longer directly benefit from the risk diversification, profits, and increased capital base presently generated by such activities. Rather, the benefit to the bank from these activities, as well as from the expanded powers proposed to be available to bank securities affiliates and to nonbank holding company subsidiaries under the “financial nature” test, would have been much more attenuated—deriving mainly from the the bank holding company’s increased ability to act as a “source of strength.”

### B. Senate Legislation

The Treasury proposal served as the foundation for subsequent legislative proposals, including Senator Garn’s “Financial Services Competitive Equity Act,” which passed the Senate in September 1984.<sup>275</sup> This bill adopted the Treasury proposal’s bank securities affiliate concept by amending the Glass-Steagall Act to permit affiliations and interlocks with “depository institution securities affiliates” (DISAs).<sup>276</sup> In addition to the powers and restrictions of securities activities contained in the Treasury proposal, DISAs would also have been authorized to deal in and underwrite certain industrial development bonds, to deal in and underwrite mortgage-backed securities, and to underwrite and sell commercial paper issued by any entity.<sup>277</sup> Both the bank and the DISA could have advised closed-end investment companies, but a bank that was affiliated with a DISA could not have advised an investment company other than a closed-end investment company.<sup>278</sup> Authority to underwrite mutual funds was deleted in the committee mark-up.<sup>279</sup>

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<sup>275</sup> S. 2851, *supra* note 264; see 130 CONG. REC. S11,162 (daily ed. Sept. 13, 1984) (Senate passage of S. 2851).

<sup>276</sup> S. 2851, *supra* note 264, § 101.

<sup>277</sup> *Id.* § 104(e).

<sup>278</sup> *Id.* See also S. REP. NO. 560, 98th Cong., 2d Sess. 58 n.2 (to accompany S. 2851). The two main types of investment companies are closed-end investment companies and open-end investment companies (popularly known as mutual funds). Closed-end investment companies, like regular corporations, have a fixed number of shares of stock authorized and outstanding and may occasionally offer new shares to the public. Their shares are publicly traded and are normally not redeemable. Mutual funds, on the other hand, continuously offer new shares to the public at a price approximating the current pro rata net asset value of the fund’s portfolio and redeem outstanding shares upon presentation at the same price. See generally W. WIDICUS & T. STITZEL, PERSONAL INVESTING 294–326 (3rd ed. 1980).

<sup>279</sup> See 1984 Legislation, *supra* note 262, at 7.

As to the expansion of other nonbank activities of holding company subsidiaries, S. 2851 would not have gone as far as the Treasury proposal. Instead of the "financial nature" test, the Garn bill would have liberalized the "closely related" to banking test by directing the Board to consider "technological or other innovations in the provision of banking or bank-related services" in its determinations under the "closely related" test.<sup>280</sup> The bill would have restricted the ability of state bank subsidiaries of bank holding companies to engage in activities outside the bank's home state. Under the proposed bill, such a bank could have engaged in activities outside the bank's home state only to the extent that such activities would be permissible under section 4(c) of the Bank Holding Company Act.<sup>281</sup> The bill also would have placed limits on insurance activities of all subsidiaries and affiliates of a bank holding company, including state bank subsidiaries and their affiliates.<sup>282</sup>

In addition, the Garn bill specifically addressed the nonmember bank loophole of the Glass-Steagall Act. The bill would have made the affiliation and interlock prohibitions of sections 20 and 32 of the Glass-Steagall Act applicable to FDIC-insured nonmember banks and FSLIC-insured thrift institutions.<sup>283</sup> Such relationships which existed prior to July 1, 1983 would have been grandfathered, and any relationship not grandfathered would have been subject to a two-year divestiture period.<sup>284</sup>

Section 105 of the bill would have added a new section 23B to the Federal Reserve Act.<sup>285</sup> These new restrictions would have applied in addition to the present section 23A restrictions on interaffiliate transactions.<sup>286</sup> The bill would have required that certain transactions between banks and their affiliates be at arm's-length.<sup>287</sup> In addition, the new section 23B would have prohibited a bank or its affiliate from advertising or entering into any agreement "stating or suggesting that the bank shall in any way be responsible for the obligations of its affiliates," and would have prohibited a bank and its DISA from using similar

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<sup>280</sup> See S. 2851, *supra* note 264, § 104(d).

<sup>281</sup> *Id.* § 104(g).

<sup>282</sup> *Id.* § 104(d).

<sup>283</sup> *Id.* §§ 106, 112.

<sup>284</sup> *Id.*

<sup>285</sup> *Id.* § 105.

<sup>286</sup> See *supra* notes 182-83 and accompanying text.

<sup>287</sup> See S. 2851, *supra* note 264, § 105.



names.<sup>288</sup> Additional restrictions on interaffiliate transactions were described in the Committee Report accompanying S. 2851 as follows:

Specific restrictions and limitations are also imposed on a bank's purchase of securities from an affiliate for the bank's own account or the account of a customer. When a securities affiliate is a principal underwriter of securities, a bank affiliate may purchase such securities during the underwriting only if, prior to the initial public sale of the securities, a majority of the bank's outside directors approve such a purchase. In addition, a bank may not purchase as fiduciary any securities from any affiliate unless such purchases are permitted by the instrument establishing the fiduciary relationship, by court order or by law of the state under which the trust is administered.<sup>289</sup>

Despite Senate passage, this bill never received consideration by the House and died at the end of the 98th Congress.

Like the Treasury proposal, S. 2851 provided for only limited bank product expansion and required depository institutions affiliated with DISAs to transfer certain securities activities to the DISAs. Moreover, the liberalized "closely related to banking" test contained in the bill would have authorized even less product expansion for nonbank holding company subsidiaries than that contemplated by the "financial nature" test contained in the Treasury proposal. Thus, the Senate bill would also have failed to realize the full potential of greater bank product deregulation. Similarly, by restricting the activities in which depository institutions affiliated with DISAs could engage, directly or through a subsidiary, the Senate bill deviated from the goal of increasing the soundness of depository institutions.

### *C. House Legislation*

Unlike the Senate and Treasury proposals, in the House of Representatives, the Financial Institutions Equity Act of 1984, sponsored by Congressman St. Germain (D-R.I.), provided for the closing of loopholes without permitting any expansion of securities activities of banks. H.R. 5916, as reported by the House Banking Committee, would have extended sections 20 and 32 of the Glass-Steagall Act to cover nonmember insured

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<sup>288</sup> *Id.*

<sup>289</sup> S. REP. NO. 560, *supra* note 278, at 22.

and noninsured banks, as well as thrift institutions.<sup>290</sup> The bill would not have grandfathered previous relationships, but rather provided for a two-year divestiture period.<sup>291</sup> In addition, section 4 of the bill would have expanded section 21 of the Glass-Steagall Act to provide that "engaging in the business of receiving deposits through affiliates shall be deemed to be the same as engaging in the business of receiving deposits directly."<sup>292</sup> This section also would have mandated a two-year divestiture period.<sup>293</sup>

Furthermore, H.R. 5916 would have placed additional restrictions on state-chartered depository institutions. Under this bill, state-chartered banks could have engaged in activities outside of their home state only if national banks were authorized to engage in the activity directly under federal law or if bank holding companies were authorized to engage in the activities under section 4(c)(8) of the Bank Holding Company Act.<sup>294</sup> Comparable restrictions would have applied to state-chartered thrift institutions.<sup>295</sup>

H.R. 5734, the predecessor bill to H.R. 5916, would also have prohibited any depository institution (or any subsidiary or affiliate thereof) from providing retail securities brokerage services.<sup>296</sup>

The bill passed by the House Banking Committee was essentially flawed in its attempt to shore up the policy of separation. By preventing bank product expansion, this bill sought to maintain the artificial barriers to competition erected by the Glass-Steagall Act. This attempt at reregulation would have denied to consumers and depository institutions the potential benefits of deregulation and thus would have represented a move backwards towards the antiquated system of separation.

## VI. CONCLUSION

The policy of separating the commercial and investment banking industries is unjustified. Bank product expansion into secu-

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<sup>290</sup> H.R. 5916, *supra* note 266, §§ 3, 5.

<sup>291</sup> *Id.*

<sup>292</sup> *Id.* § 4.

<sup>293</sup> *Id.*

<sup>294</sup> *Id.* § 6.

<sup>295</sup> *Id.*

<sup>296</sup> H.R. 5734, 98th Cong., 2d Sess. § 5 (1984); *see also* H.R. REP. NO. 889, *supra* note 267, at 9.

urities activities can be expected to produce benefits for both consumers and banks, and potential harms can be addressed adequately through regulation. Attempts to reinforce the policy of separation, as in the recent House Banking Committee proposal, are unlikely to be effective in a competitive environment of rapid market and technological changes and would be detrimental to the goal of promoting a strong banking system. The Treasury and Senate approaches, while moving in the proper direction, fail to provide the full benefits of bank product expansion. In addition, both of these proposals would prevent most banks from engaging in securities activities through subsidiaries.

The FDIC's regulations, on the other hand, permit greater bank product expansion into securities activities and do not prohibit securities subsidiaries of banks. Yet, they presently provide incentives to organize in the form of sister affiliates. By eliminating product restrictions and easing restrictions on inter-affiliate transactions in the context of securities subsidiaries of banks, these regulations could be modified to provide an incentive to establish securities subsidiaries rather than sister affiliates.

Wholly-owned securities subsidiaries would provide the risk-reducing and other benefits of an affiliate relationship, would minimize the amount of regulation needed to limit conflicts of interest hazards, and would allow banks to maximize the benefits of product expansion. The proposal recommended in this Note would not require banks to transfer profitable securities activities to their securities subsidiaries or affiliates and would thereby avoid the detrimental impact that such a transfer would have on ensuring the stability of the banking system. Moreover, this type of modified FDIC regulatory approach would let management decide, within the confines of the regulations suggested, which affiliate structure is best suited for its organization to maximize the benefits of bank product expansion. As Congress again considers the question of the optimal degree of regulation of the securities activities of banks, it should look closely at the FDIC's regulations governing the securities activities of insured nonmember banks to see whether in fact they serve as the best basis from which to proceed.



# Legislative Research Bureau Report

## The Quest for Balance: Public Policy and Due Process in Medical Malpractice Arbitration Agreements

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*This report originated as a project of the Harvard Legislative Research Bureau ("LRB"), at the request of New York Governor Cuomo's office. The LRB, affiliated with the HARVARD JOURNAL ON LEGISLATION, assists clients in local, state, and national governmental offices by providing technical services in the preparation and drafting of legislation. The LRB is staffed completely by students of Harvard Law School, and is a non-profit, non-partisan organization.*

Ten years after the medical malpractice insurance crisis of the 1970's,<sup>1</sup> the issues of rising insurance costs and their implications for the health care system have once again captured public attention.<sup>2</sup> Compared to the present situation, the crisis of 1975 appears mild: a study by the American Medical Association reports that in 1983 more than sixteen of every hundred doctors were sued, greater than three times the rate during the peak period of 1975.<sup>3</sup> In addition, awards over the one million dollar

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<sup>1</sup> See U. S. Dep't of Health, Educ. & Welfare, MEDICAL MALPRACTICE: REPORT OF THE SECRETARY'S COMM'N ON MEDICAL MALPRACTICE (1973); Sheehan, *The Medical Malpractice Crisis in Insurance: How it Happened and Some Proposed Solutions*, 11 FORUM 80 (1975); CONGRESSIONAL RESEARCH SERVICE, MEDICAL MALPRACTICE: A SURVEY OF ASSOCIATED PROBLEMS AND PROPOSED REMEDIES 7-8 (1975).

<sup>2</sup> See Zanca, *Medical Malpractice Battles Heat Up in States*, Legal Times, July 22, 1985, at 2, col. 1 (estimates that 38 states will consider medical malpractice bills in 1985-86); Brinkley, A.M.A. *Study Finds Big Rise in Claims for Malpractice: A 'Crisis Stage' Reported*, N.Y. Times, Jan. 17, 1985, at A1, col. 6 (New York Governor Mario Cuomo (D) to introduce bill limiting the amount of court and jury awards to injured patients, or reduce the number of claims, or both); Sullivan, *Cuomo Offers Plan to Cut Malpractice Costs*, N.Y. Times, Mar. 4, 1985, § 2, at 6, col. 4; Dabilis, *Malpractice Rules Proposed*, Boston Globe, Oct. 29, 1985, at 1, col. 3 (Massachusetts Governor Michael Dukakis (D) proposing changes in malpractice regulations); Middleton, *The Medical Malpractice War*, NAT'L L.J., Aug. 27, 1984, at 1, col. 2; Clifford, *Details of Malpractice Act Explained*, CHI. DAILY L. BULL., Aug. 12, 1985, at 2, col. 2.

<sup>3</sup> See Brinkley, *supra* note 2. There is significant debate today on whether a crisis in the medical malpractice field actually exists, however. See, e.g., Middleton, *supra* note 2; Blodgett, *Malpractice Crisis*, 71 A.B.A. J. 18 (June, 1985); Baldwin, *The Phony Medical Malpractice "Crisis"*, 21 TRIAL 4 (April, 1985); Goddard, *The American Medical Association is Wrong—There is No Medical Malpractice Insurance Crisis*, L.A. Daily J., May 17, 1985, at S15, col. 1. Regardless of the existence of this crisis, state officials are taking action to remedy what they perceive as problems within the medical malpractice insurance system. See *supra* note 2.

mark are becoming increasingly common.<sup>4</sup> Coupled with a corresponding increase in the costs of litigation, these trends have driven insurance rates skyward,<sup>5</sup> making it difficult or even impossible for many physicians to obtain coverage, particularly in high-risk specialties such as obstetrics.<sup>6</sup>

State legislatures responded to the previous crisis by enacting a number of statutes aimed at screening out frivolous malpractice claims and reducing both the litigation and settlement costs of valid claims. Most of these statutes, while differing in the scope and rigor of their requirements, established or formalized systems to review medical malpractice claims either as a prerequisite or an alternative to the court system, primarily through medical malpractice screening panels<sup>7</sup> or binding arbitration.<sup>8</sup>

Today, with legislatures and state officials again looking for solutions to the problem of medical malpractice costs,<sup>9</sup> it is

<sup>4</sup> Several hundred awards in the last few years have exceeded one million dollars. See Brinkley, *supra* note 2.

<sup>5</sup> See Foreman, *Malpractice Insurance Curbs Urged*, Boston Globe, Oct. 11, 1985, at 21, col. 4; Sullivan, *Doctors' Insurers Win 52% Rate Rise*, N.Y. Times, Jan. 15, 1985, at A1, col. 3 (malpractice insurance rates for obstetricians on Long Island have risen from \$54,282 a year in 1984 to \$82,000 in 1985) [hereinafter cited as Sullivan, *Doctors' Insurers*]; Sullivan, *State University Losing Insurer on Malpractice*, N.Y. Times, Mar. 14, 1985, § 2, at 7, col. 1 [hereinafter cited as Sullivan, *State University*].

<sup>6</sup> See Sullivan, *Two State Hospitals Say Insurance Rates Threaten Their Department*, N.Y. Times, Mar. 10, 1985, § 2, at 3, col. 1; Sullivan, *Doctors' Insurers*, *supra* note 5; Sullivan, *State University*, *supra* note 5.

<sup>7</sup> ARIZ. REV. STAT. ANN. § 12-567 (West Supp. 1984-85); DEL. CODE ANN. tit. 18, §§ 6803-6814 (Michie Supp. 1984); HAWAII REV. STAT. §§ 671-11 to 671-20 (Supp. 1984); IDAHO CODE §§ 6-1001 to 6-1013 (Supp. 1985); IND. CODE ANN. §§ 16-9.5-9-1 to 16-9.5-9-10 (Burns 1983 & Supp. 1985); KAN. STAT. ANN. §§ 65-4901 to 65-4908 (1984); LA. REV. STAT. ANN. § 40:1299.47 (West 1985) (provides for review panel unless submitted for binding arbitration); MD. CTS. & JUD. PROC. CODE ANN. §§ 3-2A-01 to 3-2A-09 (Supp. 1985); MASS. ANN. LAWS ch. 231, § 60B (Michie/Law. Co-op. 1984); MONT. CODE ANN. §§ 27-6-101 to 27-6-704 (1983); N.H. REV. STAT. ANN. §§ 519-A:1 to 519-A:10 (1983); N.M. STAT. ANN. §§ 41-5-14 to 41-5-28 (1982); N.Y. JUD. LAW § 148-a (Consol. 1983 & Supp. 1985); OHIO REV. CODE ANN. §§ 2711.21-2711.24 (Page 1981); 40 PA. CONS. STAT. ANN. § 1301.309 (Purdon Cum. Supp. 1985); VT. STAT. ANN. tit. 12, §§ 7001-7008 (1984); WIS. STAT. ANN. §§ 655.02 to 655.21 (West Supp. 1985). Other statutes have since been repealed. See ARK. STAT. ANN. §§ 34-2601 to -2612 (repealed 1985); FLA. STAT. § 768.44 (repealed 1983); ME. REV. STAT. ANN. tit. 24, §§ 2701-2715 (repealed 1983); MO. ANN. STAT. §§ 538.010 to 538.080 (repealed 1984); NEV. REV. STAT. §§ 41A.010-.095 (repealed 1981); N.D. CENT. CODE § 32-29.1 (repealed 1981); R.I. GEN. LAWS §§ 10-19-1 to -10 (repealed 1985); TENN. CODE ANN. §§ 29-26-1-1 to -121 (repealed 1985).

<sup>8</sup> ALA. CODE § 6-5-485 (Supp. 1985); ALASKA STAT. § 09.55.535 (1983); CAL. CIV. PROC. CODE § 1295 (West 1982); GA. CODE ANN. § 9-9-112 (1982); ILL. REV. STAT. ANN. ch. 10 § 201-214 (Smith-Hurd Supp. 1985); LA. REV. STAT. ANN. § 9:4230-4236 (West 1983); MICH. COMP. LAWS ANN. §§ 600.5040-.5065 (West Supp. 1985); OHIO REV. CODE ANN. §§ 2711.21-.24 (Page 1981); P.R. LAWS ANN. tit. 26, §§ 4110-4114 (1978); S.D. COMP. LAWS ANN. §§ 21-25B-1 to 25B-26 (1979 & Supp. 1984); VA. CODE § 8.01-581.12 (1984).

<sup>9</sup> See *supra* note 2.

appropriate to review the status of these earlier attempts. This Report focuses on judicial treatment of agreements to submit medical malpractice claims to binding arbitration. It first summarizes existing legislation providing for arbitration and then addresses the constitutional and contractual challenges to the use of arbitration as an alternative to the court system. Particular attention is given to the treatment of Michigan's Medical Malpractice Arbitration Act (MMAA),<sup>10</sup> the most rigorous of the state arbitration statutes, which was upheld in 1984 by the Michigan Supreme Court,<sup>11</sup> and which has received attention as a possible model for other states.<sup>12</sup>

## I. LEGISLATION

Over the past ten years, states have adopted a number of schemes to reduce the expenses incurred in litigating medical malpractice claims. The most common approach appears to be mandatory, nonbinding arbitration or screening panels.<sup>13</sup> These panels are composed of some combination of health care providers, attorneys, and laypersons, and are intended to screen

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<sup>10</sup> MICH. COMP. LAWS ANN. §§ 600.5040-.5065 (West's Cum. Supp. 1985). While Michigan has the strictest of the state statutes, Puerto Rico has the most rigorous statute dealing with medical malpractice arbitration agreements. *See infra* note 28.

<sup>11</sup> *Morris v. Metriyakool*, 418 Mich. 423, 344 N.W.2d 736 (1984). There are two plurality opinions of the Court in this case, one by Justice Kavanagh, 418 Mich. at 429, 344 N.W.2d at 737, and one by Justice Ryan, 418 Mich. at 443, 344 N.W.2d at 743. Justice Ryan did not reach the issue of whether the statute violates the rights to trial by jury or to an impartial decisionmaker, since he concluded that there was no state action, and that the due process clause was therefore not implicated. *Morris*, 418 Mich. at 468-69, 344 N.W.2d at 755. Ryan also did not reach the issue of whether the agreements were unenforceable for lack of a voluntary, intelligent, knowing waiver, since the issue was not raised in the lower courts. *Morris*, 418 Mich. at 474, 344 N.W.2d at 757-58. All citations are to the opinion by Justice Kavanagh.

<sup>12</sup> This report has its origin in research done for New York Governor Cuomo, who considered proposing a statute similar to the MMAA. In addition, one commentator has proposed a Model Medical Malpractice Arbitration Act which is strikingly similar to the MMAA. *See Note, Medical Malpractice Arbitration: Time for a Model Act*, 33 RUTGERS L. REV. 454 (1981) [hereinafter cited as *Model Act*].

<sup>13</sup> *See supra* note 7. Although the terms arbitration and screening panels are both used in state statutes, there is essentially no difference between them if the arbitration is not binding. Both attempt to limit the number of claims which reach the courts and to facilitate settlements, but do not restrict plaintiffs' ability ultimately to proceed to court. The only difference may be in the procedure for selecting the members: arbitrators are generally chosen by the parties, whereas screening panels are selected by some outside authority, often a judge or state commission. *See infra* note 73.

out frivolous claims and to facilitate settlements.<sup>14</sup> In states utilizing this approach, review by a screening or arbitration panel is required before a claim may be brought in court.<sup>15</sup> Although the panel's findings are not binding on the parties, who may reject the decision and proceed to court,<sup>16</sup> the panel's conclusions are admissible as evidence in most states.<sup>17</sup>

Other states take a different approach, allowing medical providers to offer binding, irrevocable arbitration agreements to patients.<sup>18</sup> These agreements may be signed by the patient prior to undergoing medical treatment,<sup>19</sup> or may be required by the health insurance plan in which the patient is enrolled.<sup>20</sup> In contrast to the mandatory nature of the screening panels, binding arbitration agreements are normally voluntary on the part of

<sup>14</sup> See, e.g., MONT. CODE ANN. § 27-6-102 (1983). The purpose of the review panel is "to prevent where possible the filing in court of actions against health care providers and their employees for professional liability in situations where the facts do not permit at least a reasonable inference of malpractice and to make possible the fair and equitable disposition of such claims against health care providers as are or reasonably may be well founded." *Id.*

<sup>15</sup> See, e.g., HAWAII REV. STAT. §§ 671-11 to -12 (Supp. 1984); IND. CODE ANN. § 16-9.5-9-2 (Burns 1983 & Supp. 1985).

