HARVARD JOURNAL

on

LEGISLATION

VOLUME 11 DECEMBER 1973 NUMBER 1

ARTICLES

PROPERTY TAX ABATEMENT: AN INCENTIVE FOR LOW INCOME HOUSING
Norman Alpert 1

CONGLOMERATE MERGERS: PROPOSED GUIDELINES
Shelby Bryan 31

TAX EFFORT AS A DETERMINANT OF REVENUE SHARING ALLOTMENTS
James A. Maxwell 63

STATUTE

AN ACT TO REGULATE GROUP LEGAL SERVICES PLANS
Garrick F. Cole 68

NOTE

LIMITED FEDERAL CONSTITUTIONAL CONVENTIONS: IMPLICATIONS OF THE STATE EXPERIENCE 127

Published four times during the academic year (December, February, April, and June) by the Harvard Legislative Research Bureau, Langdell Hall, Harvard Law School, Cambridge, Mass. 02138. Application to mail at second-class postage rates is pending at Boston, Mass., and at additional mailing offices.

Subscriptions per year: United States, $7.50 (single copy, $2.50); foreign, $9.00 (single copy, $3.00). Subscriptions are automatically renewed unless a request for discontinuance is received.

Back issues prior to current volume are available from Fred B. Rothman & Co., 57 Leuning St., South Hackensack, New Jersey 07606, at $3.50, check with order. For prices of complete back volumes or of sets, please inquire of Fred B. Rothman & Co.

Copyright © 1973 by the Harvard Legislative Research Bureau.

HARVARD JOURNAL ON LEGISLATION

E. JOSEPH DEAN
President

WILLIAM L. RICHEY
Articles Editor

DAVID M. LINDLEY
Managing Editor

JOHN P. JAMES
Note Editor

RICHARD O. LEVINE
Congress Issue Editor

DANIEL C. SMITH
Symposium Issue Editor

BRADLEY A. OLSEN
Director of Legislation

Board of Editors

THOMAS H. ALLEN
THOMAS G. BOWE
KENNETH N. BURNS
BRUCE D. CORKER
CARY H. HALL
KENNETH N. KLEE
ROBERT C. RANDOLPH

CAROLYN E. BECK
Book Review Editor

Published four times during the academic year by the Harvard Legislative Research Bureau

RICHARD G. CALDWELL
STEPHEN CALKINS
ROLAND CASTANEDA
J. KENNERLY DAVIS
RENDALL A. DAVIS, JR.
MARK A. DICKERSON
MICHAEL C. DRAFFIN
HAYWARD L. DRAPER
SCOTT B. HARRIS
RICHARD E. HECKLINGER
JOHN C. HENRY
ALBERT H. HILLER
JAMES A. HINDS
GEORGE K. HOUSER
PHILLIP C. HUNT
MARK A. JARBOE
LAWRENCE J. LIPPOLIS
RACHEL MILLER
GREGORY R. MOWE
WILLIAM L. NEFF
KEVIN J. O'CONNOR
FREDERICK W. PETERS
THOMAS R. PHILLIPS
ARTHUR G. POWERS
THOMAS W. QUEEN
JOHN B. QUINN
PETER RAVEN-HANSEN
GLENN R. REICHARDT
MABRY E. ROGERS
ROBERT A. ROSENFELD
THOMAS C. RUSSLER
JOHN A. SATORIUS
THEODORE P. SETO
RICHARD L. SCHULTZE
E. LEO SLAGGIE
STAFFORD SMILEY
JOHN W. TITCOMB
LAURENCE D. WELTMAN
KEVIN S. WILEY
ERIC J. ZAHLER
ROBERT E. ZAHLER

Faculty Advisers

ROBERT E. KEETON
DAVID L. SHAPIRO
RICHARD B. STEWART

JOHN WILEY
Staff Assistant

PROPERTY TAX ABATEMENT: AN INCENTIVE FOR LOW INCOME HOUSING

NORMAN ALPERT*

In 1969 the National Commission on Urban Problems estimated that at least 11 million dwellings, amounting to approximately 16 percent of all housing in the United States, were substandard and overcrowded.[1] Congress, in the Housing and Urban Development Act of 1968, concluded that 26 million new or rehabilitated housing units would have to be produced before 1978 to eliminate substandard housing and accommodate anticipated housing needs.[2] A partial solution to the problem of inadequate housing might be provided by eliminating property taxes, thus increasing returns on capital investment in housing and making such investment attractive to private landlords. At present, the ad valorem property tax takes from urban landlords as much as 21 percent of the rents they collect.[3] Furthermore, the increased housing supply stimulated by such an exemption might result in a reduction of rental rates, as the increase in supply began to outstrip increases in demand. This Note deals with the equitable considerations involved in granting property tax abatement to profit seeking landlords of low and moderate income housing and the efficiency of such abatements in stimulating investment in housing.

---

* A.B., 1970, Yeshiva; J.D., 1973, Harvard University. This article stems from a paper written by Mr. Alpert for Professor Oliver Oldman at the Harvard Law School.

1 NATIONAL COMMISSION ON URBAN PROBLEMS, BUILDING THE AMERICAN CITY, H.R. Doc. No. 34, 91st Cong., 1st Sess. 74 (1969). *See also* Keith, *An Assessment of National Housing Needs*, 32 LAW & CONTEMP. PROB. 209, 211-12 (1967). Goals set by the Douglas Report are apparently being met. *See* 3 HUD NEWSLETTER, Sept. 25, 1972, at 39. That portion of the improvement attributable to HUD programs must be discounted because the Administration imposed a moratorium on housing programs on Jan. 8, 1973. 31 CONG. Q. WEEKLY REP. 40 (1973). Consequently property tax abatement at the state and local levels merits much closer analysis.

2 42 U.S.C. § 1441a (1970).