Screening panels have been challenged on many of the same grounds as binding arbitration agreements. See, e.g., *infra* note 36 and accompanying text. In addition, numerous screening panel statutes have been challenged on the grounds that such statutes deny equal protection to malpractice claimants by requiring them, unlike other tort claimants, to submit their claims to review boards before proceeding to court. See, e.g., *Eastin v. Broomfield*, 116 Ariz. 576, 570 P.2d 744 (1977); *Johnson v. St. Vincent Hosp., Inc.*, 404 N.E.2d 585 (Ind. 1980); *Everett v. Goldman*, 359 So. 2d 1256 (La. 1978); *Attorney General v. Johnson*, 282 Md. 274, 385 A.2d 57 (1978); *Beatty v. Akron City Hosp.*, 67 Ohio St. 2d 483, 424 N.E.2d 586 (1981); *State ex rel. Strykowski v. Wilkie*, 81 Wis. 2d 491, 261 N.W.2d 434 (1978). Courts have upheld these statutes, finding that the state interest in curbing the cost of medical malpractice insurance is sufficiently compelling to justify different treatment of malpractice claimants. See *Eastin*, 116 Ariz. at 585-86, 570 P.2d at 753-54; *Johnson*, 404 N.E.2d at 603-05; *Everett*, 359 So. 2d at 1265-67; *Attorney General v. Johnson*, 282 Md. at 306-13, 385 A.2d at 76-79; *Beatty*, 67 Ohio St. 2d at 491-97, 424 N.E.2d at 591-95; *Strykowski*, 81 Wis. 2d at 506-12, 261 N.W.2d at 441-44. Arbitration statutes have not generally been challenged on equal protection grounds, perhaps because the arbitration agreements are not mandated for medical malpractice claimants, and in fact are available to all potential litigants under general arbitration statutes.

<sup>16</sup> See, e.g., ARIZ. REV. STAT. ANN. § 12-567(H) (West Supp. 1984-85); DEL. CODE ANN. tit. 18, § 6811(d) (Michie Supp. 1984); HAWAII REV. STAT. § 671-16 (Supp. 1984).

<sup>17</sup> See, e.g., DEL. CODE ANN. tit. 18, § 6811(c) (Michie Supp. 1984); IND. CODE ANN. § 16-9.5-9-9 (Burns 1983 & Supp. 1985); *but see* HAWAII REV. STAT. § 671-16 (Supp. 1984) (findings not admissible).

<sup>18</sup> See *supra* note 8. Throughout this Report, "arbitration" is used to refer to binding arbitration agreements, unless otherwise noted.

<sup>19</sup> See, e.g., *Sanchez v. Sirmons*, 121 Misc. 2d 249, 467 N.Y.S. 2d 757 (1983); *Wheeler v. St. Joseph Hosp.*, 63 Cal. App. 3d 345, 133 Cal. Rptr. 775 (1976); *Morris v. Metriyakool*, 418 Mich. 423, 344 N.W.2d 736 (1984).

<sup>20</sup> See, e.g., *Madden v. Kaiser Foundation Hosps.*, 17 Cal. App. 3d 699, 552 P.2d 1178, 131 Cal. Rptr. 882 (1976); *Hawkins v. Superior Court*, 89 Cal. App. 3d 413, 152 Cal. Rptr. 491 (1979).



both the patient and the health care provider.<sup>21</sup> However, if the parties do sign such an agreement and proceed to arbitrate a claim, the decision of the arbitration panel is final.<sup>22</sup>

Many state statutes contain safeguards to ensure that patients entering into these agreements do so voluntarily. In Alabama, Georgia, and Vermont, a patient may enter into such an agreement only after a malpractice claim has been discovered;<sup>23</sup> in most other states, the agreement may be executed at any time prior to or subsequent to treatment.<sup>24</sup> Most statutes also provide that only the patient, not the health care provider, may revoke the signed agreement, typically within thirty to sixty days.<sup>25</sup> After this period has passed, the agreement becomes irrevocable.<sup>26</sup>

The Michigan statute<sup>27</sup> is an important exception to the voluntary nature of arbitration statutes enacted in other states.<sup>28</sup>

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<sup>21</sup> The exception to this rule is Michigan, where hospitals are required to offer binding arbitration agreements to patients. *See infra* notes 27–30 and accompanying text.

<sup>22</sup> Judicial review is limited to the arbitration agreement itself, which is challengeable on traditional contract grounds, including fraud, mistake, duress, and unconscionability. The basis of the arbitration panel's decision is outside the purview of the courts. *See Henderson, Contractual Problems in the Enforcement of Agreements to Arbitrate Medical Malpractice*, 58 VA. L. REV. 947, 976 (1972); 9 U.L.A. 7–8 (1957). *See generally infra* notes 74–101 and accompanying text.

<sup>23</sup> ALA. CODE § 6-5-485(a) (1985 Cum. Supp.); GA. CODE ANN. § 9-9-112 (1982); VT. STAT. ANN. tit 12, § 7002(a) (1984).

<sup>24</sup> *See, e.g.*, ALASKA STAT. § 09.55.535(a) (1983); OHIO REV. CODE ANN. § 2711.22 (Page 1981); S.D. COMP. LAWS ANN. § 21-25B-1 (Supp. 1984).

<sup>25</sup> *See, e.g.*, ALASKA STAT. § 09.55.535(c) (1983) (30 days); CAL. CIV. PROC. CODE § 1295(c) (West 1982) (30 days); ILL. REV. STAT. ANN. ch. 10 § 209(c) (Smith Hurd Supp. 1985) (60 days).

<sup>26</sup> Other states provide additional safeguards. In Michigan, a person receiving emergency medical treatment may only be offered the agreement after the treatment has been completed. MICH. COMP. LAWS ANN. § 600.5042(1) (West Supp. 1985). Ohio's statute specifies that the patient may not be offered the agreement "when the patient's condition prevents the patient from making a rational decision whether or not to agree." OHIO REV. CODE ANN. § 2711.23(H) (Page 1981). Georgia requires that the claimant be represented by an attorney at the time the agreement is executed. GA. CODE ANN. § 7-403 (Harrison Supp. 1985). In Illinois a patient who executes the agreement upon entering the hospital must reaffirm it upon discharge. ILL. REV. STAT. ANN. ch. 10 § 208(e) (Smith Hurd Supp. 1985).

<sup>27</sup> MICH. COMP. LAWS ANN. § 600.5040–.5065 (West Supp. 1985).

<sup>28</sup> The other major exception is Puerto Rico, which requires that all medical malpractice claims be submitted to binding arbitration, regardless of any prior agreement. P.R. LAWS ANN. tit. 26 § 4110–4114 (1978). As with binding arbitration in general, the arbitration panel's decision is subject to very limited judicial review.

One lower court held that the Puerto Rico arbitration statute was unconstitutional because it denies plaintiffs their right to jury trial by requiring that all medical malpractice claims be submitted to binding arbitration rather than litigated through the court system. *Velez Ruiz v. Estado Libre Asociado de Puerto Rico*, 111 P.R. Dec. 752, 763 (1981). However, because the right to a jury trial is not guaranteed by the commonwealth, *see Mercado v. Superior Court*, 99 P.R. 287, 297 (1970), the statute may in fact be constitutional. *See Model Act, supra* note 12 at 462–63. *See supra* notes 40–54 and

The MMAA *requires* hospitals to offer arbitration agreements to patients prior to treatment,<sup>29</sup> although the agreements are voluntary on the patient's part.<sup>30</sup> The MMAA also sets out in great detail the specific procedures governing the arbitration.<sup>31</sup>

Another important difference between the Michigan Act and other state statutes is the procedure used for selection of the arbitration panel. In most states, panels are composed of three members. Each party to the dispute selects one arbitrator and either these two arbitrators or the court selects the third.<sup>32</sup> In Michigan, by contrast, the American Arbitration Association (AAA), which is responsible for administering the Act, furnishes each party to the dispute with a list of five candidates in each of three categories: attorneys, health care licensees, and laypersons who are neither attorneys nor health care licensees.<sup>33</sup> If after two attempts the parties cannot agree on a candidate for each category, the AAA appoints the remaining arbitrator(s).<sup>34</sup>

## II. COURT CHALLENGES

All binding arbitration agreements, whether or not required or authorized by statute, present similar constitutional and con-

accompanying text. However, the Puerto Rico statute would probably be held unconstitutional in most states, which guarantee the right to trial by jury in civil cases. *See infra* note 40.

<sup>29</sup> This requirement is imposed indirectly by forbidding malpractice insurers to offer liability insurance to hospitals unless the policy contains a provision requiring the hospital to offer a form of arbitration agreement to each patient treated or admitted. MICH. COMP. LAWS ANN. § 500.3053(1) (West Supp. 1985)

<sup>30</sup> The agreement must state in 12-point boldface type: "This agreement to arbitrate is not a prerequisite to health care or treatment and may be revoked within sixty days after execution by notification in writing." MICH. COMP. LAWS ANN. §§ 600.5041(5), 600.5042(4) (West Supp. 1985).

<sup>31</sup> For example, the Act contains provisions regulating what the agreement must contain and the information that must accompany it, MICH. COMP. LAWS ANN. §§ 600.5041–.5042 (West Supp. 1985), specific procedures relating to testimony and discovery, *id.* §§ 600.5043, 600.5048–.5052, and the disposition of the claim, *id.* §§ 600.5054–.5056.

<sup>32</sup> *See, e.g.*, ALA. CODE § 6-5-485(b) (Supp. 1985); ALASKA STAT. § 09.55.535(f) (1985); GA. CODE ANN. § 7-408 (Harrison Supp. 1985).

<sup>33</sup> MICH. COMP. LAWS ANN. § 600.5044(2)–(3) (West Supp. 1985).

<sup>34</sup> *Id.* § 600.5044(5). The requirement that one member of the arbitration panel be a health care provider has provoked a number of court challenges due to the perceived bias of this member in favor of the defendant. *See, e.g.*, *Morris v. Metriyakool*, 418 Mich. 923, 344 N.W.2d 736 (1984) (constitutional); *McCloy v. Dorfman*, 123 Mich. App. 710, 333 N.W. 2d 338 (1983), *vacated*, 419 Mich. 874, 347 N.W. 2d 700 (1984) (unconstitutional); *Horn v. Cooke*, 118 Mich. App. 740, 325 N.W.2d 558 (1982) (constitutional). The role of the medical members on arbitration panels is discussed thoroughly at *infra* notes 55–73 and accompanying text.

tractual problems to their enforcement.<sup>35</sup> Arbitration agreements have been challenged as violating the constitutional right to trial by jury and by an impartial decisionmaker, and as unconscionable and unenforceable contracts. The unique aspects of the Michigan statute, particularly the requirement that hospitals offer these agreements and the composition of the arbitration panel, have exacerbated these legal difficulties. By and large, however, arbitration agreements have withstood these court challenges, and the widely disputed Michigan statute was upheld in 1984 by the state supreme court.<sup>36</sup>

### A. Right to Trial by Jury

Both arbitration agreements and mandatory screening panels have been challenged on the grounds that they deny parties their right to trial by jury.<sup>37</sup> Statutes establishing mandatory screening panels as a prerequisite to litigation have generally been upheld precisely because this right to trial by jury is ultimately pre-

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<sup>35</sup> Despite the fact that medical malpractice arbitration agreements are legal in every state and are specifically authorized by statute in numerous states and the Commonwealth of Puerto Rico, *see supra* note 8, there has been surprisingly little litigation on the subject in most states. Either arbitration agreements are not widely used in medical malpractice cases, or they are not being challenged in the courts.

The notable exceptions are Michigan and California, where numerous courts have been called upon to assess both the constitutionality of such agreements in general and the validity of the particular agreement in question. *See, e.g.*, *Beynon v. Garden Grove Medical Group*, 100 Cal. App. 3d 698, 161 Cal. Rptr. 146 (1980); *Madden v. Kaiser Foundation Hosps.*, 17 Cal. 3d 699, 552 P.2d 1178, 131 Cal. Rptr. 882 (1976); *Morris v. Metriyakool*, 418 Mich. 423, 344 N.W.2d 736 (1984); *Bowman v. Lutz*, 123 Mich. App. 733, 333 N.W.2d 346 (1983), *rev'd*, 419 Mich. 874, 347 N.W.2d 700 (1984); *Strong v. Oakwood Hosp. Corp.*, 118 Mich. App. 395, 325 N.W.2d 435 (1982). This divergence in activity may be explained by the fact that hospitals in Michigan are required to offer such agreements to all patients, *see supra* note 29, and at least two health insurance plans available in California include such agreements among their provisions, *see Madden*, 17 Cal. 3d at 699, 552 P.2d at 1178, 131 Cal. Rptr. at 146; *Beynon*, 100 Cal. App. 3d at 698, 161 Cal. Rptr. at 146, as they are authorized to do by statute. CAL. CIV. PROC. CODE § 1295 (West 1982).

<sup>36</sup> *Morris*, 418 Mich. 423, 344 N.W.2d 736.

<sup>37</sup> *See, e.g.*, *Davison v. Sinai Hosp. of Baltimore, Inc.*, 462 F. Supp. 778 (D. Md. 1978) (nonbinding arbitration); *Eastin v. Broomfield*, 116 Ariz. 576, 570 P.2d 744 (1977) (mediation panel); *Ramirez v. Superior Court, Santa Clara County*, 103 Cal. App. 3d 746, 755, 163 Cal. Rptr. 223, 228 (1980) (binding arbitration agreement); *Madden*, 17 Cal. 3d 699, 552 P.2d 1178, 131 Cal. Rptr. 882 (1976) (binding arbitration provision of state health plan); *Morris*, 418 Mich. at 430, 344 N.W.2d at 738 (binding arbitration agreement); *Prendergast v. Nelson*, 199 Neb. 97, 106, 256 N.W.2d 657, 665 (1977) (mediation panel); *Beatty v. Akron City Hosp.*, 67 Ohio St. 2d 483, 424 N.E.2d 586 (1981) (mandatory non-binding arbitration); *Velez Ruiz v. Estado Libre Asociado de Puerto Rico*, 111 P.R. Dec. 752 (1981) (mandatory binding arbitration).

served, even if it is delayed.<sup>38</sup> However, binding arbitration, by definition, is a substitute for litigation: a person who signs an agreement to submit a controversy to arbitration necessarily gives up his or her right to trial by jury.<sup>39</sup>

The possibility of "involuntary" waivers of the constitutional right to jury trial<sup>40</sup> has prompted some states to require that, to be valid, the arbitration agreement state clearly that the agreement constitutes a waiver of the right to jury trial.<sup>41</sup> Even in the absence of such a requirement, two state courts have invalidated agreements on the ground that they did not highlight their effect as a waiver and that therefore the patient could not be said to have made a conscious and deliberate decision to forego jury trial.<sup>42</sup>

<sup>38</sup> See *Davison*, 462 F. Supp. at 781; *Eastin*, 110 Ariz. at 580, 570 P.2d at 748; *Prendergast*, 199 Neb. at 105, 256 N.W.2d at 664; *Beatty*, 67 Ohio St. 2d at 487, 424 N.E.2d at 589. Several courts have held that there is no fundamental right to proceed immediately to court. See, e.g., *Hines v. Elkhart General Hosp.*, 465 F. Supp. 421, 432 (N.D. Ind.), *aff'd*, 603 F.2d 646 (7th Cir. 1979); *Everett v. Goldman*, 359 So. 2d 1256, 1258 (La. 1978); *Attorney General v. Johnson*, 282 Md. 274, 282, 385 A.2d 57, 62 (1978).

Only Missouri's supreme court has held that requiring submission of medical malpractice claims to a review board is a *per se* unconstitutional precondition on access to the courts. State *ex rel.* Cardinal Glennon Memorial Hosp. for Children v. Gaertner, 583 S.W.2d 107, 110 (Mo. 1979) (en banc). However, both the Florida and Pennsylvania Supreme Courts have held their states' statutes to be unconstitutional because, in practice, the delays and complications arising from these statutes impermissibly infringe upon the right to trial by jury. *Aldana v. Holub*, 381 So. 2d 231, 232 (Fla. 1980); *Mattos v. Thompson*, 491 Pa. 385, 396, 421 A.2d 190, 196 (1980).

<sup>39</sup> Ironically, mediation panels—which are nonbinding and therefore do not result in a complete waiver of the right to trial by jury—have weathered more Seventh Amendment challenges than binding arbitration agreements. See, e.g., *supra* note 37. This may be due to the fact that review by these panels is mandatory, see *supra* note 15 and accompanying text, whereas binding arbitration agreements are executed voluntarily. See *supra* notes 21–30 and accompanying text.

<sup>40</sup> The right to trial by jury is guaranteed in federal court by the Seventh Amendment, but the Supreme Court has not applied this right to the states in civil cases by means of the Fourteenth Amendment. *Curtis v. Loether*, 415 U.S. 189, 192 n.6 (1974). However, the constitutions of all states but Colorado and Louisiana guarantee the right to trial by jury in civil matters. See Note, *Medical Malpractice Mediation Panels: A Constitutional Analysis*, 46 FORDHAM L. REV. 322, 328 (1977).

The Supreme Court, in an attempt to minimize the possibility of unknowing and involuntary waivers of constitutional rights, has instructed courts "to indulge every reasonable presumption against waiver" of due process rights. *Aetna Insurance Co. v. Kennedy*, 301 U.S. 389, 393 (1937). The same standard is applicable for waiver in the criminal and noncriminal context, see *D.H. Overmyer Co., Inc. v. Frick Co.*, 405 U.S. 174, 185 (1972): the waiver "not only must be voluntary but must be knowing, intelligent acts done with sufficient awareness of the relevant circumstances and likely consequences." *Brady v. United States*, 397 U.S. 742, 748 (1970).

<sup>41</sup> CAL. CIV. PROC. CODE § 1295(b) (West 1982); ILL. REV. STAT. ANN. ch. 10 § 209(d) (Smith-Hurd Supp. 1985); OHIO REV. CODE ANN. § 2711.23(D) (Page 1981); S.D. COMP. LAWS ANN. § 21-25B-3 (Supp. 1984).

<sup>42</sup> *Sanchez v. Sirmons*, 121 Misc. 2d 249, 255, 467 N.Y.S.2d 757, 762 (1983); *Wheeler v. St. Joseph Hosp.*, 63 Cal. App. 3d 345, 361, 133 Cal. Rptr. 775, 786–87 (1976).

The Michigan Act, however, does not require that arbitration agreements highlight the fact that they act as a waiver of a patient's right to jury trial.<sup>43</sup> Malpractice claimants contend that these agreements force claimants to give up this fundamental constitutional right without being fully informed, arguing that the burden should rest on the party seeking to enforce the agreement to show either that the waiver was made voluntarily, knowingly, and intelligently, or that it was highlighted in the agreement.<sup>44</sup>

Both the Michigan and California supreme courts have rejected these arguments. The Michigan Supreme Court held that arbitration agreements fall under the traditional presumption that one who signs a written agreement understands it and that the burden of avoiding contracts rests with those who would avoid them.<sup>45</sup> In an earlier case, the California Supreme Court held that in light of the incompatibility of binding arbitration and trial by jury, an explicit waiver clause in the arbitration agreement was unnecessary.<sup>46</sup>

These arguments rest on the assumption that parties to an arbitration agreement know, or should know, that signing the agreement involves giving up one's right to trial by jury. The available evidence, however, indicates that this is a questionable assumption.<sup>47</sup> These agreements are frequently offered under

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<sup>43</sup> The sample arbitration agreements approved by the Michigan Commissioner of Insurance state only that "by signing this agreement, I am choosing arbitration rather than going to court as a way of deciding any future claim about my hospital or medical care." Michigan Arbitration Advisory Committee, Patient Information Booklet (copy on file at the HARV. J. ON LEGIS.) [hereinafter cited as *Patient Information Booklet*]. This booklet must accompany the form offered to patients. MICH. COMP. LAWS ANN. §§ 600.5041(6), 600.5042(7) (West Supp. 1985).

<sup>44</sup> See, e.g., *Christman v. Sisters of Mercy Health Corp.*, 118 Mich. App. 719, 721, 325 N.W.2d 801, 801-02 (1982) *appeal held in abeyance*, 334 N.W.2d 611, *rev'd and remanded*, 419 Mich. 873, 347 N.W.2d 698 (1984); *Moore v. Fragatos*, 116 Mich. App. 179, 183, 321 N.W.2d 781, 784 (1982); *McKinstry v. Valley Obstetrics-Gynecology Clinic, P.C.*, 120 Mich. App. 479, 482, 327 N.W.2d 507, 508 (1982), *appeal held in abeyance*, 336 N.W.2d 210 (1983), *vacated and remanded*, 419 Mich. 873, 348 N.W.2d 8 (1984).

<sup>45</sup> *Morris v. Metriyakool*, 418 Mich. 423, 439-40, 344 N.W.2d 736, 741-42 (1984).

<sup>46</sup> *Madden v. Kaiser Foundation Hosps.*, 17 Cal. 3d 699, 714, 552 P.2d 1178, 1188, 131 Cal. Rptr. 882, 892 (1976). The Court held that "to destroy [the] viability [of arbitration agreements] upon an extreme hypothesis that they fail expressly to negative jury trials would be to frustrate the parties' interests and destroy the sanctity of the mutual promises." *Id.*

<sup>47</sup> Of 391 patients surveyed in Michigan who had been offered arbitration agreements upon admission to the hospital, 62.2% believed that "a patient who signs an agreement to arbitrate [a claim] can still choose to pursue his case in court" and 74.2% thought they could later go to court if they "[did not] like the arbitrator's decision." MICH. DEP'T OF COMMERCE, MICHIGAN'S MEDICAL MALPRACTICE ARBITRATION PROGRAM:

circumstances in which the patient may be unlikely to understand fully the implications of the agreement.<sup>48</sup> While some state statutes have safeguards to alleviate this concern,<sup>49</sup> a provision allowing patients thirty to sixty days to revoke the agreement<sup>50</sup> may not be a viable safeguard if the patients are unaware of the significance of the agreement.<sup>51</sup>

Courts have stated that public policy favors arbitration over litigation as a means of settling disputes,<sup>52</sup> and that agreements should be interpreted in favor of arbitration.<sup>53</sup> Yet, there is a tension between this policy and the constitutional rights of malpractice claimants. While courts might be constrained to uphold agreements absent clear evidence of mistake, duress, or fraud,<sup>54</sup> legislators might well consider adopting stricter standards for such agreements in order to protect malpractice claimants.

### B. *Right to an Impartial Decisionmaker*

Many challenges to the Michigan Act relate to the statute's requirement that a health care licensee be a member of the arbitration board.<sup>55</sup> Malpractice claimants have challenged the Act on the grounds that the composition of the arbitration board violates the plaintiff's due process right to an impartial decisionmaker, because of the high potential<sup>56</sup> for bias of the medical

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INTERIM REPORT II 102-03 (1979) [hereinafter cited as INTERIM REPORT II], cited in Mengel, *The Constitutional and Contractual Challenges to Michigan's Medical Malpractice Arbitration Act*, 59 U. DET. J. URB. L. 319, 336 (1982).

<sup>48</sup> See Note, *Medical Malpractice Arbitration: A Patient's Perspective*, 61 WASH. U.L.Q. 123, 145 (1983); Moore v. Fragatos, 116 Mich. App. 179, 197, 321 N.W.2d 781, 790 (1982) (waiver of right of access to courts signed by patient when in considerable pain held involuntary); Sanchez v. Sirmons, 121 Misc. 2d 249, 255, 467 N.Y.S.2d 757, 761 (1983). "A patient being wheeled into the operating room should not have to contemplate the pros and cons of litigating the surgeon's alleged mistakes before a tribunal of arbitrators rather than before a jury in a court of law." *Id.*

<sup>49</sup> See *supra* notes 23-26 and accompanying text.

<sup>50</sup> See *supra* note 25.

<sup>51</sup> See *supra* note 47 and accompanying text.

<sup>52</sup> See, e.g., Guadano v. Long Island Plastic Surgical Group, P.C., 607 F. Supp. 136, 139 (E.D.N.Y. 1982); Madden v. Kaiser Foundation Hosps., 17 Cal. 3d 699, 706-07, 552 P.2d 1178, 1182, 131 Cal. Rptr. at 886-87 (1976); Ramirez v. Superior Court, Santa Clara County, 103 Cal. App. 3d 746, 751, 163 Cal. Rptr. 223, 225 (1980).

<sup>53</sup> See, e.g., Baker v. Sadick, 162 Cal. App. 3d 618, 623-24, 208 Cal. Rptr. 676, 679 (1984); Ramirez, 103 Cal. App. 3d at 751, 163 Cal. Rptr. at 225-26; Gaer Bros., Inc. v. Mott, 144 Conn. 303, 307, 130 A.2d 804, 806 (1957); James Julian, Inc. v. Raytheon Service Co., 424 A.2d 665, 667 (Del. 1980).

<sup>54</sup> See *Morris*, 418 Mich. at 440, 344 N.W.2d at 742.

<sup>55</sup> MICH. COMP. LAWS ANN. § 600.5044(2) (West Supp. 1985).

<sup>56</sup> Challenges on these grounds generally involve a claim of potential, not actual, bias. See, e.g., *Morris*, 418 Mich. at 433, 344 N.W.2d at 739; *State ex rel. Strykowski v. Wilkie*, 81 Wis. 2d 491, 516, 261 N.W.2d 434, 446 (1978).

member in favor of malpractice defendants.<sup>57</sup> Claimants argue that doctors have a direct pecuniary interest in the outcome of malpractice cases,<sup>58</sup> and that medical members of arbitration panels identify with the defendants in a malpractice case, which obscures their objectivity and biases them in favor of the defendants.<sup>59</sup>

Courts have uniformly rejected these arguments,<sup>60</sup> and the Michigan Supreme Court has refused to invalidate arbitration agreements for failing to alert the potential claimant to such potential bias.<sup>61</sup> While recognizing that there is a relationship between the number and size of medical malpractice awards and the costs and availability of insurance, courts have found that the interest of medical panel members in the outcome of a malpractice case is too indirect to affect their neutrality.<sup>62</sup> Since

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<sup>57</sup> See, e.g., *Morris v. Metriyakool*, 418 Mich. 423, 344 N.W.2d 736 (1984); *McCloy v. Dorfman*, 123 Mich. App. 710, 333 N.W.2d 338 (1983), *vacated*, 419 Mich. 874, 347 N.W.2d 700 (1984); *Edwards v. St. Mary's Hosp.*, 120 Mich. App. 1, 327 N.W.2d 377 (1982), *appeal held in abeyance*, 334 N.W.2d 611, *rev'd*, 419 Mich. 862, 346 N.W.2d 842 (1984); *Horn v. Cooke*, 118 Mich. App. 740, 325 N.W.2d 558 (1982).

Other arbitration acts escape such challenges by allowing each party to choose one arbitrator, who then choose the third panel member, rather than requiring specifically that one member be a health care provider. See *supra* note 32 and accompanying text. Most screening panels mandated by state statutes, however, also contain members who are medical providers. See, e.g., 40 PA. CONS. STAT. ANN. § 1301.308(b) (Purdon Supp. 1985); LA. REV. STAT. ANN. § 40:1299.47(C) (West 1985); WIS. STAT. ANN. § 655.03 (West Supp. 1985); ARIZ. REV. STAT. ANN. § 12-567(B) (West Supp. 1984-85); DEL. CODE ANN. tit. 18, § 6804(a) (Michie Supp. 1984); HAWAII REV. STAT. § 671-11-(b) (Supp. 1984). Some of these statutes have been challenged on the same grounds as the Michigan statute, and all have been upheld. See *Vincent v. Romagosa*, 425 So. 2d 1237, 1239 (La. 1983); *Derouen v. Kolb*, 397 So. 2d 791, 793 (La. 1981); *Parker v. Children's Hosp. of Philadelphia*, 483 Pa. 106, 128, 394 A.2d 932, 943 (1978); *Strykowski*, 81 Wis. 2d at 515-16, 261 N.W.2d at 445 (1978).

<sup>58</sup> See *Vincent*, 425 So. 2d at 1239; *Morris*, 418 Mich. at 433-34, 344 N.W.2d at 739; *Strykowski*, 81 Wis. 2d at 514, 261 N.W.2d at 445.

<sup>59</sup> *Morris*, 418 Mich. at 434, 344 N.W.2d at 740; *Parker*, 483 Pa. at 128, 394 A.2d at 943.

<sup>60</sup> See *Vincent*, 425 So. 2d at 1239; *Derouen*, 397 So. 2d at 793; *Parker*, 483 Pa. at 128, 394 A.2d at 943; *Strykowski*, 81 Wis. 2d at 515-16, 261 N.W.2d at 445.

<sup>61</sup> *Morris*, 418 Mich. at 441-42, 344 N.W.2d at 742-43 (1984). The court found that the booklet given to patients as they sign the agreement, *Patient Information Booklet*, *supra* note 43, as required by statute, MICH. COMP. LAWS ANN. §§ 600.5041 (6), 600.5042 (7) (West Supp. 1985), sufficiently informs them of the panel's composition. *Morris*, 418 Mich. at 441-42, 344 N.W.2d at 742-43.

However, studies show that most patients do not read these booklets and are unaware of their contents. Of 101 completed patient surveys, 49% of those who signed arbitration agreements indicated they did not read the Patient Information Booklet before signing, and a third of the patients signing could not recall being presented with a booklet. APPLIED SOCIAL RESEARCH, INC., EVALUATION, STATE OF MICHIGAN MALPRACTICE ARBITRATION PROGRAM: SUMMARY REPORT 19 (1983) (copy on file at the HARV. J. ON LEGIS.) [hereinafter cited as SUMMARY REPORT].

<sup>62</sup> *Vincent*, 425 So. 2d at 1239; *Morris*, 418 Mich. at 436, 344 N.W.2d at 740; *Linder v. Smith*, 629 P.2d 1187, 1192 (Mont. 1981); *Strykowski*, 81 Wis. 2d at 515-16, 261

"[p]anel members are presumed to be persons of honesty and integrity,"<sup>63</sup> courts have found that mere speculation of bias is insufficient to establish a probability of actual bias which violates due process.<sup>64</sup>

While this presumption of honesty may be valid, courts tend to ignore the fact that medical members are expected to act differently on an arbitration board than lay jurors.<sup>65</sup> If they were not, there would be no reason for mandating their presence.<sup>66</sup> The legislation establishing arbitration and screening of medical malpractice claims was enacted to lower insurance costs and increase availability of medical care by reducing the number and amount of malpractice awards.<sup>67</sup> Presumably, a physician's expertise and experience enables him or her to screen out frivolous or unsubstantiated claims to a greater degree than do juries. The data on this matter is inconclusive,<sup>68</sup> although the fact that health care providers strongly support arbitration and screening procedures,<sup>69</sup> when virtually all challenges to the agreements come from malpractice claimants, substantiates the *perception* that these procedures favor the medical profession.

This is not to say that legislators, in designing these statutes, wished health care providers to act with a bias against medical malpractice claimants. It is the medical expertise of the providers and not their financial interest or anti-claimant prejudice that

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N.W.2d at 446; ; see also *Derouen*, 397 So. 2d at 793-94 (fact that panel members were staff members of defendant hospital does not prove that they were so biased as to deprive plaintiff of due process).

<sup>63</sup> *Parker*, 483 Pa. at 130, 349 A.2d at 947.

<sup>64</sup> See *supra* note 58.

<sup>65</sup> There is a general perception that juries are more swayed by sympathetic plaintiffs than are arbitrators. See Comment, *Michigan's Medical Malpractice Legislation—Prognosis: Curable Defects*, 55 U. DET. J. URB. L. 309, 324-25 (1978) [hereinafter cited as *Prognosis: Curable Defects*]. At least one state bar feels that "the profligate jury is largely a myth . . ." Franck, *State Bar Position on Malpractice Bills*, 54 MICH. ST. B.J. 262, 266 (1975).

<sup>66</sup> Courts have claimed that health care licensees on the arbitration board will provide needed medical expertise. See, e.g., *Strykowski*, 81 Wis. 2d at 516-17, 261 N.W.2d at 446. Presumably, however, this information could be obtained through expert testimony before the panel.

<sup>67</sup> See, e.g., *McCarthy v. Mensch*, 412 So. 2d 343, 345 (Fla.), *cert. denied*, 459 U.S. 833 (1982); *Morris*, 418 Mich. at 477-78, 344 N.W.2d at 759 (Cavanagh, J., dissenting); *Strykowski*, 81 Wis. 2d at 508, 261 N.W.2d at 442.

<sup>68</sup> See SUMMARY REPORT, *supra* note 61, at 7-14. Of 36 formal arbitration hearings and 63 formal trials between June 1, 1978 and June 31, 1982, plaintiffs were successful in 27% of all court trials and 31% of all arbitration hearings. *Id.* at 13. The median award was \$1000 by arbitration panels and \$1875 in court. *Id.*

<sup>69</sup> See Sohn, *An Examination of Alternatives to Suit in Doctor-Patient Disputes*, 48 ALB. L. REV. 669, 678 n.33 (1984); *Prognosis: Curable Defects*, *supra* note 65, at 321; *Morris*, 418 Mich. at 433, 344 N.W.2d at 739.



should lead them to find more often for the defendant. In fact, legislators presumably hope that using arbitration or screening boards will avoid the bias of *juries* towards sympathetic plaintiffs.<sup>70</sup> Nevertheless, the effect is to provide claimants with a forum which is less favorable to them than the court system.

Even if this potential for bias is purely speculative, the perception that it does exist may undermine a system of voluntary arbitration. Arbitration is consensual in nature,<sup>71</sup> and in order to be enforceable, the agreement must have been executed voluntarily.<sup>72</sup> To the extent that patients are aware that their claims may be decided by a board containing a health care licensee, they may be less willing to enter into arbitration agreements, thus minimizing the use of arbitration as an alternative to the court system.

Ironically, there is actually less potential for unfairness in Michigan's system, which mandates that a health care licensee be on the arbitration panel, than in the usual scheme, in which each side picks one arbitrator and these two pick the third. If defendant-physicians believe that they will get more favorable hearings from their colleagues, we can expect that there will be a medical member on the board under either system. Under the Michigan system, however, the health care licensee is chosen from a pool of candidates who are screened by the American Arbitration Association.<sup>73</sup> This screening presumably protects the claimant to a greater degree than a system in which the defendant-physician has the unfettered choice of an arbitrator.

Nevertheless, depending on one's view of due process, the due process rights of medical malpractice claimants may still conflict with the purpose behind having a health care licensee on the arbitration board. If due process requires only a fair

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<sup>70</sup> See sources cited *supra* note 65.

<sup>71</sup> *Wheeler v. St. Joseph Hosp.*, 63 Cal. App. 3d 345, 355, 133 Cal. Rptr. 775, 782 (1976); *Miner*, 101 Misc. 2d at 816, 422 N.Y.S.2d at 337. See *Henderson*, *supra* note 22, at 985.

<sup>72</sup> See, e.g., *Moore v. Fragatos*, 116 Mich. App. 179, 186, 321 N.W.2d 781, 785 (1982); *Sanchez*, 121 Misc. 2d at 253, 467 N.Y.S.2d at 760.

<sup>73</sup> MICH. COMP. LAWS ANN. § 600.5044(3) (West Supp. 1985). Other states also have impartial parties select the medical member of the arbitration panels. See, e.g., ARIZ. REV. STAT. ANN. § 12-567(B)(4) (West Supp. 1984-85) (presiding superior court judge of the county in which the claim was filed); MASS. ANN. LAWS ch. 231, § 60B (Michie/Law. Co-op. 1984) (judge sitting on the panel, who selects from a list of doctors provided by the Massachusetts Medical Society, who practice in the field in which the alleged injury occurred); 40 PA. CONS. STAT. ANN. § 1301.308(a) (Purdon Supp. 1985) (Administrator for Arbitration Panels for Health Care); WIS. STAT. ANN. § 655.03 (West Supp. 1985) (director of state courts).

hearing, arbitration proceedings are probably a sufficient alternative to the court system. If due process requires that all the advantages of the court system be preserved, arbitration may fail to protect adequately the rights of malpractice claimants.

### III. CONTRACTUAL CHALLENGES

In light of these potential problems with arbitration agreements, it is essential that patients enter into such agreements voluntarily. Consequently, a number of courts have considered whether medical malpractice arbitration agreements are invalid as contracts of adhesion or are otherwise unenforceable on grounds of unconscionability.<sup>74</sup>

A contract is unconscionable when the parties have unequal bargaining power and the resulting contract solely benefits the stronger party<sup>75</sup> or its terms are against public policy.<sup>76</sup> A contract of adhesion is one which is offered on a standardized form, without the opportunity for bargaining, under circumstances in which the weaker party cannot obtain the desired service or product without agreeing to the terms of the contract.<sup>77</sup> While an adhesive contract is not *per se* invalid, courts will refuse to enforce it if its terms are unconscionable or if it contains terms of which the signer was unaware and which are beyond the expectations of an ordinary person.<sup>78</sup>

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<sup>74</sup> See, e.g., *Guadano v. Long Island Plastic Surgical Group*, 607 F. Supp. 136 (E.D.N.Y. 1982); *Wheeler v. St. Joseph Hosp.*, 63 Cal. App. 3d 345, 133 Cal. Rptr. 775 (1976); *Morris v. Metriyakool*, 418 Mich. 423, 344 N.W.2d 736 (1984); *Miner v. Walden*, 101 Misc. 2d 814, 422 N.Y.S.2d 335 (1979).

<sup>75</sup> The precise elements of unconscionability are not clear. Perhaps the most widely used definition comes from Judge Skelly Wright: "Unconscionability has generally been recognized to include an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party." *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 449 (D.C. Cir. 1965). Another widely used definition is: "[a]n unconscionable contract is one which no man in his right senses would make on the one hand and which no fair and honest man would accept on the other." *Newberry Co. v. Mixon*, 440 F. Supp. 20, 21 (E.D. Mo. 1977) (citing *Hume v. United States*, 132 U.S. 406 (1889)). For a general discussion of unconscionability, see 15 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS, § 1763A (3d ed. 1960 and Supp. 1979).

<sup>76</sup> See E. ALLAN FARNSWORTH, CONTRACTS, §§ 5.1-5.9 (1982).

<sup>77</sup> *Morris*, 418 Mich. at 440, 344 N.W.2d at 742.

<sup>78</sup> *Wheeler*, 63 Cal. App. 3d at 357, 133 Cal. Rptr. at 783; see *Beynon v. Garden Grove Medical Group*, 100 Cal. App. 3d 698, 705, 161 Cal. Rptr. 146, 149 (1980); *Sanchez v. Sirmons*, 121 Misc. 2d 249, 252-54, 467 N.Y.S.2d 757, 759-61 (1983).

Courts favor arbitration<sup>79</sup> and do not view arbitration agreements in and of themselves as unconscionable or oppressive.<sup>80</sup> Courts also will not find an arbitration agreement unenforceable as a contract of adhesion merely because it was offered on a standardized form.<sup>81</sup> Nor, for the most part, have courts been persuaded that arbitration agreements are contracts of adhesion because of the presumed superior bargaining power of health care providers.<sup>82</sup>

In fact, few medical malpractice arbitration agreements are contracts of adhesion *per se*.<sup>83</sup> With the exception of emergency medical services,<sup>84</sup> a patient generally has the opportunity to

<sup>79</sup> See *supra* note 52 and accompanying text.

<sup>80</sup> See *Wheeler*, 63 Cal. App. 3d at 354, 133 Cal. Rptr. at 783-84. Noting that "[t]he speed and economy of arbitration, in contrast to the expense and delay of jury trial, could prove helpful to all parties," *Madden v. Kaiser Foundation Hosps.*, 17 Cal. 3d 699, 711, 552 P.2d 1178, 1186, 131 Cal. Rptr. 882, 890 (1976), the California Supreme Court found that an arbitration requirement within a personal health insurance plan "lacks those oppressive features which have characterized the contracts" other courts have found unconscionable. *Madden*, 17 Cal. 3d at 710, 552 P.2d at 1185, 131 Cal. Rptr. at 889. Similarly, after determining that arbitration agreements do not violate the rights to trial by jury or to an impartial decisionmaker, *Morris*, 418 Mich. at 436-40, 344 N.W.2d at 740-42, the Michigan Supreme Court refused to find the agreements unconscionable for failure to highlight the waiver of jury trial or the composition of the arbitration board. *Morris*, 418 Mich. at 441, 344 N.W.2d at 742-43. A New York court, by contrast, found unconscionable an arbitration agreement which excluded claims of money due for services rendered (the only claims which the doctor would have against the patient), noting that the patient promised to arbitrate her own claims without a corresponding promise on the doctor's part. *Miner*, 101 Misc. 2d at 819, 422 N.Y.S.2d at 339.

<sup>81</sup> See *Guadano*, 607 F. Supp. at 139-40; *Wheeler*, 63 Cal. App. 3d at 354, 133 Cal. Rptr. at 783-84.

<sup>82</sup> See *Guadano*, 607 F. Supp. at 138 (plaintiff undergoing elective surgery failed to allege any special circumstances which might indicate unequal bargaining power between her and the surgeon); *Sanchez*, 121 Misc. 2d at 252, 467 N.Y.S.2d at 759 (court rejected argument that patient had no realistic bargaining power since she could have obtained an elective abortion elsewhere); cf. *Madden v. Kaiser Foundation Hosps.*, 17 Cal. 3d 699, 711, 552 P.2d 1178, 1186, 131 Cal. Rptr. 882, 890 (1976) (although state employees did not individually agree to arbitration provision in health plan, they were represented by the state retirement board, and therefore the arbitration agreement was the product of negotiations between parties with equal bargaining power).

<sup>83</sup> Some state statutes provide that arbitration agreements conforming with the statute are presumed valid, see, e.g., MICH. COMP. LAWS ANN. § 600.5041(7) (West Supp. 1985), or are not contracts of adhesion, see, e.g., CAL. CIV. PROC. CODE § 1295(e) (West 1982). As one writer has pointed out, medical malpractice arbitration agreements executed in Michigan may be contracts of adhesion from the hospital's perspective, since, unlike the patient, the hospital is required under Michigan law to offer the agreement. See *Prognosis: Curable Defects*, *supra* note 65, at 323. However, Michigan's Act has never been challenged on this ground.

<sup>84</sup> If the patient signed the agreement prior to receiving emergency medical services, the court may not enforce it. See *Ramirez v. Superior Court, Santa Clara County*, 103 Cal. App. 3d 746, 757, 163 Cal. Rptr. 223, 229 (1980) "[W]here the arbitration agreement is signed as part of the admission procedure in an emergency room something less than fraud or imposition would surely suffice for explaining failure to read the instrument." *Id.* The Michigan and Ohio statutes restrict the use of arbitration agreements in connection with emergency medical services. See *supra* note 26.

refuse to sign the agreement and go elsewhere for medical care.<sup>85</sup> Similarly, a health plan enrollee can select a plan which does not require arbitration of malpractice claims.<sup>86</sup> Though at least one court has confronted a situation in which a health care provider required that a patient sign an arbitration agreement before receiving medical services,<sup>87</sup> more typically the patient has had some opportunity to reject the agreement but was either unaware of the arbitration provision or did not understand its implications.<sup>88</sup>

Nevertheless, in light of the importance of the right to jury trial, courts are fairly strict in assessing whether these rights were waived in a knowing, intelligent, and voluntary manner. Patients may feel pressured to sign the agreement despite the fact that the agreement is not a prerequisite to health care,<sup>89</sup> and courts customarily find an arbitration agreement to be an unenforceable contract of adhesion when the patient believed he or she must sign the agreement before receiving medical services.<sup>90</sup> Despite the general rule that one who signs a contract is presumed to know and understands its contents,<sup>91</sup> courts also may find a contract adhesive or unconscionable when the arbitration clause is buried unobtrusively in the middle of a hospital

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<sup>85</sup> See, e.g., *Guadano*, 607 F. Supp. at 138 (plaintiff undergoing elective cosmetic surgery failed to assert any special need for particular surgeon to perform operation); *Sanchez*, 121 Misc. 2d at 252, 467 N.Y.S.2d at 759 (agreement was not contract of adhesion *per se* because petitioner, not confronted with a medical emergency, could have obtained an elective abortion elsewhere).

<sup>86</sup> See *Madden*, 17 Cal. 3d at 711, 552 P.2d at 1186, 131 Cal. Rptr. at 890 (where plaintiff could select among several medical plans, some not having arbitration provisions, the arbitration clause in the health plan was not a contract of adhesion).

<sup>87</sup> *Miner v. Walden*, 101 Misc. 2d 814, 422 N.Y.S.2d 335 (1979).

<sup>88</sup> See, e.g., *Ramirez*, 103 Cal. App. 3d at 756, 163 Cal. Rptr. at 229 (patient should be given opportunity to show why she did not read notice of waiver of jury trial); *Wheeler*, 63 Cal. App. 3d at 361, 133 Cal. Rptr. at 786-87 (evidence showed patient was unaware of "Arbitration Option" provision); *Sanchez*, 121 Misc. 2d at 253-54, 467 N.Y.S.2d at 760 (patient signing "Consent to Abortion" form did not notice arbitration clause).

<sup>89</sup> *Wheeler*, 63 Cal. App. 3d 345, 133 Cal. Rptr. 775 (agreement found invalid as a contract of adhesion despite fact that patient could elect not to arbitrate by initialing form in space provided). Despite the fact that arbitration agreements in Michigan must state that the agreement is not a prerequisite to health care, *supra* note 30, a survey reported that 15.6% of patients signing such agreements felt pressure to do so. INTERIM REPORT II, *supra* note 47, at 104, cited in *Mengel*, *supra* note 47, at 336.

<sup>90</sup> See, e.g., *Ramirez*, 103 Cal. App. 3d at 757, 163 Cal. Rptr. at 229; *Wheeler*, 63 Cal. App. 3d at 360, 366, 133 Cal. Rptr. at 786, 789; *Miner v. Walden*, 101 Misc. 2d 814, 820, 422 N.Y.S.2d 335, 340 (1979).

<sup>91</sup> *Wheeler*, 63 Cal. App. 3d at 359, 133 Cal. Rptr. at 785; *Madden*, 17 Cal. 3d at 710, 552 P.2d at 1185, 131 Cal. Rptr. at 889; *Morris*, 418 Mich. at 438-39, 344 N.W.2d at 741.

admissions form<sup>92</sup> or is executed under circumstances in which the patient is under considerable stress and may be excused from not having read the arbitration provisions.<sup>93</sup>

Despite the long debate in Michigan's lower courts over the effect on the validity of arbitration agreements of the patient's state of mind when signing the agreement,<sup>94</sup> a discussion of such humanitarian and practical concerns is entirely lacking from the Michigan Supreme Court decision upholding the Act. While the statute mandates that the form state that the agreement is not a prerequisite to medical care,<sup>95</sup> a number of courts and commentators have questioned whether, in light of the circumstances surrounding the provision of medical care, patients are aware that the agreement is voluntary.<sup>96</sup> Nevertheless, the Michigan Supreme Court held that

[r]egardless of any possible perception among patients that the provision of optimal medical care is conditioned on their signing the arbitration agreement, we believe that the sixty-day rescission period, of which patients must be informed, fully protects those who sign the agreement. The patients' ability to rescind the agreement after leaving the hospital allows them to obtain the desired service without binding them to its terms.<sup>97</sup>

Yet the ability to rescind the agreement within sixty days is meaningless if the patient has not understood the significance of the agreement until it is used against him or her after the rescission period has ended. Despite the Michigan Court's assertion that "[w]e do not believe that an ordinary person signing this agreement to arbitrate would reasonably expect a jury trial,"<sup>98</sup> what little empirical evidence there is indicates that this view is largely mistaken.<sup>99</sup>

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<sup>92</sup> See *Wheeler*, 63 Cal. App. 3d at 360-61, 133 Cal. Rptr. at 786; *Sanchez*, 121 Misc. 2d at 253-54, 467 N.Y.S.2d at 760.

<sup>93</sup> See *Ramirez*, 103 Cal. App. 3d at 229, 163 Cal. Rptr. at 786; *Wheeler*, 63 Cal. App. 3d at 360, 133 Cal. Rptr. at 786; *Moore v. Fragatos*, 116 Mich. App. 179, 321 N.W.2d 781 (1982); *Sanchez*, 121 Misc. 2d at 255, 467 N.Y.S.2d at 761.

<sup>94</sup> See, e.g., *Christman v. Sisters of Mercy Health Corp.*, 118 Mich. App. 719, 722, 325 N.W.2d 801, 802 (1982), *appeal held in abeyance*, 334 N.W.2d 611, *rev'd*, 419 Mich. 873, 347 N.W.2d 698 (1984) (valid); *Strong v. Oakwood Hosp. Corp.*, 118 Mich. App. 395, 403, 325 N.W.2d 435, 442 (1982) (invalid); *Moore*, 116 Mich. App. at 197-203, 321 N.W.2d at 790-93 (invalid).

<sup>95</sup> See *supra* note 30.

<sup>96</sup> See sources cited *supra* notes 47, 65, 68.

<sup>97</sup> *Morris*, 418 Mich. at 440, 344 N.W.2d at 742.

<sup>98</sup> *Id.* at 441, 344 N.W.2d at 742.

<sup>99</sup> See *supra* note 47.

## CONCLUSION

Agreements to submit medical malpractice claims to binding arbitration present difficult problems for courts and legislators. Since these agreements require waiver of one's constitutional right to trial by jury, it is essential that the decision to enter into such an agreement be made knowingly, willingly, and intelligently. This is especially important when the arbitration board contains a health care licensee, since the proceeding may then differ even more substantially from jury trial.

The effectiveness of arbitration as an alternative to the court system and as a partial solution to the medical malpractice crisis depends on the ability of arbitration agreements to withstand challenges to their validity. Courts are more likely to uphold agreements which clearly spell out the waiver of jury trial so that a potential malpractice claimant is fully alerted to the agreement's implications.

At the same time, the effectiveness of arbitration also depends on its wide use. Potential claimants faced with an agreement stating **BY SIGNING THIS AGREEMENT YOU ARE GIVING UP YOUR RIGHT TO A TRIAL BY JURY** and informing them of the "potential bias" of the medical panel member may be much less willing to enter into such agreements in the first place. One could argue that under certain circumstances patients should not even be offered these agreements, since the stress of undergoing medical treatment and the patient's perceptions of the doctor-patient relationship may preclude a voluntary, intelligent choice regardless of the warnings contained in the agreement.

There is consequently a serious problem in determining the proper degree of paternalism a court should adopt towards persons signing medical malpractice arbitration agreements. The Michigan Supreme Court adopts the strict view that one who signs a contract is presumed to understand its contents.<sup>100</sup> This is an important rule of contract law, which should not be disregarded lightly, especially in light of the greater degree of protection already given parties to arbitration agreements by some courts and state statutes.<sup>101</sup> On the other hand, it would be bad policy to further the use of arbitration by encouraging patients to sign agreements which they do not totally understand.

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<sup>100</sup> *Morris*, 418 Mich. at 438-39, 344 N.W.2d at 741.

<sup>101</sup> See *supra* notes 23-26, 89-93 and accompanying text.

It may be impossible for courts and legislators to reconcile completely the twin goals of encouraging the use of arbitration while protecting the rights of malpractice claimants. Furthermore, in the ten years which have elapsed since the passage of the Michigan Medical Malpractice Arbitration Act, there is still no conclusive evidence on whether arbitration has been effective in reducing the costs of litigating medical malpractice claims in that state.<sup>102</sup> Until such evidence is available, states facing the problem of rising malpractice insurance costs might consider looking primarily to solutions other than arbitration, regulating the content of and procedures surrounding arbitration agreements without actively encouraging their use as in Michigan. While this may be an uneasy compromise, it addresses the concerns of health care providers facing higher insurance rates and of patients who must ultimately pay those rates, while continuing to protect the victims of medical malpractice.

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<sup>102</sup> See INTERIM REPORT II, *supra* note 47, cited in Mengel, *supra* note 47, at 336; SUMMARY REPORT, *supra* note 68, at 7-14. Other state statutes have had similarly mixed results. See, e.g., Lund, *Medical Malpractice Legislation: Rx for Utah*, 11 J. CONTEMP. L. 287 (1984); Note, *Ohio's Attempts to Halt the Medical Malpractice Crisis: Effective or Meaningless?*, 9 U. DAYTON L. REV. 361 (1984).





# COMMENT

## RISKY BUSINESS: CONSUMER PROTECTION IN THE INSURANCE INDUSTRY

NANCY R. PAGE\*

There are no stronger supporters of state regulation than the four of us [state insurance commissioners] here, but within twelve months to two years, we'd call for federal regulation if there's not fundamental changes in the way we do our business in this country.—Lyndon Olson, Jr., Chairman, Texas State Board of Insurers.<sup>1</sup>

A diverse group of liability insurance consumers,<sup>2</sup> ranging from doctors and day-care centers to transit authorities and municipalities, is experiencing a crisis in the availability and affordability of liability insurance.<sup>3</sup> Industry spokesmen and

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<sup>1</sup> Moderating an industry panel discussion, Oct. 1985. *Quoted in* Herbert, *Tougher Insurance Rules Loom*, J. Commerce, Oct. 10, 1985, at 1A, col. 2 [hereinafter *Tougher Rules*].

<sup>2</sup> Liability insurance is a submarket of casualty and property insurance. Liability insurance is a contract in which the insurance company agrees to indemnify the policyholder for liability to third parties.

<sup>3</sup> State governments are among the hardest hit. Wyoming, Colorado, Utah, Idaho, and New Mexico recently had their general comprehensive liability coverage "non-renewed." *5 Rocky Mountain States Lose Liability Cover*, J. Commerce, June 27, 1985, at 10A, col. 1. Municipalities face similar difficulties. Many have recently had policies cancelled in mid-term or renewed at much higher premium rates. Baltimore's master property insurance rates, for example, increased from \$315,714 in 1984 to \$1,696,995 in 1985. *See Crisis in the Property-Casualty Insurance Market: The Scarcity and High Cost of Liability Coverage: Hearings Before the Subcomm. on Commerce, Transportation and Tourism of the House Comm. on Energy and Commerce, 99th Cong., 1st Sess. (Sept. 19, 1985) (in press) (testimony of Hyman Pressman, Comptroller, City of Baltimore) [hereinafter cited as Crisis Hearings]; see also Municipalities Face Hike in Liability Insurance*, J. Commerce, July 22, 1985, at 8A, col. 4; *Pa. Municipal Liability Board Muddled*, J. Commerce, Oct. 7, 1985, at 8A, col. 1.

Private organizations, such as day-care centers, have also been unable to secure liability coverage. The Maryland Insurance Commissioner intervened to prevent a California carrier from cancelling in mid-term the policies of 242 Maryland day-care centers. *See Child Care: The Emerging Insurance Crisis; Part Two: Hearings Before the House Select Comm. on Children, Youth and Families, 99th Cong., 1st Sess. (July 30, 1985) (in press) (testimony of Edward Muhl, Insurance Commissioner, Maryland) [hereinafter cited as Child Care Hearings]*.

The Executive Vice President of the American Medical Association recently told the National Association of Insurance Commissioners ("NAIC"), the representative body of state insurance commissioners, "[w]e are on the crest of a crisis in medical malpractice

consumer advocates vigorously disagree as to both the causes of this crisis and the appropriate cure. The insurance industry argues that reckless court decisions and spendthrift juries have rendered insurers' costs for liability coverage too unpredictable, and have led to larger and more numerous claims than expected. Consumer advocates suggest that lower industry returns are not substantial enough to warrant recent rate increases, and contend that the current crisis in the availability and affordability of liability insurance can be traced to the industry's business cycle and the absence of vigorous regulation of the insurance industry.

The National Insurance Consumer Organization (NICO)<sup>4</sup> has proffered a legislative solution to the liability insurance crisis facing consumers today. The proposed Omnibus Reinsurance Act of 1985<sup>5</sup> addresses the problems of costly and scarce liability coverage. NICO's proposal, if adopted, would authorize a federal program to create pools of insurance, thereby encouraging private insurers to continue coverage within distressed markets.<sup>6</sup>

Insurance is a mammoth industry. Insurance companies control over eight hundred million dollars in assets.<sup>7</sup> Insurance premiums cost American consumers over ten percent of their after-tax personal income;<sup>8</sup> property and casualty insurers alone receive over one hundred billion dollars in premiums annually.<sup>9</sup> Nevertheless, the industry has enjoyed a low profile, largely avoiding federal antitrust oversight. Relatively low consumer awareness and concern have insulated the industry from the reforms consumer advocates have successfully pressed upon

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that would make 1975 look like a ripple." Herbert, *NAIC Confronts Tort Reform*, J. Commerce, June 13, 1985, at 8A, col. 1. See also Carpenter, *Nurse-Midwives College Loses Insurance*, J. Commerce, July 22, 1985, at 8A, col. 1.

Transit authorities have encountered premium increases of 300% to 1000% this year, even though the insurance industry's "loss ratio," an indicator of profitability, has remained constant. Adell, *Transit Systems Face Liability Shortage*, J. Commerce, July 12, 1985, at 8A, col. 1.

<sup>4</sup> NICO is a nonprofit, tax-exempt organization affiliated with consumer advocate Ralph Nader. It was founded in 1980 by its current President, actuary J. Robert Hunter. NICO is funded by grants from organizations, membership fees, and sales of publications.

<sup>5</sup> On file at the HARV. J. ON LEGIS.

<sup>6</sup> The federal government would help to spread risk by sharing in the liabilities and the premiums of insurance in these markets. See *infra* note 56.

<sup>7</sup> This figure includes both life insurance and property/casualty insurance. See U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 511, Nos. 862, 864 (105th ed. 1985) [hereinafter cited as STATISTICAL ABSTRACT].

<sup>8</sup> *Insurance Industry Woes Spread*, J. Commerce, Sept. 9, 1985, at 8A, col. 2 [hereinafter *Woes*].

<sup>9</sup> STATISTICAL ABSTRACT, *supra* note 7, at 511.

other segments of the financial services market.<sup>10</sup> The liability insurance crisis has increased consumer awareness.<sup>11</sup> What was once a publicity backwater, a boring sideshow to banking, has become a subject of intense public debate.<sup>12</sup>

The McCarran-Ferguson Act,<sup>13</sup> which mandates preemptive state regulation of insurance companies, has made the task of drafting consumer-oriented legislation difficult.<sup>14</sup> Absent a federal agency to which they can appeal, consumer advocates are cast, by default, directly into the legislative arena.<sup>15</sup> NICO's proposal for limited federal intervention in a largely state-regulated industry illustrates the tension between the need for insurance company responsiveness to consumer needs and the institutional limits to national insurance policymaking under current law. The proposal is a reminder that as long as the policy of federal abstention from insurance regulation remains intact, the only viable national channel for consumer input on insurance

<sup>10</sup> For example, consumer advocates have successfully proposed legislation requiring banks to credit customer deposits in a timely manner and to provide credit applicants with clear information on the cost of credit. *See, e.g.*, MASS. GEN. LAWS ANN. ch. 167D, § 34, ch. 140D, § 8 (West Supp. 1985); Consumer Credit Protection Act, CAL. CIV. CODE §§ 1785.1-1785.35 (West 1985).

<sup>11</sup> The Chairman of the House Select Comm. on Children, Youth, and Families, Rep. George Miller (D-Cal.), concluded that problems in the day-care markets are "the beginning of political wildfire." *Day-Care Liability: Scarce, Expensive*, J. Commerce, July 23, 1985, at 8A, col. 4.

Consumer awareness has been heightened by the difficulties that various liability insurance consumers have had in procuring coverage or securing affordable rates, difficulties that indirectly affect many consumers and taxpayers. *See, e.g.*, Yemma, *Caught in the Insurance Squeeze*, Christian Science Monitor, Sept. 13, 1985, at 3; Diamond, *Sweeping Insurance Changes May Increase Business Costs*, N.Y. Times, June 11, 1984, at 1, col. 2; *see also Study: NY Doctors Spend 10% of Fees on Insurance*, J. Commerce, Oct. 9, 1985, at 8A, col. 1.

<sup>12</sup> *See, e.g.*, Albany *G.O.P. Acts to Aid Localities*, N.Y. Times, Oct. 13, 1985, at 69, col. 6; Foreman, *Malpractice Insurance Curbs Urged*, Boston Globe, Oct. 11, 1985, at 21, col. 4; Work, *As Liability-Insurance Squeeze Hits Everyone—*, U.S. NEWS & WORLD REPORT, Oct. 7, 1985, at 56; Abramowitz, *Congress Urged to Act on Liability Insurance*, Wash. Post, Sept. 20, 1985, at E4; Koepf, *Insurance Shock; Premiums Up, Coverage Down*, TIME, Sept. 16, 1985, at 55.

<sup>13</sup> Act of Mar. 9, 1945, ch. 20, 59 Stat. 33 (codified as amended at 15 U.S.C. §§ 1011-15 (1982)).

<sup>14</sup> *See infra* text accompanying notes 37-46.

<sup>15</sup> The Federal Trade Commission ("FTC") attempted to oversee competition in the insurance industry in 1979. An FTC staff report concluded that "[p]rice competition is so ineffective in the life insurance industry that companies paying 20-year rates of return of 2% or less successfully compete against companies paying 4% to 6%. This disparity should be contrasted with the banking industry, where differences of a quarter of a percent are considered to be competitively crucial." FTC STAFF REPORT, LIFE INSURANCE COST DISCLOSURE (1979). The FTC was subsequently prohibited from investigating or reporting on the "business of insurance" unless specifically requested to do so by the House or Senate Commerce Committee. Federal Trade Commission Improvements Act of 1980, Pub. L. No. 96-252, § 5(a), 94 Stat. 374, 375 (codified at 15 U.S.C. § 46 (1982)).

policy is a direct appeal to Congress.<sup>16</sup> NICO paired the release of its proposed federal solution<sup>17</sup> with a call for Congress to review the wisdom of state regulation of the insurance industry. Even state insurance commissioners are beginning to wonder aloud, in light of the industry's current woes, whether the time has come for comprehensive federal insurance regulation.<sup>18</sup>

This Comment discusses in Part I the industry's and NICO's varying explanations for the cause of the current crisis; outlines in Part II the severe limits on federal oversight of the industry under current law; and explores in Part III NICO's proposal as a welcome counterpoint to current law. Part IV concludes that the current crisis is another example of the failure of the McCarran-Ferguson regime to provide adequate consumer protection, and suggests that, beyond adoption of NICO's proposal, a more ambitious scheme of comprehensive federal regulation of insurance should be established.

## I. THE INDUSTRY'S AND CONSUMERS' FINANCIAL WOES: TWO PERSPECTIVES

Much of the disagreement between consumer advocates and industry spokesmen on the merits of NICO's legislative proposal rests upon differing explanations of the cause of the current crisis.

Industry spokesmen argue that it has become prohibitively expensive to do business in certain markets:<sup>19</sup> expansive court

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<sup>16</sup> Of course, many other considerations beyond the scope of this Comment support greater federal oversight of the insurance industry. The insurance industry, for instance, has shown increasing interest in competing directly with federally regulated banks in the financial services market. The reasons for federal regulation of the banking industry may now apply equally well to the insurance industry, as the industry rapidly enters other financial services markets. See, e.g., *Recent Insurer-Broker Mergers*, N.Y. Times, Nov. 6, 1984, at D4, col. 1 (summarizing insurance companies' recent acquisitions of brokerage and securities firms); *Tougher Rules*, *supra* note 1, at 5A, col. 3.

The president of the nation's sixth largest insurer, E. James Morton of John Hancock, recently advocated combined state and federal regulation, in light of banks' excursions into insurance territory, in order to facilitate insurers' access to a broader range of financial services markets. Nolan, *Federal Regulation of Insurers Urged*, J. Commerce, Sept. 18, 1985, at 8A, col. 1.

<sup>17</sup> NICO released its proposal in August 1985.

<sup>18</sup> See *Tougher Rules*, *supra* note 1, at 5A, col. 2. Insurers have for the most part opposed federal regulation of their industry. See, e.g., Nolan, *Insurers Set to Fight Off Federal Rule*, J. Commerce, Nov. 13, 1985, at 1A, col.2. "The executives are telling each other that they must strengthen existing state regulation of the industry, lest the feds move in." *Id.*

<sup>19</sup> See, e.g., *Crisis Hearings*, *supra* note 3 (testimony of Franklin Nutter, President, Alliance of American Insurers).

constructions of policy coverage and overly generous juries have made insurers' liabilities too uncertain, too unpredictable, and too risky for insurance.<sup>20</sup> The industry views its withdrawal from troubled markets as a natural consequence of a run-away tort system.<sup>21</sup> Insurers feel that they alone should determine the scope of liability for their policies, and that limits should be placed on jury awards.<sup>22</sup> They assert that courts have given unjustifiably expansive readings to carefully crafted policy language, thus greatly increasing insurers' risk,<sup>23</sup> and making it more difficult to predict claims levels.

Predicting claims and pooling risks is the business of insurance.<sup>24</sup> When accurate prediction is no longer possible, some liability markets become theoretically too risky for insurance.<sup>25</sup>

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<sup>20</sup> "Many of today's availability problems flowing from the action of insurers can be translated into this message: Insurers are not the bankers of the tort system and insurance . . . cannot finance its uncharted and undescribable growth." *Crisis Hearings, supra* note 3 (testimony of Franklin Nutter, President, Alliance of American Insurers). "Many of us believe we are living under a tort system that is completely out of control." *Child Care Hearings, supra* note 3 (testimony of Frank Neuhauser Jr., Vice President and Actuary, AIG Risk Management Inc.). John J. Byrne, then Chairman & CEO of Geico Corp., declared at a Casualty Actuaries of New York meeting in June 1985: "[A]nyone who puts his private capital behind lines such as malpractice is putting himself in the hands of a zany judge or jury out in California. To my mind, he is absolutely stupid." Nolan, *Insurers Told: Exit Some Lines*, J. Commerce, June 18, 1985, at 10A, col. 1. See also *Crisis Hearings, supra* note 3 (statement of Andre Maisonpierre, President, Reinsurance Ass'n of America, app. A).

The difficulties municipalities have had in obtaining coverage are ascribed to "the erosion of a well-settled principle of law that governmental entities could not be sued without their consent," court-imposed liability for "violation of the constitutional rights of citizens, and court-imposed municipal indemnification of claims against municipal employees." *Crisis Hearings, supra* note 3 (testimony of Franklin Nutter, President, Alliance of American Insurers).

<sup>21</sup> In their hurry to withdraw from markets, insurers have sometimes cancelled policies in midterm. See *supra* note 3. A recent national survey found that over 70% of child-care centers during the summer of 1985 either lost their liability coverage or faced premium increases of at least 100%. See *Woes, supra* note 8, at 8A, col. 2. In the case of day-care insurance, merely the spectre of court imposed liability has been sufficient to provoke insurers' withdrawals from the market. See *Child Care Hearings, supra* note 3 (statement of Frank Neuhauser Jr., Vice President and Actuary, AIG Risk Management Inc.) (asserting that the potential for multimillion-dollar judgments exists, but noting that no such award has yet been paid in a child abuse case).

<sup>22</sup> See *supra* note 20.

<sup>23</sup> See *infra* note 25.

<sup>24</sup> Insurance companies must keep reserves sufficient to meet expenses and claims from terminated or outstanding contracts. Insurance companies are required by state laws to set reserves conservatively in accordance with state commissioners' rules and regulations. See, e.g., ALA. CODE §§ 27-36-1 to 27-36-7 (Supp. 1985); CAL. INS. CODE §§ 923.5, 11558 (West Supp. 1985). Unexpected and drastic fluctuations in income or claim reserves, however, can affect solvency.

<sup>25</sup> The expansion of liability by legislatures and courts discourages the underwriting of risks that the industry "cannot understand, rate or limit with any certainty." *Crisis Hearings, supra* note 3 (statement of Andre Maisonpierre, President, Reinsurance Ass'n of America).

Insurance companies argue that judicially created liability and large jury awards have made some lines of business prohibitively risky and that the industry must withdraw to more statistically satisfying lines of business.<sup>26</sup> The solution to the current crisis, the companies argue, must include legislative reform of the tort system.<sup>27</sup>

Consumer advocates contend that the extent of court-imposed liability is a red herring and that insurers intentionally are exaggerating their lowered returns.<sup>28</sup> NICO concludes that the current fiscal problems of property and casualty companies should not be attributed to the legal system. NICO charges that insurance companies sold to poor risks in the late 1970's and early 1980's in order to invest premiums at the prevailing high

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<sup>26</sup> Insurers have urged state commissioners to adopt policy coverage forms for liability insurance that would protect the policyholder only if the claim is made while the policy is in force (typically one year). Such forms would replace current "occurrence" claim forms that protect insurance consumers for damage that happens during the policy year, regardless of when the claim is filed. This change in policy would constitute a major change in the scope of liability coverage. It would shield insurers from claims for injury and property damage not filed by the policyholder before the end of the policy year. The difference in policy forms becomes crucial in cases involving exposure to asbestos or toxic wastes, for example, where the injury often is not discovered until after the end of the policy year.

The Risk and Insurance Management Society, Inc., a group of over 3000 corporate insurance consumers, has declared this proposal to be "a substitute of uncertainty for certainty," the result of a "conscious decision on the part of insurers not to offer coverages needed by the buying public," and "an abuse of the anti-trust [sic] exemption granted to insurers by the McCarran Ferguson Act." J. Harkavy & W. Blick, Testimony on the Proposed ISO Claims Made Liability Policy before the New York Insurance Department (May 16, 1985, as revised, expanded and submitted to the record, June 5, 1985).

<sup>27</sup> See, e.g., *Crisis Hearings*, *supra* note 3 (statement of Andre Maisonpierre, President, Reinsurance Ass'n of America; statement of Franklin Nutter, President, Alliance of American Insurers).

<sup>28</sup> See NICO NEWSLETTER, *THE CYCLE: A SPECIAL REPORT* 4 (July/Aug. 1985). Although property and casualty companies sustained \$20.5 billion in underwriting losses in 1984, they realized \$20.8 billion in investment income and capital gains, thus realizing a profit of \$300 million. From 1975 to 1984, property and casualty companies lost approximately \$42.0 billion in underwriting and gained \$119.1 billion in investments, for a net industry gain of about \$77.1 billion. Natwar Gandhi, Group Director, General Accounting Office, address before the American Risk and Insurance Ass'n, Vancouver, B.C. (Aug. 20, 1985).

Some industry observers contend that regulators must scrutinize rates on the basis of investment income as well as underwriting losses. The minority report to an NAIC study noted that "[i]t has long been obvious that the [majority report], which took over a year to 'craft' under the concerted guidance of America's dominant property and casualty underwriters, would exhibit 'the incisiveness of a marshmallow,'" and asserted that "failure to include investment income explicitly in the ratemaking and approval process is tantamount to not regulating insurance industry profits at all." J. WILSON & J. HUNTER, *INVESTMENT INCOME AND PROFITABILITY IN PROPERTY/CASUALTY INSURANCE RATEMAKING* 1, 3 (1983) (independent report to the NAIC Task Force on Profitability and Investment Income).

interest rates and that they are passing on the lower returns of these sales to consumers in the form of both higher costs and lower availability of coverage.<sup>29</sup>

Insurance industry statistics confirm that during the late 1970's and early 1980's insurance companies began to compete aggressively for premium dollars, and that, as a result, underwriting standards dropped dramatically. The Insurance Services Offices, an industry-funded rate-setting and policy-setting body, and the National Association of Independent Insurers concluded in a joint study that "[t]he property/casualty industry must accept major responsibility for its current financial condition."<sup>30</sup> Consumer advocates assert that it is this stricter underwriting, associated not with trends in tort law but with falling investment income from relatively low interest rates, that is the principal cause of the drastic premium increases, mid-term cancellations, and scarcity of liability insurance. NICO contends that the industry is attempting to use the tort system as a scapegoat for a fiscal crisis that is largely self-imposed.<sup>31</sup>

NICO has called for an investigation by the Department of Justice to determine if insurance companies are illegally boy-

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<sup>29</sup> Thus, high underwriting losses could be offset by high investment income. See NICO NEWSLETTER, THE CYCLE: A SPECIAL REPORT 4 (July/Aug. 1985).

<sup>30</sup> Nolan, *Study Analyzes Industry Woes*, J. Commerce, June 20, 1985, at 8A, col. 1.

<sup>31</sup> See NICO NEWSLETTER, THE CYCLE: A SPECIAL REPORT (July/Aug. 1985).

The property and casualty markets have now swung toward strict underwriting in the cycle of price-cutting and price-raising well known to the industry. In 1974-75, when the industry's profits hit a low point, property and casualty insurance rates increased dramatically. See STATISTICAL ABSTRACT, *supra* note 7, at 511 (net income before taxes).

The insurance industry's emphasis on the tort system distracts from recent rate increases in other lines of property and casualty insurance. Substantial rate hikes in lines not currently experiencing dramatic and sudden common law revision support NICO's thesis that the industry's cyclical swings account for much of the availability and price problems now plaguing consumers. For example, auto insurance rates for the year ending in August 1985 were up 11.1% over the fiscal year, compared with a 3.6% rise in the Consumer Price Index. *Auto Insurance Costs Outpace CPI*, J. Commerce, Sept. 3, 1985, at 1A, col. 4. Aircraft manufacturers, despite improvement of their safety records, witnessed premium increases of over 2000% in the last four years. *Carpenter, Aircraft Makers Consider Self-Insured Liability Pool*, J. Commerce, Oct. 10, 1985, at 5A, col. 6. The cost of liability insurance for New York City apartment dwellers has risen as much as 400%, a phenomenon the New York State Department of Insurance Superintendent James Corcoran has ascribed to "a six- to 10-year rate war between insurance firms who quote very low prices to gain new business . . ." Rondinaro, *Apartment Premiums Are Soaring*, N.Y. Times, June 2, 1985, § 8, at 6, col. 1. These recent increases cannot be explained by tort law developments. Trends toward stricter product liability and no-fault accident laws began years ago. One study found that state legislatures' efforts at tort reform, enacted when liability insurers experienced similar capacity problems at the bottom of the last underwriting cycle, did not appreciably affect premium levels. See generally Sloan, *State Responses to the Malpractice Insurance 'Crisis' of the 1970s: An Empirical Assessment*, 9 J. HEALTH POL., POL'Y & L. 629 (1985).

cotting markets to pressure legislatures for tort reform.<sup>32</sup> There is mounting evidence that the industry's actions go beyond justified responses to the financial imperatives of the distressed liability markets. For example, the American Insurance Association (AIA)<sup>33</sup> has concluded that

[c]urrent insurance market conditions for day-care centers suggest a market in transition rather than chaos. The countrywide experience for . . . day nurseries appears to conform with the current loss experience for the majority of commercial insurance lines. . . . Although these losses clearly indicate the need for increased rates, they do not suggest that insurers should abandon the market.<sup>34</sup>

Industry spokesmen have conceded that some insurers hope to pressure courts by withdrawing from certain markets. Recently, industry executive John J. Byrne<sup>35</sup> publicly defended the industry's refusal to write coverage for some lines of business. "It will be best for the social good to let society know that the problem is not one for the insurance industry but for society as a whole. It is right for the industry to withdraw and let the pressures for reform build in the courts and in the state legislatures."<sup>36</sup>

## II. THE McCARRAN-FERGUSON ACT OF 1945

Even insurance transactions which are properly classified as interstate commerce, and thus are subject to federal regulation under the Commerce Clause, are regulated by state insurance departments. This is the result of the McCarran-Ferguson Act,<sup>37</sup>

<sup>32</sup> Such a boycott would be a violation of the Sherman Act, 15 U.S.C. §§ 1-7 (1982). The McCarran-Ferguson Act, 15 U.S.C. §§ 1011-15 (1982), legislated an exception to state regulation to permit federal antitrust oversight of certain practices, including the practice of boycotting markets. See *infra* text accompanying notes 37-46.

Ralph Nader has offered a less generous analysis of problems like the day-care problem, arguing that the industry is "going on strike," and charging excessive rates to garner higher profits and force changes in the tort system. See Young, *Critics Press Congress to License Anew Insurers*, J. Commerce, Sept. 20, 1985, at 1A, col. 2; Nader *Asserts Insurance Industry Inflates Rates and Denies Policies*, N.Y. Times, Aug. 16, 1985, at D15, col. 1.

<sup>33</sup> A national trade association representing over 175 property and casualty companies.

<sup>34</sup> *Child Care Hearings*, *supra* note 3 (statement of James Kimble, Senior Counsel, American Insurance Ass'n).

<sup>35</sup> Then Chairman and CEO of the Washington-based insurance company, Geico Corporation, and now the chief executive of the Fireman's Fund Corp.

<sup>36</sup> Nolan, *Insurers Told: Exit Some Lines*, J. Commerce, June 18, 1985, at 10A, col. 2.

<sup>37</sup> Act of Mar. 9, 1945, ch. 20, 59 Stat. 33 (codified as amended at 15 U.S.C. §§ 1011-15 (1982)).



which stated that "continued regulation and taxation by the several states is in the public interest . . . ."<sup>38</sup> This standardless delegation of insurance regulation to the states bars comprehensive federal oversight of the industry; current law prevents even routine federal antitrust oversight.

McCarran-Ferguson's grant of regulatory power to the states contains two important reservations. The first, section 1012(b),<sup>39</sup> permits federal regulation to the extent that states do not exercise their power to regulate the business of insurance in interstate commerce. Federal regulation under the section 1012(b) exception is relatively rare, in part because of the way the courts have interpreted that section. Courts have ruled that section 1012(b) does not require that *effective* state regulation exist to preclude federal antitrust law—it is sufficient that a state have a comprehensive regulatory scheme on the books.<sup>40</sup>

The second major exception to state regulation, section 1013(b), allows the Sherman Act to be applied to "any agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation."<sup>41</sup> Section 1013(b) applies not only to competi-

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<sup>38</sup> 15 U.S.C. § 1011 (1982). The McCarran-Ferguson Act of 1945 was Congress's response to a 1944 Supreme Court decision, *U.S. v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944). In *South-Eastern*, the Court held for the first time that an insurance company operated in interstate commerce and hence was subject to federal antitrust laws.

Congress hoped McCarran-Ferguson would assuage state fears about whether they would be allowed to continue to regulate insurance companies. *See* SEC v. National Securities, Inc., 393 U.S. 453, 459 (1969); H.R. Rep. No. 143, 79th Cong., 1st Sess. (1945). Congress established a preemptive regulatory role for the states, assuring them that federal law would not interfere with their regulation of the "business of insurance." Insurance companies, however, must still comply with the myriad federal laws that apply generally to all businesses. These include regulations promulgated by the SEC. *See, e.g.*, SEC v. National Securities, Inc., 393 U.S. at 461-64 (McCarran-Ferguson does not bar complaint of violation of SEC rules on fraud). *But see S.E.C. Guides Proposed on Insurance Policies*, N.Y. Times, Nov. 21, 1984, at D12, col. 5 (discussing proposed SEC guidelines to assist insurance companies in avoiding SEC jurisdiction). They also include the civil rights laws. *See, e.g.*, *Spirt v. Teachers Ins. & Annuity Ass'n*, 691 F.2d 1054 (2nd Cir. 1982), *vacated and remanded on other grounds*, 463 U.S. 1223 (1983). A recent Supreme Court decision may make insurance companies vulnerable to civil suits under the Racketeer Influenced and Corrupt Organizations Act (RICO), Pub. L. No. 91-452, 84 Stat. 941, *as amended*, 18 U.S.C. §§ 1961-68 (1982). *See* Sedima, S.P.R.L. v. Imrex Co., Inc., 105 S. Ct. 3291 (1985) (prior criminal conviction under RICO not a prerequisite for civil suits under RICO).

<sup>39</sup> 15 U.S.C. § 1012(b) (1982).

<sup>40</sup> *See* Ohio AFL-CIO v. Insurance Rating Board, 451 F.2d 1178 (6th Cir. 1971); *Fleming v. Travelers Indem. Co.*, 324 F. Supp. 1404 (D. Ma. 1980); *McIlhenny v. American Title Ins. Co.*, 418 F. Supp. 364 (E.D. Pa. 1976); *Proctor v. State Farm Mut. Auto Ins. Co.*, 406 F. Supp. 27 (D.D.C. 1975); *cf.* NATIONAL COMM'N FOR THE REVIEW OF ANTITRUST LAWS AND PROCEDURES, REPORT TO THE PRESIDENT AND ATTORNEY GENERAL, Jan. 22, 1979, Chapter 11 (calling for the repeal of McCarran-Ferguson's antitrust exemption).

<sup>41</sup> 15 U.S.C. § 1013(b) (1982).

tion between insurance companies, but also to relations between insurers and policyholders.<sup>42</sup>

The interplay between section 1012(b) and section 1013(b) is significant for proponents of greater federal oversight of the insurance industry. The courts have interpreted section 1013(b) in light of their interpretation of section 1012(b), holding that the mere existence of a state regulatory scheme, including state antitrust laws, is sufficient to preempt federal regulation.<sup>43</sup> This effectively weakens section 1013(b)'s exceptions to federal antitrust exemption and is contrary to evidence of Congress's intent to keep the antitrust exception narrow.<sup>44</sup>

The exceptions within McCarran-Ferguson's delegation of insurance regulation to the states are a subject of intense interest to both the industry and industry critics. Insurance providers remain vulnerable under section 1012(b) to the extent that an activity is deemed not to be "the business of insurance"<sup>45</sup> or to the extent that states choose not to regulate. The courts' narrow interpretation of section 1012(b), however, does not offer consumer advocates much room in which to maneuver. Furthermore, section 1013's exemption encompasses only a small subset of violations under the Sherman Act.<sup>46</sup>

The idea of a federally regulated insurance industry is not new. In 1905, Louis Brandeis vigorously opposed a legislative effort to establish federal regulation. He argued that "[t]he sole effect of a Federal Law would be . . . to free the companies

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<sup>42</sup> See *St. Paul Fire & Marine Insurance Co. v. Barry*, 438 U.S. 531, 538-51 (1978) (section 1013(b) language is broad and unqualified and encompasses protection of policyholders from acts of boycott, coercion, or intimidation). The meaning of a "boycott" in the context of McCarran-Ferguson is the same as in standard antitrust discourse: a concerted abstention or a concerted attempt to induce others to abstain. *Professional Adjusting Systems, Inc. v. General Adjustment Bureau, Inc.*, 64 F.R.D. 35 (S.D.N.Y. 1974).

<sup>43</sup> See, e.g., *Seasongood v. K & K Ins. Agency*, 548 F.2d 729, 734 (8th Cir. 1977) (antitrust immunity extends to complaint of Sherman Act violation in restraint of trade and "does not depend on the zeal and efficiency displayed by a state in enforcing its laws").

<sup>44</sup> See Weller, *The McCarran-Ferguson Act's Antitrust Exemption for Insurance: Language, History, and Policy*, 1978 DUKE L.J. 587, 589-97, 615-19. For a thorough discussion of McCarran-Ferguson's legislative history, see also *Crawford v. American Title Ins. Co.*, 518 F.2d 217, 220-22, 230-36 (5th Cir. 1975) (Godbold, J., dissenting).

<sup>45</sup> Compare *Metropolitan Life Ins. Co. v. Mass.*, 105 S. Ct. 2380, 2387-88, 2391 (1985) (rejecting a narrow reading of the term "business of insurance") with *Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205 (1979) (discussing the definition of "business of insurance").

<sup>46</sup> See, e.g., *Mackey v. Nationwide Ins. Co.*, 724 F.2d 419, 420-21 (4th Cir. 1984) (Sherman Act antitrust claim against insurer precluded by McCarran-Ferguson).

from the careful scrutiny of the commissioners of some of the states."<sup>47</sup> Early proposals for federal regulation failed because state regulation was regarded as more effective.<sup>48</sup> Some modern-day proponents of state regulation present a similar argument: "[S]tate insurance departments are closer to the people than a federal agency in Washington would be. Thus, state regulation is more apt to be responsive to the needs of the consumer."<sup>49</sup>

Most modern-day proponents of strict control of insurance companies would, however, favor federal regulation.<sup>50</sup> State regulation also imposes inefficiencies upon insurance companies. The insurance industry cannot lobby for tort reform through the intermediary of a federal agency, but must take its case directly to the state and federal legislatures.<sup>51</sup> The industry also must endure the inconsistencies and vagaries of fifty state regulatory jurisdictions.<sup>52</sup> Many independent studies decry the level of funding and staffing in state commissioners' offices and question the vigor with which states regulate the insurance industry.<sup>53</sup>

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<sup>47</sup> Quoted in *U.S. v. South-Eastern Underwriters Ass'n*, 322 U.S. 533, 594 (1944) (Jackson, J., dissenting).

<sup>48</sup> See, e.g., *FTC v. Travelers Health Ass'n*, 362 U.S. 293 (1960). "One of the major arguments advanced by proponents of leaving regulation to the states was that the States were in close proximity to the people affected by the insurance business and, therefore, in a better position to regulate that business than the Federal Government." *Id.* at 302.

<sup>49</sup> Trowbridge, *The Superiority of State Regulation*, in *INSURANCE DEREGULATION: ISSUES AND PERSPECTIVES* 20 (N. Weber ed. 1982).

<sup>50</sup> See *infra* note 53.

<sup>51</sup> Legislators confronted with policy decisions on tort reform and insurance regulation are deprived of the objective, detailed analyses on national trends in the insurance industry that could accompany federal regulation.

<sup>52</sup> "As much as one may complain about inefficient and sprawling bureaucracy, it is doubtful that regulation of national insurance companies by fifty different state bodies can be as cost-effective as uniform regulation by a single body." Shenefield, *Competition and the Insurance Industry: The New Frontier of Deregulation*, in *INSURANCE DEREGULATION: ISSUES AND PERSPECTIVES* 18-19 (N. Weber ed. 1982).

<sup>53</sup> See, e.g., CONFERENCE OF INSURANCE LEGISLATORS, *RISK, REALITY AND REASON* (Sept. 1983); GENERAL ACCOUNTING OFFICE, *ISSUES AND NEEDED IMPROVEMENTS IN STATE REGULATION OF THE INSURANCE BUSINESS* (1979); see also *Competition in the Insurance Industry: Hearings Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary*, 99th Cong., 1st Sess. 45-63 (1985) (statement of Andrew Tobias, author) (arguing that structural deficiencies exist in the insurance industry which require federal oversight of the insurance industry); *State Insurance Regulation, 1979: Hearings Before the Subcomm. on Antitrust, Monopoly and Business Rights of the Senate Comm. on the Judiciary*, 96th Cong., 1st Sess. 27, 37 (1979) (statement of Harry Havens, General Accounting Office) (offering alternatives for reform, including "a stand-by Federal role through the amendment of the McCarran-Ferguson Act . . . , the establishment of specific Federal standards through legislation, or the repeal of the McCarran-Ferguson Act and active Federal regulation").

## III. NICO'S PROPOSAL

The proposed Omnibus Reinsurance Act of 1985<sup>54</sup> would create federal pools of insurance for distressed markets in order to lessen the impact of the property and casualty's underwriting cycle on consumers. A federal agency would monitor the reinsurance program and set certain safety standards, thereby encouraging better risk management by consumers and insurance providers alike.<sup>55</sup> NICO's proposal entails greater federal involvement in the insurance industry, representing a welcome counterpoint to McCarran-Ferguson.

NICO's proposal does not address the industry's right to dictate the limits of policy coverage in all circumstances. The federal government could not, under NICO's proposal, force insurance companies to offer coverage. Rather, it makes the existence of such coverage much more likely by providing reinsurance<sup>56</sup> when insurance companies are unwilling to meet consumer demand in an insurance market. By granting the FTC the power to authorize reinsurance when companies attempt to withdraw from distressed markets, the proposal anticipates occasions when the consumer need for a specific type of insurance coverage will outweigh the industry's willingness to expand coverage at an affordable price.<sup>57</sup>

The NICO draft is modelled in part on the Urban Property Protection and Reinsurance Act of 1968 (Riot Reinsurance

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<sup>54</sup> On file at the HARV. J. ON LEGIS.

<sup>55</sup> The industry is also proposing federal legislation responsive to what it asserts has caused the current market dislocations in liability insurance. Senate bill 100 proposes a uniform product liability law that would lessen recovery in certain tort actions. S. 100, 99th Cong., 1st Sess., 131 CONG. REC. 217-23 (1985).

<sup>56</sup> Reinsurance is an important and frequent transaction that can help insurance companies distribute risks amongst each other. In a typical reinsurance agreement, one company agrees to indemnify another for all or part of the loss that the latter may incur under a set of policies. In exchange, the reinsurer receives a share of the premium for the ceding company's policies. In this way, insurers spread risks and the associated losses among themselves, effectively insuring each other. Reinsurance lends stability to insurance markets and encourages underwriting of high-risk or high-loss policies. Just as businesses would be reluctant to operate without insurance when the possibility of a large loss exists, so insurance companies' willingness to offer "risky" coverage is often determined by the availability of reinsurance.

<sup>57</sup> At the bottom of this cycle in price-cutting and underwriting standards, the property and casualty markets are unable to meet consumer demand. Industry analysts gauge this inability or lack of desire to write as much insurance as consumers want in terms such as a shortfall in "market capacity." The Insurance Services Office Inc. ("ISO"), an industry-rating and data-gathering service, recently predicted a \$65 billion shortfall in capacity in the next few years, although the New York State Insurance Superintendent has not endorsed ISO's prediction. See Nolan, *Casualty Key Concern of NAIC Meeting*, J. Commerce, Sept. 10, 1985, at 8A, col. 4.

Act).<sup>58</sup> The Riot Reinsurance Act created a federal reinsurance program for the specific peril of riots, to prevent the casualty and property insurers from withdrawing coverage from troubled inner city areas in the late 1960's. The NICO proposal would authorize the FTC to consider applications from any "manufacturer, service provider or any group . . . representing such"<sup>59</sup> or to investigate on its own initiative the availability and affordability of a line of insurance.<sup>60</sup> If the FTC determines that: (1) insurance is not available, or not "reasonably affordable;" (2) that assistance is necessary for the insurance consumers to have regular operations; and (3) that the availability of the product or service in question is "essential to promote the public health, welfare or the general commerce of the United States," the FTC may create and administer a pool of insurers for the distressed market and enter into reinsurance agreements.<sup>61</sup> Funding is provided from reinsurance premiums collected in the course of the program,<sup>62</sup> and from a one-quarter percent surcharge on all property and casualty premiums.<sup>63</sup> As in the case of the Riot Reinsurance Act, NICO's proposal requires rates that will create a self-funding reinsurance program, as opposed to an entitlement program.<sup>64</sup>

The NICO proposal is more general than the Riot Reinsurance Act and other federal insurance programs. The FTC's authority would be more extensive than that conveyed by other market-specific federal reinsurance programs. The FTC would be authorized to define the scope of the reinsurance program; subject to the availability of funds, the Commission could initiate new

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<sup>58</sup> Act of Aug. 1, 1968, Pub. L. No. 90-448, 81 Stat. 556, codified at 12 U.S.C. § 1749bbb (1970), amended by Act of Dec. 31, 1970, Pub. L. No. 91-609, 84 Stat. 1789, codified at 12 U.S.C. § 1749bbb (1975). Telephone interview with Timothy Hogan, author of the NICO proposal (Oct. 6, 1985).

For a general discussion of the riot reinsurance program, see *Oversight on the Reauthorization of the Flood Insurance Program and the Extension of the Crime and Riot Reinsurance Programs: Hearing Before the Subcomm. on Insurance of the Senate Comm. on Banking, Housing, and Urban Affairs*, 96th Cong., 2d Sess., 341 (1980) (background memorandum to NAIC).

<sup>59</sup> Omnibus Reinsurance Act § 1(a) (1985) [hereinafter cited as NICO proposal].

<sup>60</sup> *Id.* at § 1(b).

<sup>61</sup> *Id.* at § 1(d)(1).

<sup>62</sup> The federal government actually made over \$125 million administering the riot reinsurance program. See *Hearings on S. 1022 Before the Subcomm. on Housing and Urban Affairs of the Senate Comm. on Banking, Housing, and Urban Affairs*, 97th Cong., 1st Sess. 11, 283 (1981) (statement of the Alliance of American Insurers and the National Ass'n of Mutual Insurance Companies).

<sup>63</sup> NICO proposal at § 5(b)(4)(A).

<sup>64</sup> *Id.* at § 5(b).

programs based on whatever market dislocations occur.<sup>65</sup> This would be a welcome expansion of federal oversight of and commitment to continuous insurance coverage.

NICO's proposal establishes the eligibility of certain distressed markets for federal reinsurance: "to further the purposes of this act and in recognition of the critical situation facing both day-care centers in insuring for the specific peril of child abuse and nurse-midwives in obtaining medical malpractice insurance, the Congress makes the necessary determination for the Commission" on the above eligibility guidelines.<sup>66</sup> The proposal also seeks to prevent the reinsurance program from discouraging safety improvements. The FTC must establish safety standards as a prerequisite for the program<sup>67</sup> and refuse to reinsure any business the Commission determines is too risky.<sup>68</sup> A subordinate Bureau of Competition would review the program's progress and, at Congress's request, investigate and report on the current market status of product lines under the Commission's jurisdiction.<sup>69</sup>

NICO's proposal would not solve the problem of inadequate regulation of the insurance industry. In strategic terms, the proposal serves the defensive purpose of "buy[ing] time to allow for substantive review of the contemporary tort system . . . . Congress and the states will then have time to perform careful laser surgery to excise any abuses rather than undertaking radical heart transplants under the duress of doctors walking off the job or day-care centers shutting down."<sup>70</sup> The proposal is limited to liability insurers, but indirectly moves the whole industry closer to comprehensive federal regulation by establishing greater federal involvement in the property and casualty markets. It reaches beyond the current crisis and seeks to create a structure for dealing with the capacity problems the property and casualty industry's underwriting cycle causes. It is not a full-fledged attack on Congress's policy of state regulation. The FTC's Bureau of Competition would have some freedom to investigate peripheral issues, but its purview would nevertheless

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<sup>65</sup> *Id.* at § 1(d)(1).

<sup>66</sup> *Id.* at § 1(d)(2).

<sup>67</sup> *Id.* at § 1(d)(3)(A).

<sup>68</sup> *Id.* at § 3(b)(1)(C). The NICO proposal unfortunately does not articulate standards for uninsurability.

<sup>69</sup> *Id.* at § 7(b)(1).

<sup>70</sup> NICO NEWSLETTER, THE CYCLE: A SPECIAL REPORT 4 (July/Aug. 1985).

be limited to "distressed" markets, as determined by the FTC.<sup>71</sup> More comprehensive, routine federal oversight of the insurance industry, designed to anticipate and prevent less severe crises or market dislocations in the life insurance markets, would require an even more ambitious assault upon McCarran-Ferguson's delegation of insurance regulation to the states.

#### IV. FEDERAL REGULATION OF INSURANCE

[C]ompanies want enough regulation to say they're regulated, but not enough to keep them from doing as they damn please.—Tennessee State Insurance Commissioner John C. Neff, October 1985.<sup>72</sup>

Some industry spokesmen are beginning to wonder if greater federal regulation of insurance might not be in order.<sup>73</sup> Perhaps not coincidentally, some states have acted to bar mid-term cancellations of policies, lack of proper notice before non-renewals, and large premium increases.<sup>74</sup> These movements toward greater oversight of the industry should help redress the imbalances in an industry more responsive to its internal underwriting cycle than to important consumer needs.

The merits of NICO's legislative proposal rest in large part on whom one believes—the industry or consumer advocates—on the issue of why liability insurance consumers are unable to find reasonably priced insurance. An examination of past underwriting standards justifies the conclusion that the industry's exclusive focus on the tort system is simplistic and misleading.<sup>75</sup>

The business of insurance is the equitable distribution of risks.<sup>76</sup> Insurance companies tend to be very conservative and

<sup>71</sup> NICO proposal at § 7(b)(1).

<sup>72</sup> Quoted in *Tougher Rules*, *supra* note 1, at 5A, col. 2.

<sup>73</sup> For example, the President of American International Group, Inc., M.R. Greenberg, recently suggested, albeit hesitantly, that insurance companies should be given a choice on whether to be state or federally regulated. "I thought I'd never hear myself say that, but I'm coming very close to saying that." Herbert, *AIG Head Urges Tort Reform*, J. Commerce, Sept. 24, 1985, at 8A, col. 1.

<sup>74</sup> New Jersey Governor Thomas Kean declared an emergency on Sept. 17, 1985, enabling him to amend the state insurance regulations to forbid withdrawal of coverage from whole lines of business and mid-term premium and coverage modifications within individual policies. See Nolan, *NJ Acts to Curb PIC Practices*, J. Commerce, Sept. 19, 1985, at 8A, col. 1. (also discussing state regulatory reform efforts in Florida and Oregon).

<sup>75</sup> See *supra* note 31, text accompanying notes 33–36.

<sup>76</sup> If, as insurance industry spokesmen insist, a major cause of the liability crisis is the destabilizing, unpredictable nature of court decisions in the affected lines, the industry should welcome NICO's plan. To the extent that the industry's withdrawal from whole lines of business and abrupt increases in premium rates is motivated by other factors, the industry has little to lose from passage of NICO's proposal other than the opportunity to use the tort system as a scapegoat.

risk-averse.<sup>77</sup> From the perspective of an industry free of federal regulation, court decisions affecting the industry may seem more sudden, intrusive, or threatening. The property and casualty industry's complaint is nevertheless a peculiar one for a business enterprise founded on analyzing and mastering risk:

It is true, of course, in the insurance industry, as in any other, that no one can guarantee what the judicial decisions of tomorrow may bring. But insurance executives appear to demand a higher degree of certainty in judicial matters than in any other area of business. It is difficult to see how such a demand is justified.<sup>78</sup>

Court decisions that are responsive to the insurance consumer's expectations should have become regarded as routine long ago.

The property and casualty insurer, if aware of the rule of law in advance, can adjust future premium rates to account for changes. Rates will no doubt rise if average jury awards increase, but the industry's specific claim that the risk associated with the magnitude of these awards is prohibitive or incalculable underestimates the skills of the actuaries that analyze the companies' claim risks.

Courts have made decisions on the proper scope of insurance liability, and have thereby helped determine the shape and social role of the industry, without meaningful federal guidance. The McCarran-Ferguson Act has not prevented, nor could it prevent, courts from resolving disputes properly before them. Yet, the absence of comprehensive federal regulation has prevented the formation of a coherent, uniform set of regulations to guide courts in deciding given cases. Because Congress's delegation of state insurance regulation was standardless, courts have had to assume substantial initiative in determining McCarran-Ferguson's effect on other federal laws and federal policy goals.<sup>79</sup>

Even if one assumes that the unpredictable nature of the tort system has created the current availability and affordability problems in the liability market, the proper strategy is not to pressure courts and legislatures to adopt rigid rules unfavorable to tort victims. The harms underlying child abuse lawsuits and toxic torts will not disappear in the near future. Precipitous reforms of the tort system may not provide a full discussion of

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<sup>77</sup> The property and casualty field is not, by any reasonable measure, a particularly high-risk business. See J. WILSON & J. HUNTER, *supra* note 28, at 76-96.

<sup>78</sup> Shenefield, *supra* note 52, at 17.

<sup>79</sup> See *supra* text accompanying notes 39-53.



the important public policy issues regarding how certain liability risks should be distributed. Pressures for a rollback in insurer liability are antithetical to many consumers' needs.<sup>80</sup> There should be an institutional process that will incorporate the needs of policyholders, as well as the interests of insurers, into comprehensive policy decisions.

One industry observer noted that "[t]he McCarran-Ferguson Act admittedly has had the useful effect of making it possible for the states to serve as laboratories for testing different types and degrees of regulatory supervision over the industry."<sup>81</sup> The results from the experiment with state regulation are in. Despite the best efforts of understaffed and underfunded state insurance departments, a more fundamental change in the insurance industry than NICO's proposal is warranted. Day-care centers, municipalities, doctors, nurse-midwives, product manufacturers, transit authorities, and state governments all depend on continuous and affordable coverage. Because such a broad cross-section of the public is affected, some type of legislative response is inevitable. State legislatures are already passing remedial measures,<sup>82</sup> but the seriousness of the situation, the need for a thorough and unified response, and the need for federal oversight to prevent such market dislocations militate for more than a piecemeal approach to a national problem.

Consumer advocates such as NICO should not have to sponsor national legislation each time they wish to be heard, nor should they be forced to wage fifty-state legislative campaigns for reform of a national industry undergoing a national crisis. Under the status quo, important questions of public policy are decided with little or no consumer input.<sup>83</sup> State regulations

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<sup>80</sup> By contrast, NICO's suggestion that risk management be a required part of the federal reinsurance program (NICO proposal at § 1(d)(3)(A)) reinforces insurers' and consumers' common interest in lessening liability exposure.

<sup>81</sup> Shenefield, *supra* note 52, at 15.

<sup>82</sup> See *supra* note 74.

<sup>83</sup> State insurance commissioners have not been as receptive to consumer input as one would hope. NAIC recently vetoed a resolution providing funding for consumer participation in its proceedings. Herbert, *NAIC Denies Funding to Consumer Groups*, J. Commerce, June 14, 1985, at 8A, col. 3.

Larger consumers have been able to influence indirectly insurance market practices by threatening to leave or actually leaving the market. Fifteen U.S. corporations recently formed their own underwriting firm and withdrew from the private insurance market. Nolan, *15 Major Firms Form Insurer*, J. Commerce, July 5, 1985, at 1A, col. 3. Twenty-five hundred western banks, disenchanted with premium increases and an ever-restricting scope of coverage, created a captive insurance company to supply them with private liability insurance. Nolan, *Banks Form Insurance Company*, J. Commerce, July 11, 1985, at 8A, col. 1. Aircraft manufacturers have been studying a scheme of self-insurance

have, no doubt unwittingly, become an institutional barrier to greater consumer input. In a 1978 antitrust case, Justice William Brennan stated:

It fairly may be questioned whether the consumers in question . . . have a meaningful chance of influencing the state legislature to outlaw on an ad hoc basis whatever anticompetitive practices petitioners may direct against them from time to time. . . . In enacting the Sherman Act, however, Congress mandated competition as the polestar by which all must be guided in ordering their business affairs. It did not leave this fundamental national policy to the vagaries of the political process . . . .<sup>84</sup>

This line of reasoning applies directly to McCarran-Ferguson's antitrust exemption, but it is also applicable to important public policy decisions that the industry now makes, with minor exceptions, independently of federal oversight. Federal regulation is one way of assuring greater consumer access to and input in important policy decisions on insurance. There should be a federal agency which routinely studies, investigates, and regulates the national trends in the insurance industry.

## V. CONCLUSION

Insurance has changed dramatically since the late 17th Century, when shipowners met in Edward Lloyd's London coffee-house to spread the risks of business among themselves. It has changed dramatically in the last four decades since McCarran-Ferguson was enacted, evolving in large part independently of federal regulation. The industry and insurance consumers have not been able to avail themselves of the benefits of long-term planning that federal oversight might offer. Many other factors must be weighed before a definitive verdict can be rendered on the policy underlying McCarran-Ferguson. However, the current liability crisis, and NICO's legislative response, is an illustrative and compelling example of the problems created by McCarran-Ferguson's standardless delegation to the states of regulatory power over such an important industry. Insurers have for too long enjoyed too broad an exemption from federal anti-trust scrutiny in particular, and federal oversight and policy

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for product liability coverage. Carpenter, *Aircraft Makers Consider Self-Insured Liability Pool*, J. Commerce, October 10, 1985, at 5A, col. 6.

<sup>84</sup> *Lafayette v. Louisiana Power & Light Co.*, 435 U.S. 389, 406 (1978).

formation in general. Important public policy questions inherently national in scope, such as the proper scope and function of liability insurance coverage, should be resolved at the federal level after both the insurers' and the consumers' viewpoints have been considered. NICO's proposal is a welcome first step toward greater federal oversight of the insurance industry. More fundamental change, however, is in order. The policy of state regulation of a clearly national market, as embodied in McCarran-Ferguson, should be replaced by comprehensive and affirmative federal regulation of the insurance industry.<sup>85</sup>

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<sup>85</sup> The current liability crisis is only one of many compelling arguments for federal regulation of the insurance industry. For example, although life insurance companies do not experience the severe underwriting cycles of the property and casualty markets, life insurance is a national industry with national trends most effectively and efficiently regulated on the national level. *Cf. supra* note 16.



## BOOK NOTE

### DANCING IN THE DARK: THE PHILOSOPHICAL MOVES OF RONALD DWORKIN

*Review by Brian S. Bix\**

A MATTER OF PRINCIPLE. By *Ronald Dworkin*. Cambridge, Mass.: Harvard University Press, 1985. Pp. 425, notes, index. \$25.00 cloth.

Ronald Dworkin<sup>1</sup> is perhaps the most important figure in current legal theory.<sup>2</sup> Writings such as his 1977 work, *Taking Rights Seriously*,<sup>3</sup> set the terms of the current debates on judicial process, the nature of law, and the nature of liberalism. His 1985 book, *A Matter of Principle*, contains nineteen essays which elaborate, modify, and defend ideas presented in the earlier collection.<sup>4</sup>

While *A Matter of Principle* covers a wide variety of areas, I will focus on three specific topics: Dworkin's theory of rights; his theory of judicial process; and his ideas about the nature of law and legal theory. These areas have traditionally been the most important to English-language legal philosophers, and Dworkin's writings on these topics have elicited the most critical responses. Furthermore, these essays encompass the greatest evolution in Dworkin's ideas since the publication of *Taking Rights Seriously*.<sup>5</sup>

I will argue that in each area Dworkin puts forward a subtle and provocative analysis, but that the analysis eventually fails

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<sup>1</sup> Professor of Jurisprudence, University College, Oxford University.

<sup>2</sup> His influence is demonstrated by the volume and ideological variety of the secondary writings. Dworkin's writings have been criticized by libertarians, *see, e.g.*, Macedo, *The Public Morality of the Rule of Law: A Critique of Ronald Dworkin*, 8 HARV. J.L. & PUB. POL'Y 79 (1984); conservatives, *see, e.g.*, R. POSNER, THE ECONOMICS OF JUSTICE 107-15 (1981); communitarians, *see, e.g.*, M. SANDEL, LIBERALISM AND THE LIMITS OF JUSTICE 136-47 (1982); liberals, *see, e.g.*, Richards, *Taking Rights Seriously Seriously: Reflections on Dworkin and the American Revival of Natural Law* (Book Review), 52 N.Y.U. L. REV. 1265 (1977); and radicals, *see, e.g.*, Gabel, Book Review, 91 HARV. L. REV. 302 (1977).

<sup>3</sup> R. DWORKIN, *TAKING RIGHTS SERIOUSLY* (1977) [hereinafter cited as RIGHTS].

<sup>4</sup> Sixteen of the essays were previously published elsewhere; two are based on speeches; and one is a new essay based on two previously published articles. R. DWORKIN, *A MATTER OF PRINCIPLE* 399-417 (1985) [hereinafter cited as PRINCIPLE].

<sup>5</sup> Among the matters in Dworkin's book that I cannot fully discuss here, but which are worth noting, are an interesting justification of state support for the arts, PRINCIPLE, *supra* note 4, at 221-33, and a provocative critique of the concept and use of legislative intent in statutory and constitutional interpretation, *id.* at 19-23, 38-55.

because of its own conceptual weaknesses. There is one common element to the analyses' flaws: Dworkin's arguments move too casually between descriptions of what is and theories of what should be, and these movements disguise the inadequacies of Dworkin's analysis.<sup>6</sup>

## I. DWORKIN'S THEORY OF RIGHTS

Dworkin's major project has been to construct a liberal theory of rights. According to Dworkin, a theory of rights should be delineated only relative to a background political theory.<sup>7</sup> Rights can be seen as trumps with which individuals may veto or modify decisions that would otherwise be justified by the relevant background theory.<sup>8</sup> We should select rights systems in the context of the society's background theory; we are looking for the optimal political package, a package including a background justification and limits on that justification. Different background theories will require different sets of trumps.<sup>9</sup>

Dworkin asserts without argument—apparently believing the matter to be self-evident—that the most pervasive form of legal justification in America is utilitarianism.<sup>10</sup> He argues that legal decision-making, as witnessed in American legal documents and political rhetoric, relies heavily on a utilitarian justification: that the greatest good for the greatest number is the ultimate goal of any legal decision.<sup>11</sup>

On its face, utilitarianism offers the egalitarian ideal typified by a voting booth. The preferences of each citizen are given equivalent weight to the preferences of every other citizen. Yet,

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<sup>6</sup> Cf. Ely, *Professor Dworkin's External/Personal Preference Distinction*, 1983 DUKE L.J. 959, 984. "We hear two quite different tunes from Dworkin . . . By now, however, you will have noticed that the tune varies with the occasion." *Id.* Cf. Shiffrin, *Rights v. Goals* (Book Review), N.Y. Times, June 9, 1985, § 7 at 25, col. 1. "Liberalism continues to be a matter of principle [for Dworkin], except the principle changes from chapter to chapter." *Id.*

<sup>7</sup> Dworkin, *A Reply by Ronald Dworkin* in RONALD DWORKIN AND CONTEMPORARY JURISPRUDENCE 247, 281–82, 289–91 (M. Cohen, ed. 1984) [essay hereinafter cited as *Reply*]. *Ronald Dworkin and Contemporary Jurisprudence* is a collection of previously published essays which criticize various aspects of Dworkin's writings; it also contains an essay Dworkin wrote especially in order to respond to the criticisms.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* at 281.

<sup>11</sup> See generally J.S. MILL, UTILITARIANISM (1861). Dworkin claims on numerous occasions that he himself is not a utilitarian and that he believes utilitarianism to be a weak theory. He does not claim to offer a substitute theory. PRINCIPLE, *supra* note 4, at 181–204.

from such an egalitarian process, very anti-egalitarian decisions could result. Utilitarianism could be used to justify decisions denying Jews the right to own land, Communists the right to express their beliefs, or homosexuals the right to sexual liberty.<sup>12</sup> When all the votes were counted or when all of the harms, preferences, and pleasures were aggregated, these simply were the resulting decisions. Dworkin's theory of rights would allow citizens to trump these decisions, which would otherwise be justified by the background political theory of utilitarianism.<sup>13</sup>

Dworkin bases his theory of rights on what he calls the "right of equal concern and respect" (pp. 192-94, 203-13).<sup>14</sup> Equal concern and respect is one type of equality, distinct from, for example, equal opportunity or equal distribution of goods. According to this theory, the government must treat its citizens as equals, establishing neither aristocracies nor slave-castes (pp. 180-83, 272-78).<sup>15</sup>

To determine when Dworkin's citizens can assert their right or trump, one must examine the motivation behind the governmental action. Dworkin would allow the rejection of decisions based on "improper" motives, such as a notion of inferiority. For example, if the government restricts pornography out of a belief that people who like pornography are inferior persons,

<sup>12</sup> See RIGHTS, *supra* note 3, at 234-37.

<sup>13</sup> See *id.* at 90-94. Sometimes Dworkin seems to argue that these rights are simply correctives for the counterintuitive or unjust results that would regularly come from a utilitarian system. PRINCIPLE, *supra* note 4, at 369-72; Reply, *supra* note 7, at 281-82, 289-91. At other times, Dworkin seems to argue that these rights are implicit within the theory of utilitarianism. Reply, *supra* note 7, at 284-86. Either way, the catch-phrase which is the basis of Dworkin's theory of rights is the "right of equal concern and respect." PRINCIPLE, *supra* note 4, at 192-94, 203-13; RIGHTS, *supra* note 3, at 180-83, 272-78.

<sup>14</sup> See RIGHTS, *supra* note 3, at 180-83, 272-78. Cf. *City of Cleburne, Texas v. Cleburne Living Center*, 105 S. Ct. 3249, 3260-63 (1985) (Stevens, J., concurring). In *Cleburne*, Justice Stevens argued that there need only be one standard of analysis (rather than two or three) under the Equal Protection clause: conformity to the "sovereign's duty to govern impartially." *Id.* at 3261. As elaborated, Justice Stevens' standard resembles the duty Dworkin imposes upon governments to treat their citizens with equal concern and respect. The two standards also share some of the same weaknesses: they are both sufficiently general that they do not yield a demonstrable result in particular cases.

<sup>15</sup> Dworkin concedes that "equal concern and respect" does not logically entail government neutrality towards its citizens' view of the good life. PRINCIPLE, *supra* note 4, at 191-92. Indeed, Dworkin envisions what he calls the conservative view of equality, in which a government has a dogmatic view of what constitutes the good life and imposes that vision on its citizens. *Id.* at 191. Dworkin, however, endorses a liberal view of equality, which requires government neutrality towards its citizens' views of the good life. *Id.* at 191-93. Dworkin is not always clear on what he means by "liberalism." His most comprehensive statement is found in the essay "Liberalism," *id.* at 181-204.

then that restriction would not be allowed (pp. 354–55). If, on the other hand, the restriction were based on evidence that pornography leads to violence, the restriction would be allowed (pp. 354–55).<sup>16</sup>

The difficulty lies in separating proper from improper motives when analyzing the intent of decisionmaking institutions, such as Congress, and when examining the motivations behind a person's moral judgments (pp. 356–59).<sup>17</sup> Dworkin would create, locate, or attribute individual rights whenever officials justify an infringement on an individual group's liberty because either the officials believe that the group is inferior, or because a majority of citizens believe the group to be inferior (p. 354). Citizens have a *right* to prevent their liberty from being infringed on this basis alone. Dworkin terms this the "right to moral independence":

People have the right not to suffer disadvantage in the distribution of social goods and opportunities, including disadvantage in the liberties permitted them by the criminal law, just on the ground that their officials or fellow-citizens think that their opinions about the right way for them to lead their own lives are ignoble and wrong (p. 353).

To illustrate: laws against homosexuality and against pornography are often justified by the majority's belief that those in-

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<sup>16</sup> See RIGHTS, *supra* note 3, at 270–72. Dworkin discusses as another example the well-known affirmative action case *Regents of the Univ. of Cal. v. Bakke*, 438 U.S. 265 (1978). Dworkin argues that Bakke had no right to be admitted to the university as long as that denial stemmed from an affirmative action program. PRINCIPLE, *supra* note 4, at 293–303. Dworkin's analysis begins with the background justification that affirmative action programs are needed because less severe means have failed to achieve the important societal goal of racial equality. *Id.* at 294–95. The question then becomes whether Bakke has some right which trumps the background justification of the affirmative action program.

In concluding that Bakke has no right not to be denied an important social benefit solely on the basis of race, *id.* at 300–02, Dworkin distinguishes racial discrimination, against which citizens would have a trump-right, from affirmative action, against which citizens would not have such trump-rights. *Id.* at 301. Predictably, Dworkin's distinction turns on the decisionmaker's motivation in denying admission. When the law schools refused admission to black students, the refusal was justified by the belief that black citizens were less worthy than white citizens. But when a legislature or an administration that is dominated by white citizens decides, against their apparent interests, to institute an affirmative action program, that program cannot be said to be based on the belief that white citizens are less worthy than black citizens because whites themselves made the decisions. *Id.* at 301. (Under Dworkin's analysis, it is possible that black students might have a right against the implementation of affirmative action programs; see *Bakke*, 438 U.S. at 356–62 (opinion of Brennan, White, Marshall, and Blackmun, JJ.) (possible stigma of affirmative action upon its beneficiaries)).

<sup>17</sup> See Ely, *Legislative and Administrative Motivation in Constitutional Law*, 79 YALE L.J. 1205 (1970); Ely, *The Centrality and Limits of Motivation Analysis*, 15 SAN DIEGO L. REV. 1155 (1978).



volved in the prohibited activities are less deserving of respect (p. 354).<sup>18</sup> Even if this claim is ostensibly absent, and the advocates of the laws maintain only that they are offended or bothered by the fact that other citizens are participating in those activities, Dworkin argues that their justification still lacks legitimacy. The fact of being "offended" cannot be so easily separated from the right of equal concern and respect. To Dworkin, the feeling of offense derives, at some level, from the belief that homosexuals and people reading obscene literature are less worthy of respect (pp. 353–65).<sup>19</sup>

For Dworkin, there is no general right to liberty because there is no general reason to believe that every infringement is justified by a lack of equal concern and respect (p. 366). Dworkin rejects theories which attempt to base a system of rights upon a basic right to liberty, arguing that such theories provide no basis for preserving important rights. The only basis these theories can offer for granting rights against certain infringements of liberties and not others is that some actions infringe on our liberties more than do others (pp. 188–89).<sup>20</sup> The liberties we most want to protect, however, are not the ones that are most often infringed. We value the right to free speech, for example, more highly than our right to drive the wrong way on a one-way street, even though infringement of the latter right occurs more often.<sup>21</sup> Therefore, a justification independent of the extent of depriva-

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<sup>18</sup> The modernist feminist critique of pornography asserts that pornography causes men to disrespect women and should be banned on those terms. See A. Dworkin, *Against the Male Flood: Censorship, Pornography and Equality*, 8 HARV. WOMEN'S L.J. 1 (1985); MacKinnon, *Pornography, Civil Rights, and Speech*, 20 HARV. C.R.-C.L. L. REV. 1 (1985); see also *American Booksellers Ass'n, Inc. v. Hudnut*, 771 F.2d 323 (7th Cir. 1985) (striking down the feminist anti-pornography ordinance as unconstitutional). Despite the similarity of argument terms, the feminist critique of pornography would not fit into Ronald Dworkin's analytical structure to justify the banning of pornography. Ronald Dworkin's rights apply against government actions which are based on unequal respect, not against private actions which are based on—or which might cause—unequal respect.

<sup>19</sup> Dworkin's theory of rights thus parallels in many ways John Hart Ely's procedural derivation of constitutional rights. Ely and others have noted this similarity. See Ely, *supra* note 6, at 979–81; Macedo, *supra* note 2, at 95–96; Sager, *Rights Skepticism and Process-Based Responses*, 56 N.Y.U. L. REV. 417, 429–31 (1981); see also PRINCIPLE, *supra* note 4, at 57–69.

<sup>20</sup> Such an approach views infringements on liberty in the same way that utilitarians view happiness: as comparable between persons and as quantifiable over groups of persons. Thus the more an action infringes liberty, the greater the justification citizens have for claiming a right against it. PRINCIPLE, *supra* note 4, at 188–89; RIGHTS, *supra* note 3, at 270–71.

<sup>21</sup> RIGHTS, *supra* note 3, at 270–71.

tion of liberty is needed to secure those rights we believe to be important.<sup>22</sup>

Much of Dworkin's theory of rights seems counterintuitive; it does not conform to the social and political background values which have shaped our notions about what rights are. For Dworkin, rights are the means to prevent liberty from being restricted for a "bad" reason. It is not the activity limited that is important to Dworkin, but rather the reason (stated, implicit, or probable) for the limitation (pp. 359-72). Most people, however, in deciding which activities or choices they would want protected, focus on the activity's intrinsic value to the individual. The investigation into the motive or reason for any limitation on liberty would be relevant only to determine whether there was a collective interest of sufficient weight and urgency to override the individual's interest in the right.

Dworkin's theory of rights also seems unconventional because it does not comfortably cover the rights which seem to be considered important by conservatives—liberty, autonomy, and property<sup>23</sup>—or by liberals—religious liberty and freedom of expression. Instead, Dworkin's theory tends to generate rights which protect the right of non-conforming citizens to follow their own tastes and inclinations in the face of disapproval by an active moral majority.<sup>24</sup>

Dworkin's argument that rights must be analyzed in a political context, although probably justified, also seems unfamiliar to us. Dworkin sees no meaning in discussions of "natural rights" or "human rights," no purpose to rights abstracted from society and that society's political system (pp. 369-70). Discussions of rights become meaningful only when placed in the context of a society's optimal political package of background justifications and the need for limitations on such justifications (p. 370). It might be that a different political package exists in which rights would be unnecessary because the background justifications for the governmental actions would themselves be sufficient to reach appropriate or just results.

It seems unlikely that Dworkin can deduce his elaborate liberal program by way of investigations into procedure and mo-

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<sup>22</sup> *Id.*

<sup>23</sup> See Veatch, *Comment: On Taking Rights Still More Seriously*, 8 HARV. J.L. & PUB. POL'Y 109, 111 (1985); Macedo, *supra* note 2, at 93-97.

<sup>24</sup> See Veatch, *supra* note 23, at 110-11.

tivation.<sup>25</sup> For Dworkin's analysis to work in the way he wishes it to, he must prove that his analytical structure can distinguish between affirmative action and maximum working-hours legislation on the one hand (acceptable), and racial segregation and anti-homosexual legislation on the other (unacceptable).<sup>26</sup> It is my opinion, as well as that of most other writers, that he does not succeed.

Dworkin does not offer a sufficiently subtle analysis of the possible motivations for legislation that subjugates a minority sub-group to make his analytical structure work. He identifies the lack of equal concern and respect as the primary motivation for such legislation. A second type of motivation is selfishness: we have migrant workers and slaves so that our lives might be more affluent and so that we might avoid menial labor.<sup>27</sup> A third type of motivation is the belief that a society ordered according to the legislation would be closer to an ideal society. Dworkin seems to recognize the last two types of motivation, but he argues that they can be assumed to depend at some level on the primary motivation of unequal concern and respect (pp. 371–72).

It seems at least equally plausible, however, that these three motivations are simply different characterizations, each equally justifiable, derived from different viewpoints of the same action. Arguably, Dworkin bases his characterization of a piece of legislation on his opinion of that legislation: for Dworkin anti-homosexual legislation is undoubtedly the product of a lack of equal concern and respect; reverse discrimination and the *Lochner*<sup>28</sup> legislation are based on officials' views of how society ought to be. As many writers have pointed out, opposite characterizations in these cases would be equally justifiable.<sup>29</sup>

<sup>25</sup> See generally Sager, *supra* note 19, at 432–36.

<sup>26</sup> See Ely, *supra* note 6, at 959. See generally *id.* at 959–72.

<sup>27</sup> See Sager, *supra* note 19, at 429 & n.26, 433–34.

<sup>28</sup> *Lochner v. New York*, 198 U.S. 45 (1905).

<sup>29</sup> See Ely, *supra* note 6, at 959–72; Sager, *supra* note 19, at 432–36.

The pro-worker legislation of the turn of the century was in fact then seen as disrespecting workers and also as treating employers' contract rights less well than it treated workers' contract rights. See Pound, *Liberty of Contract*, 18 YALE L.J. 454, 454, 463 (1909). Whether a government action is seen as granting equal concern and respect or as simply reinforcing inequalities behind a mask of formal equal treatment may change over time with changes in our ways of viewing reality or discussing justice. See L. TRIBE, *CONSTITUTIONAL CHOICES* 14–20, 165–87, 238–45 (1985).

At a deeper level of analysis, Dworkin's examination exemplifies a common liberal misunderstanding of traditional conservative positions. See Tushnet, *Sex, Drugs, and Rock 'n' Roll: Some Conservative Reflections on Liberal Jurisprudence* (Book Review),

Dworkin's formulation of motive, that we think less of those who commit a wrong act, simply does not correspond to actual experience. For example, when parents forbid their children from engaging in some activity, the parents do not imply that their children are less worthy of concern and respect for having engaged in that activity. Consider also a legislature's action restricting access to pornography or contraceptives. Given that the legislature may suspect that a large portion of its constituents read or use such material, the legislature's action cannot readily be seen as a show of disrespect to all those who read pornography or use birth control.<sup>30</sup> Our experience is that we can—and do—separate our evaluations of the actor from our evaluations of the act.

Ultimately, the basic assumptions of Dworkin's rights analysis can be questioned.<sup>31</sup> The justification for government actions in

82 COLUM. L. REV. 1531 (1982). Liberals do not understand the conservative view of socio-political reality, a view that sees institutions, ideology, and morality each as organic wholes, greater than the sum of their parts. *Id.* at 1536–39. The liberal vision disaggregates the unities, and challenges the value and the validity of every individual component. *Id.*

The disaggregation analysis assumes that there must be a particular reason for, *e.g.*, anti-homosexual legislation and that this reason must stand up on its own to philosophical and constitutional scrutiny. A conservative would resist this divide and conquer strategy. Conservatives view legislating morality as part of the moral structure of society; to attack part of the structure is to wage war on the structure itself. Tushnet, *supra*, at 1542–43. For our purposes, it is sufficient to note that a conservative would not acquiesce in Dworkin's characterizations of conservative legislation as being based on the belief that certain groups are less worthy of concern and respect.

In a recent book review, Dworkin seemed more receptive to "organic" analyses. See Dworkin, *The High Cost of Virtue* (Book Review), 32 N.Y. REV. OF BOOKS, Oct. 24, 1985, at 37, 37–39.

<sup>30</sup> Ely, *supra* note 6, at 971 & n.43.

<sup>31</sup> There is an ongoing debate between Dworkin and H.L.A. Hart which exposes Dworkin's vacillation in this area. The debate centers on Dworkin's argument that external preferences (in other words, what one individual thinks should happen to someone else) should not be counted as part of Dworkin's "corrected" utilitarian calculus. Dworkin argues that counting such preferences denies equal concern and respect, for it counts both a citizen's preferences for herself and her preference that other persons be denied certain goods. Dworkin describes this as a form of "double-counting." RIGHTS, *supra* note 3, at 233–35.

Hart's counterargument is that, by discounting someone's preference at any point, we will be denying that person equal concern and respect. The equality of the utilitarian calculus lies in its counting of every citizen's preferences equally, without regard to the status of the citizen or to the value of the preference. Hart, *Between Utility and Rights*, in RONALD DWORKIN AND CONTEMPORARY JURISPRUDENCE, *supra* note 7, at 214, 219–24.

Dworkin responds that we should not confuse the utilitarian calculus with voting. PRINCIPLE, *supra* note 4, at 365–72. Hart's analysis makes sense in the context of voting, where every citizen gets only one vote. In utilitarianism, where all the citizen's preferences are counted, it does not seem so unjust to discount a citizen's external preferences, for her personal preferences on the issue will still be counted. *Id.* at 365–72. This dialogue illustrates the dependence of Dworkin's argument on utilitarian theory

America is not usually couched in terms of utilitarian theory. American political rhetoric does not speak of the intensities of citizens' preferences, nor do our decisionmakers try to consider more than one preference from each citizen on a given issue; both factors would be expected if our background justification were utilitarianism. The rhetoric is rather that of participatory democracy; the catchwords most often heard are majority rule, one person/one vote, equality of suffrage, and so on.

Dworkin's structure would therefore have to be remodeled by focusing on the rights needed to make optimal a political package in which the ostensible justification of collective actions is participatory democracy. John Hart Ely has made an elaborate attempt to justify rights in exactly this way. Ely depicts rights as internal correctives on democratic processes, just as Dworkin's rights were internal correctives on the utilitarian calculus.<sup>32</sup> Ely might be able to derive substantive rights from a correction of process;<sup>33</sup> however, Ely himself admits that the "right to be different"—the core set of rights within Dworkin's writings—cannot be so derived.<sup>34</sup>

## II. DWORKIN'S THEORY OF JUDICIAL PROCESS

Dworkin's theory of rights is integrally connected to his theory of judicial process. Dworkin argues that judges must characterize what the law is in given areas according to a certain methodology in order to express litigants' rights of equal concern and respect. Dworkin's proposed methodology is complex, but it fails on its own terms at a number of points due to structural flaws.

Before examining the flaws in Dworkin's analysis, it is necessary to understand the rights litigants have within Dworkin's system as well as the process by which Dworkin would have judicial decisions made. According to Dworkin, litigants have a right to judicial decisions based on "principle," an analysis of

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and the confusion that occurs when Dworkin's arguments are applied to contexts where utilitarian theories do not predominate. *See infra* text accompanying notes 31-34.

<sup>32</sup> J. ELY, *DEMOCRACY AND DISTRUST* (1980).

<sup>33</sup> *But see* Tribe, *The Puzzling Persistence of Process-Based Constitutional Theories*, 89 *YALE L.J.* 1063 (1980) (criticizing Ely's theory); Tushnet, *Darkness on the Edge of Town: The Contributions of John Hart Ely to Constitutional Theory*, 89 *YALE L.J.* 1037 (1980) (same).

<sup>34</sup> *See* Ely, *Democracy and the Right To Be Different*, 56 *N.Y.U. L. REV.* 397 (1981).

pre-existing individual rights, rather than “policy,” some calculation of which choice would contribute more to some general good.<sup>35</sup> As part of a government’s duty to treat its citizens with equal concern and respect, judges in Dworkin’s system may not settle litigation through retroactive “legislation.”<sup>36</sup> Litigants are entitled to consistency in judicial decisionmaking, and cases should be decided according to what the law is. To change the law, to decide X’s case differently today than the way the judge decided Y’s case yesterday (even if the change is justified by some utilitarian argument) is to treat X as being less worthy of respect than Y. Or so Dworkin argues.<sup>37</sup>

Two premises, for the most part unstated, underlie Dworkin’s argument for consistent, principled adjudication.<sup>38</sup> The first premise involves a Kantian notion that citizens should not be treated as means to an end. He rejects adjudication based on policy as opposed to principle because policy does not allow for sufficient respect to the parties. By Dworkin’s definition, adjudication based on policy considerations would use persons—or at least their rights—as means to various collective goals.<sup>39</sup> Without this first premise, it might be argued that an adjudication system that based legal decisions on maximizing some value, and applied this decision-mechanism equally in all cases, fulfilled the duty to treat litigants with equal concern and respect. Dworkin rejects this position.<sup>40</sup>

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<sup>35</sup> See Dworkin, “Natural” Law Revisited, 34 U. FLA. L. REV. 165 (1982) [hereinafter cited as “Natural” Law].

<sup>36</sup> Dworkin claims that one advantage of his rights thesis over legal positivism is that his approach avoids the retroactive application of law upon parties involved in a “hard case.” This argument has been rebutted in an excellent recent article by Kenneth Kress which seriously undermines Dworkin’s theory. Kress demonstrated that Dworkin’s approach—indeed, any approach that accepts both a coherence theory and the doctrine of precedent—also leads to the retroactive application of law. See Kress, *Legal Reasoning and Coherence Theories: Dworkin’s Rights Thesis, Retroactivity, and the Linear Order of Decisions*, 72 CALIF. L. REV. 369 (1984).

<sup>37</sup> “Natural” Law, *supra* note 35, at 185–87.

<sup>38</sup> This section is meant as a beginning of an answer to a question of origin: What might be the basis and the justification for choosing the right of equal concern and respect as the basic right in a moral system, and for interpreting that right one way rather than another?

<sup>39</sup> See “Natural” Law, *supra* note 35, at 187–88; *Reply*, *supra* note 7, at 267. Dworkin does not seem as bothered by the anti-Kantian aspects of the utilitarianism he condones outside the judicial context, for example, in legislative decisions not trumped by individual rights. Michael Sandel discusses this irony within the writings of liberal theorists like Dworkin and John Rawls. Their writings are based on Kantian notions of individual dignity, yet they seem surprisingly casual in condoning coercive collective decisions based on utilitarianism. See M. SANDEL, *supra* note 2, at 139–68.

<sup>40</sup> “Natural” Law, *supra* note 35, at 181–88.

Dworkin's second unstated premise is that adjudication should adhere to certain values and procedures because of the nature, purpose, and function of adjudication.<sup>41</sup> According to Dworkin, we have a different set of rights against the judiciary than we have against the legislature, apparently due to the different functions and values of adjudication. Arguments based on the nature of the judicial process resonate of the writings of Lon Fuller.<sup>42</sup> Without this second premise, it would be hard to justify Dworkin's distinction between rights against judges and rights against the legislature. It would also be hard to explain the emphasis Dworkin places on the litigant's right to consistent decisions.

In addition to claiming that litigants have a right to consistency in adjudication, Dworkin also argues that each case has a right answer.<sup>43</sup> Dworkin points out that within the context of adjudication, we feel confident in saying that particular results or arguments are better or more reasonable than other results or arguments. Dworkin admits that his right answer thesis could be rephrased in the following way: Of all the possible results, one result is the most reasonable of all (and although competent lawyers may disagree about *which* result is the most reasonable, they will agree that there is one most reasonable result).<sup>44</sup>

But how is a judge to choose *which* answer is right? In deciding cases, a judge faces an enormous volume of statutes, past cases from his or her jurisdiction, and past cases from other jurisdictions, all of which may offer inconsistent rules, principles, and holdings. In cases in which the law is not clear, Dworkin would have judges choose a characterization of the doctrine which "fit" the past cases (pp. 158-62). At a minimum, the characterization should adequately explain and justify most of the holdings of past cases in the area in question (pp. 158-66).

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<sup>41</sup> According to Dworkin, we have a right against the legislature based on general moral/political theory corresponding to whatever duties a government owes its citizens under such theories. Our rights against judges are narrower, constrained by past judicial decisions and legislative enactments. See *Reply*, *supra* note 7, at 256-59.

<sup>42</sup> Cf. Winston, *Taking Dworkin Seriously* (Book Review), 13 HARV. C.R.-C.L. L. REV. 201 (1978) (discussing the similarities between the writings of Dworkin and Fuller). See generally Fuller, *The Forms and Limits of Adjudication*, 92 HARV. L. REV. 353 (1978); L. FULLER, *THE MORALITY OF LAW* (1964).

<sup>43</sup> Dworkin argues that concepts of truth take the meaning they have from the function they play in our reasoning, argument, and conviction. Moral truths can be argued only within a moral context; legal truths can be argued only within a legal context. PRINCIPLE, *supra* note 4, at 167-77.

<sup>44</sup> *Reply*, *supra* note 7, at 278.

The judges know that there will always be cases whose holdings will be inconsistent with whatever theory of the doctrine that they adopt; these cases would be treated as mistakes. An optimal characterization will be one that justifies the most cases in the clearest terms while minimizing the number of cases that would have to be treated as mistakes (pp. 158–62).<sup>45</sup> The process of finding the theory which “fits” the cases at some threshold level is analogous to the statistical process of finding the line which best “explains” the group of data points found in a scientific experiment.<sup>46</sup>

Of course, more than one characterization of the law could conceivably meet some minimum threshold of “fit.”<sup>47</sup> To determine which available “fit” is best, Dworkin introduces a moral twist to the line-drawing exercise. Dworkin’s judges would choose between possible characterizations of a given doctrine based upon which theory gives the best justification for the case law, “best” here defined by the judge’s own political morality.<sup>48</sup> For example, a theory which explained past accident cases by the principle that “persons are liable for the consequences of their negligent acts” would probably be considered a better justification under American political morality than an explanation based on the principle that “in accident cases, the loss will be left to lie with the richer party,” even if both principles “fit” the past cases equally well.<sup>49</sup>

<sup>45</sup> *Id.* at 272.

<sup>46</sup> *Id.* at 271–75. Dworkin wants to treat legal history as involving more than just a collection of individual holdings or data points. For example, everything else being equal, a characterization that justified fewer cases but which better explained a trend in the cases would be better under Dworkin’s standards than a theory which could explain more cases but which could not account for the trend. *Id.* at 272.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> Dworkin compares a judge’s legal interpretation to literary interpretation. PRINCIPLE, *supra* note 4, at 146–66. According to Dworkin, the best interpretation of a novel would be one that was consistent with all the facts presented in the novel’s narrative while viewing the novel in a way that makes it the best story it can be. *Id.* at 151–58. “Best” here is relative to the interpreter’s aesthetic theory (a theory of what the nature and purpose of writing is). *Id.* at 151–52. Analogously, a judge interpreting the law in a particular area should choose the interpretation which meets the minimum requirement of “fit” with the precedents while viewing the precedents in a way that gives the doctrine the best justification possible, relative to the judge’s political morality. *Id.* at 158–62.

The judge thus implicitly views the past rulings as if they all had been made by a single author. In the effort to portray the law as speaking with one voice, judges might create harmonies where there are none within the precedents, and they might hide the disharmonies which reflect the struggles going on within and about the law. See Hoy, *Interpreting the Law*, 58 S. CAL. L. REV. 135, 174–76 (1985); Hutchinson, *Of Kings and Dirty Rascals: The Struggle for Democracy*, 9 QUEENS L.J. 273, 280–86 (1984).



Dworkin's right answer theory is undermined by its subjective elements. Dworkin's analysis assumes that there is a "community of discourse": a shared understanding of terms and of what constitutes an acceptable argument.<sup>50</sup> But the "community of discourse" breaks down at the point where Dworkin introduces personal political ideology into the judge's analysis of what the law is. Because Dworkin presents no common ground or shared criteria upon which judges and lawyers can determine which political theory is better or more reasonable, there is no basis for believing, even in theory, that the law—as opposed to the individual judge applying the law—can offer one right answer to a particular hard case.

True consistency is impossible because the way the case is resolved will depend, as Dworkin admits, upon which judge decides it. *For each judge*, there is one right answer in a hard case; but because of their differing political moralities, judges will necessarily differ about what theory offers the best justification for the prior cases, and therefore they will formulate different "right answers." As Allan Hutchinson argues, Dworkin's theory of right answers seems now to be a political rather than an epistemological claim.<sup>51</sup> In cruder terms, the notion of what the right answer is in a hard case has become subjective.<sup>52</sup>

Ironically, even if Dworkin's community of discourse/right answer theory is valid, applying it may not preserve the very goal—the right of equal concern and respect—for which it was intended. What we consider acceptable arguments or reasonable conclusions within a given system has been established by the powerful groups within that system.<sup>53</sup> If the interests of the

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<sup>50</sup> See generally Fiss, *Objectivity and Interpretation*, 34 STAN. L. REV. 739, 744–50 (1982); Fish, *Fish v. Fiss*, 36 STAN. L. REV. 1325 (1985).

<sup>51</sup> Hutchinson, *supra* note 49, at 276–77.

<sup>52</sup> Dworkin reacts strongly—and with some justification—against the insertion of the terms "subjective" and "objective" into the discussion of legal theory. PRINCIPLE, *supra* note 4, at 167–77; Reply, *supra* note 7, at 275–78. It is misleading and perhaps nonsensical to infer that an "objective" position is a viable alternative for analysis. What would it mean to argue, abstracted from all political and societal contexts, that persons have objective natural rights? What is the difference in meaning between the statements "slavery is unjust" and "slavery is objectively unjust"? PRINCIPLE, *supra* note 4, at 167–77; Reply, *supra* note 7, at 275–78. Dworkin claims that the confusion within the critics' arguments when they talk about objective truths comes from a background imagery of physical objects. Objectivity in talking about furniture means that the table is "out there somewhere," but this type of analysis does not transfer well to discussions about the objectivity of truth. *Id.* at 277–78.

<sup>53</sup> This phenomenon reflects Michel Foucault's discussion of the interrelationship between power and knowledge. See generally M. FOUCAULT, *POWER/KNOWLEDGE* (1980).

powerful are incorporated into the political and moral structure within which judges determine what individuals' rights are, then how valuable are these rights as trumps? Dworkin's theory, on the surface an ambitious attempt to secure equal concern and respect for all citizens, may actually result only in reinforcing the status quo.

### III. THE NATURE OF LAW

In evaluating Dworkin's theory of rights and of judicial process—and, indeed, to evaluate any theory—it is necessary to focus on two complementary criteria. First, we must approach the theory on its own terms and determine its nature and purpose. Hence, the operative question becomes, "What is the theory trying to do?" Second, we must place the theory in a concrete context and determine its practical relevance. Is Dworkin's theory *useful*, either as a basis of moral criticism or as an analytical tool? Unfortunately, Dworkin's theory falls short under both of these criteria.

Dworkin's judges have a duty to consider every case, statute, and executive action related to the cases before them. They must develop unifying explanatory theories, and decide which among the possible theories offers the best political justification for the past state actions. Dworkin admits that this task is beyond the physical and intellectual capabilities of actual judges. In his writings, he posits a hypothetical superhuman judge "Hercules" to do the work, noting that judges in the world would be able to perform only a fragment of this task—a task Dworkin considers necessary to treat litigants with equal concern and respect.<sup>54</sup>

What are we to make of this and similar impossible dreams? The answer may be found in the way Dworkin discusses the general nature of legal theory.<sup>55</sup> Dworkin points out that neither

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<sup>54</sup> RIGHTS, *supra* note 3, at 105–30.

<sup>55</sup> In his writings, Dworkin joins the debate about law's relationship to morality. Legal positivists argue that legal validity is completely autonomous from morality—that we can determine what the law is (*e.g.*, for application by a judge to a hard case) without reference to a moral judgment about what the law ought to be. *See generally* H.L.A. HART, *THE CONCEPT OF LAW* (1961). Truth conditions about the existence of a particular law reduce to questions of historical conditions: for example, whether the legislature took all the required steps to pass a statute.

H.L.A. Hart argues that his theory of legal positivism has the advantage of making some moral evaluations clearer. *Id.* at 203–07. Questions of whether a particular law

H.L.A. Hart's legal positivism nor Dworkin's own alternative to positivism can be seen as merely *describing* the way most citizens or lawyers use the word law, if for no other reason than because there is no underlying consensus in the use of that term.<sup>56</sup>

Dworkin argues that the definition of law, like the definition of justice, is a politically "contested concept."<sup>57</sup> The battle over legal theory thus becomes one facet of political/moral theory: a battle of moral judgments over the way society ought to be structured.

I think Dworkin mischaracterizes Hart's theory. Hart sought to restate systematically the way we use the word law. His theory attempted to describe the validity of the law without presupposing the moral value of the law's content.<sup>58</sup> Hart chose a model based on habit and social rules.<sup>59</sup>

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should be obeyed or enforced are clearer if we do not muddy our initial description of *what the law is* with an evaluation of the law's merit. To confuse what the law is with what we want it to be, or by positing minimal moral requirements for what we will call "law," is to risk two errors: first, believing that because something is the law it is morally worthy; and second, a tendency to ignore institutions and practices which, however objectionable, must be taken into account (as law) in any realistic analysis of a society. *Id.* at 197-207. See *infra* text accompanying notes 60-64.

Much of Dworkin's writing has had the purpose—or at least the effect—of blurring the line Hart tried to draw between law and morality. One recent chapter to this conflict involves Dworkin's theory of legal interpretation, in which he argues that judges do, should, and must interpret past cases in light of the judges' political morality. PRINCIPLE, *supra* note 4, at 158-66. Only in light of moral justification, Dworkin argues, can choices be made among possible characterizations of what the law is in a given area. (Dworkin is not timid about the role his writings have had in breaking down the theoretical barriers between law and morality. He recently described his views on law as being a "natural law theory." See generally "Natural" Law, *supra* note 35. Though his ideas remain distant from classical natural law theories, they do meet the criterion that moral judgment is required in order to determine what the law is.)

The question then becomes whether for Dworkin there is *any* distinction between law and morality. Dworkin still seems to think that there is a difference. He claims that while both are "creatures of morality," legal rights are different from moral rights because they are based on the political history and the past collective decisions of the community, and because they have special institutional force against judges. *Reply, supra* note 7, at 256-59.

<sup>56</sup> *Reply, supra* note 7, at 250-52, 255-56.

<sup>57</sup> *Id.* Justice is an abstract ideal that can be used to critique government actions or to help construct governmental institutions. See generally Rawls, *Justice as Fairness: Political not Metaphysical*, 14 PHIL. & PUB. AFFAIRS 223 (1985); J. RAWLS, *A THEORY OF JUSTICE* (1971). Law, on the other hand, refers to actual practices in the world. The problems that derive from the deficiency in Dworkin's analogy are discussed in the text accompanying notes 62-68.

<sup>58</sup> H.L.A. HART, *supra* note 55, at 151-80. This standard positivist amoral approach is historically rather new: it begins with Jeremy Bentham (1748-1832). Before Bentham, theorists would not consider examining the use of state coercion without also considering whether the coercion was justified, for example, by the consent of the governed or by the divine right of kings. See Deigh, *Rights and the Authority of Law* (Book Review), 51 U. CHI. L. REV. 668, 671-77 (1984).

<sup>59</sup> H.L.A. HART, *supra* note 55, at 50-60, 77-96.

The problem is that no matter how we try to circumscribe official actions within descriptive legal theory, at some point an action done in the name of "law" will exceed the boundaries that our theories set for "valid law."<sup>60</sup> At this point, Hart's analysis takes on an evaluative tone without actually being evaluative. Actions outside the analytical structure (e.g., statutes not promulgated according to the set process) are not "law." That the officials did not follow the procedures that they promised to follow may be a basis of external criticism about the moral value of the law, but it need not be. Hart leaves the moral question open.<sup>61</sup>

Dworkin argues that since legal theories are not merely descriptive exercises, they must incorporate political theories.<sup>62</sup> But other formulations of the purpose of a given theory may be equally tenable. Hart's theory, for example, can be seen as an analytical tool and nothing more. Dworkin's legal theory, by contrast, is harder to classify. He seems to be taking the legal system as he finds it and giving it the best political justification he can.<sup>63</sup> In the process, he advises certain modifications in the way judges adjudicate. Dworkin thus uncomfortably straddles the fence between description and prescription. It is hard to view Dworkin's theory, a grafting of a better political justification onto actual practice, as anything other than the legitimation of what may often be illegitimate.<sup>64</sup>

In defense of Dworkin's theory, it could be argued that the theory was intended only to offer us ideals.<sup>65</sup> Judges may not

<sup>60</sup> See Recent Publication, 22 HARV. J. ON LEGIS. 620, 623-24 (1985).

<sup>61</sup> See H.L.A. HART, *supra* note 55, at 151-80. Admittedly, to view Hart's theory as a purely analytical theory may be to give it solidity at the cost of making it peripheral to the basic moral questions regarding state coercion.

<sup>62</sup> Reply, *supra* note 7, at 250-52, 255-56.

<sup>63</sup> Cf. *id.* at 254 (discussing the role of judges).

<sup>64</sup> See Gabel, *supra* note 2, at 306-11.

<sup>65</sup> Professor John Oakley argues that Dworkin's theories should be seen as offering a different kind of ideal: that the purpose of law should be to offer a public forum to resolve questions of justice and of rights against the state. See J. Oakley, *The Legality of a Political System: Positivism, Political Morality and the Point of Theories of Law* 13 (forthcoming in RECHTSTHEORIE, Beiheft No. 9 (1985)) [on file at HARV. J. ON LEGIS.]. Cf. PRINCIPLE, *supra* note 4, at 70-71. This interpretation perhaps overstates Dworkin's argument. In Dworkin's system, claims of rights against the state, when pressed for in litigation, would often be burdened by the general right to consistent judgments.

Oakley interprets Dworkin to say that societies which respect individuals' institutional rights against legislators and against judges obtain "the status of legality"—those societies' rules have the status of *prima facie* moral rights. Oakley, *supra*, at 6, 13. This argument generates moral obligation from a near-vacuum. The statement "you ought to follow the law" is answered by "why?" The response "because the courts respect certain

be able to perform Herculean tasks, and principled adjudication may be tainted regularly by policy considerations, but the ideals remain. Is Dworkin's ideal one that we would want? Some critics have argued that Dworkin's ideal is too skewed towards individual rights, and that group and societal interests should be considered even within adjudication.<sup>66</sup>

The procedures Dworkin offers do not adequately ensure that Dworkin's ideal, even if desirable, will be attained. For example, the decisions will necessarily fall far short of reflecting the moral rights the citizen holds against the state,<sup>67</sup> because Dworkin's judges must decide cases in a way that reflects the litigants' right to consistent decisions. Because the right of consistency takes precedence over the other moral rights against the state in Dworkin's theory of judicial process, judicial decisions will also be constrained by the necessity of accounting for and reconciling past unjust decisions.<sup>68</sup> The inequalities, oppression, and stereotypes at the heart of past decisions get papered over and repackaged as respect for the individual litigant's right to equal treatment.

### CONCLUSION

Dworkin's ambitious plans to justify judicial review and to perfect judicial process have serious conceptual flaws. If his plans are failures, however, they are provocative failures. Dworkin has elaborated and tried to answer difficult basic questions within legal and political theory. Perhaps we must begin to consider the consequences of such failures of theory: there may be no simple justification for judicial review and no easy way to generate and justify rights for all the values we wish to protect. Without such questioning of how we can justify our society's use of state coercion, we—like our theoretical apologists—will only be dancing in the dark.

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individual rights" can be met by the curt "so what?" The problem of why law should be obeyed is not so easily solved as Oakley, and perhaps Dworkin, believe. *See generally* H. Kelsen, *Pure Theory of Law* (1967).

<sup>66</sup> *See* Shiffrin, *supra* note 6, at 25, col. 2. "If we take rights seriously, we cannot make a fetish of principle." *Id.* Levinson, *Taking Law Seriously: Reflections on "Thinking Like a Lawyer"*, 30 *STAN. L. REV.* 1071, 1096-99 (1978) (criticizing Dworkin's "methodological individualism").

<sup>67</sup> The citizens' moral rights come into the adjudication process only when the judges are choosing among possible characterizations of past decisions. *See* PRINCIPLE, *supra* note 4, at 14-15.

<sup>68</sup> *Id.* *See* "Natural" Law, *supra* note 35, at 181-88.



## RECENT PUBLICATIONS

TAX EXPENDITURES. By *Stanley S. Surrey & Paul R. McDaniel*. Cambridge, Mass.: Harvard University Press, 1985. Pp. 239, notes, index. \$27.50 cloth.

The percentage oil depletion allowance, the exclusion of municipal bond interest, and the investment tax credit are all examples of *tax expenditures*; they represent departures from the structural norm of the tax system. The structural norm consists of the basic provisions needed to implement a tax system, such as accounting rules, rate schedules, exemption levels, and so on. Departures from the structural norm of a tax system are labelled tax expenditures because they represent government spending for favored activities or groups, effected through the tax system rather than through direct grants, loans, or other forms of government assistance.

In *Tax Expenditures*, Surrey and McDaniel argue that tax expenditures introduce a great deal of complexity into the tax system and also lead to perceptions of unfairness. Surrey and McDaniel document that the vast majority of tax expenditures benefit upper-income groups (p. 72). Fully 70% of taxpayers use only the standard deduction rather than itemizing; moreover, 70% of those who use only the standard deduction have incomes of less than \$15,000 per year. Yet a taxpayer must itemize deductions to benefit from many tax expenditures. In 1985, for example, an estimated 30% of tax expenditures for individual taxpayers will be in the form of itemized deductions. Even among taxpayers who do itemize, taxpayers in higher tax brackets benefit more from deductions. A taxpayer in a 50% bracket saves \$50 in taxes for each \$100 deduction; a taxpayer in a 30% bracket saves only \$30 (p. 79).

The inequitable effects of a tax deduction, Surrey and McDaniel note, can be mitigated with a refundable tax credit (pp. 108–11). The value of a deduction depends on the taxpayer's marginal tax rate; the value of a credit does not. A nonrefundable credit, however, is limited to the amount of the taxpayer's tax liability. Refundable credits are necessary to permit low-income taxpayers to benefit fully from tax expenditures.

Surrey and McDaniel contend that tax expenditures and direct expenditures should be analyzed on equal terms (p. 98). Tax expenditures that could not be justified as direct expenditures

should be repealed. They suggest that many tax expenditures would not survive such scrutiny.

In the area of constitutional law, the authors argue, tax expenditures and direct expenditures should be treated identically (p. 118). The constitutional doctrines that limit certain kinds of direct expenditures should also limit tax expenditures. In at least one case, the Supreme Court has agreed with the view that tax exemptions and deductions are forms of subsidy.<sup>1</sup> The Court's treatment of tax expenditures for parochial education, however, has often been muddy (pp. 132-37).

The authors assert that tax expenditures reduce the perceived fairness of the tax system; however, some tax expenditures nonetheless appear to have broad public support. One explanation is that the longer a tax expenditure has been allowed, and the more taxpayers who benefit, the more likely that the public will view the provision as part and parcel of a "fair system." In addition, the affluent taxpayers who benefit most from the provisions are also best able to finance publicity campaigns to convince others that the threatened provisions actually "help the little guys." Current publicity campaigns against President Reagan's proposal to eliminate deductions for state and local taxes are an example; deductions for state and local taxes, like other itemized deductions, benefit mainly upper-income taxpayers.

One difficulty in Surrey and McDaniel's approach is the occasional ambiguity in defining the structural norm of a tax system. Some special provisions in the tax code are systemic adjustments rather than tax expenditures. For example, the authors state that the deduction for two-earner families is a tax expenditure, rejecting the argument that the deduction is needed to adjust for the exclusion of the imputed income of one-earner families and to relieve two-earner families from their higher marginal rates. The authors' conclusion seems difficult to reconcile with the idea that a tax expenditure is a government subsidy for favored activities or groups. The favored activity here is work, producing additional taxable income.

Part of the difficulty lies in drawing the line between business and personal expenditures. Personal expenditures are not deductible; business expenditures are. Taxpayers consider increases in personal expenditures, however, in deciding whether

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<sup>1</sup> *Regan v. Taxation With Representation*, 461 U.S. 540 (1983).



to work and where to work. If a distant job pays only slightly more than a job near the taxpayer's home, the taxpayer might consider the cost of commuting and parking—personal expenses—in the decision of where to work. Any reduction in the marginal tax rate is an added incentive to produce income, but provisions that attempt to mitigate the increased personal expenditures of working should be considered systemic adjustments rather than tax expenditures.

*Tax Expenditures* is not the first exposition of the tax expenditure concept, but its thorough and up-to-date coverage makes it valuable. An understanding of the identity between tax expenditures and direct expenditures will help politicians and the public navigate the road to tax reform.

Kathy Johnstone

HEAVY LOSSES. By *James Coates & Michael Kilian*. New York, N.Y.: Viking Press, 1985. Pp. 370, notes, appendix, index, \$22.95 cloth.

Despite the high priority the Reagan Administration has placed on national defense, and the mammoth amounts of money spent on the largest peacetime defense buildup in American history, there is a growing fear that the U.S. military machine is in poor shape and would face catastrophe in a major encounter. Although the Department of Defense (DoD) denies that a serious problem exists, this anxiety has led to numerous calls for fundamental structural change from both liberals and conservatives in and outside of government.<sup>1</sup> *Heavy Losses* joins the growing national debate on this issue by documenting the failures of the American military establishment and reviewing various proposals for reform. In doing so, it discusses many of the exposés and reform proposals that have appeared recently in the popular press. By putting these within one easily understood volume, and showing how they relate to each other, Coates and Kilian's work makes a useful contribution to the dialogue on this subject.

According to the authors, U.S. defense "has become at once dangerously costly and dangerously weak" (p. 4). As a result of

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<sup>1</sup> The diverse group calling for change includes congressmen, private citizens, and even the chairman of the commission appointed by President Reagan to examine the issue. See N.Y. Times, Oct. 11, 1985, at A1, col. 2; *Drums Along the Potomac*, TIME, Oct. 21, 1985, at 34.

backroom politics, wasteful bureaucrats, and timid policymakers who disperse responsibility and protect the status quo, the authors claim that the U.S. military suffers from a top-heavy, bureaucratic officer corps, an underequipped combat force dependent on weapons of poor quality, and a lack of clear-cut strategy and tactics for protecting U.S. interests (p. 4). The authors view the military as undergoing a crisis that encompasses not just its Pentagon establishment but the entire military-political-industrial complex. This crisis is one Coates and Kilian say must be resolved immediately because the U.S. will otherwise have to rely on its nuclear deterrent as its only effective protection. That, in turn, will increase the risk of nuclear war (p. 7).<sup>2</sup>

The authors analyze the defense establishment by examining individual components such as the "high command" (Joint Chiefs of Staff), the "Hill" (Congress), "generalissimos in suits" (civilian DoD officials), "outside brains" (consultants), and "makers" (arms industry). Within each of these sections, *Heavy Losses* describes foul-ups. These include DIVAD, an air defense gun "that couldn't hit a moving target" (p. 162); the Aegis naval radar-weaponry system, unable to defend against expected low-flying anti-ship missiles (p. 260); and a whole fleet of Army helicopters that are easy to shoot down but continue to be built because the Army is not allowed any fixed-wing aircraft and the Air Force refuses to place enough priority on ground support (pp. 138-39). Nearly all of the problems discussed result from failures in one of two broad categories: government organization and weapons programs.

Coates and Kilian find failures in government organization throughout the national security apparatus. On the highest level, these failures include a poorly run National Security Council supported by an ill-trained staff (p. 79) and a military high command seemingly designed to cause problems while not having much power to do anything useful (pp. 118-22). At the Pentagon, they include a structure that encourages inter-service rivalries, a civilian leadership handling tasks better left to military professionals, and an officer corps becoming increasingly bu-

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<sup>2</sup> The fear is a realistic one. For example, Dr. Fred Ilke, Under Secretary of Defense for Policy, said he was impressed by arguments that the only weapons the U.S. can rely on to work are its nuclear weapons. See Schemmer, *Does the U.S. Now Have the World's Worst Weapon System Acquisition Process?*, ARMED FORCES J. INT'L, Sept. 1984, at 92.

reaucratic as it is forced to do jobs, such as managing weapons procurement, better left in civilian hands (pp. 83, 136).

Coates and Kilian propose solutions to these problems, ranging from remodelling the Joint Chiefs of Staff and Joint Staff along the lines of the famed Prussian General Staff (pp. 128–30) to more drastic steps such as a complete restructuring of the DoD. The latter proposal would take civilians out of daily military management and put them in charge of weapons acquisitions (pp. 89, 168); it would also restructure combat forces by abolishing the Air Force, giving all tactical aircraft to the Navy, Marines, and Army, and creating a “U.S. Strategic Force” to run all strategic nuclear forces, whether based in missiles, submarines, or bombers (p. 150).

The cost overruns and poor weapons designs that Coates and Kilian describe result from systemic flaws in the defense establishment. Chief among these is the “buying-in” tactic of weapons vendors who submit unrealistically low contract bids. They do so confident that future price increases will be paid willingly by members of Congress more concerned about getting defense funds for constituents than about the effect their votes have on national defense (p. 248).

As the authors point out, Congress and industry are not the only parties at fault for weapons program failures. Blame also rests with the think tanks, both private and governmental, which “suggest ever more elaborate (and costly) alterations in projects” (p. 248). More importantly, the authors find fault in the creation of a “procurement elite” within the uniformed services, “ever eager to increase the costs of their projects in hopes of more bureaucratic power and promotion . . . [and] with an eye to future industry jobs after retirement” (p. 248).

In addition to replacing the procurement elite with a more stable civilian agency staffed by career civil servants not dependent on supervision of increasingly costly contracts for promotions nor worried about post-service careers, the authors propose changing the procurement system itself. Under their reform scheme, contractors would submit bids with fixed prices and subject to warranties (pp. 250, 275). Financing problems would be avoided through the creation of risk-sharing consortiums (p. 250). In addition, multi-year contracts would be awarded to counter inflation by permitting long-term stocking of raw materials (p. 250). These contracts would always be split among at least two companies to promote competition, and incentives

would be provided for work done under budget or ahead of schedule (pp. 154, 172, 250). Finally, any company facing a legitimate financial crisis would be put under temporary government receivership until reorganized or shut down (p. 250).

Although occasionally repetitious, *Heavy Losses* provides a thorough treatment of the range of problems presented, and proposes a number of reasonable solutions. This quality is not surprising, given the authors' lengthy experience as journalists specializing in military affairs and their centrist point of view. Coates and Kilian avoid knee-jerk reactions to the questions posed by flaws in the U.S. defense complex. They instead present an evenhanded analysis and are careful to present points of view different from their own.

By showing the relationships between various problems and reform proposals, Coates and Kilian help to prevent their views from having "all the impact of tossing a rose petal into the Grand Canyon and waiting for the echo" (p. 10), which they say is the normal reception given to critiques of the defense establishment (p. 10). Sadly, the authors probably have not prevented this kind of reception, due to their failure to provide an analysis of the political feasibility of their ideas. *Heavy Losses* would have been much stronger if, instead of merely admitting that much of what they recommend "is more theoretically than politically possible" (p. 10), the authors had included a discussion noting which of their ideas have strong chances of success and which do not. For those found politically unrealistic, the authors could have provided less visionary but more practical replacements. That, in turn, would have reduced the danger that *Heavy Losses* and similar works will be ignored by true reformers and instead exploited by those seeking to weaken the defense establishment.

Despite its failure to discuss political realities, *Heavy Losses* remains helpful because it presents the problems of the U.S. national security apparatus in a way easily understood by laymen. This understanding, in turn, gives a foundation for participation in reasoned discussion of future reform proposals. If the U.S. military establishment is now at a critical juncture, as the authors suggest, then that is justification enough for Coates and Kilian's work.

*Roger I. Cohen*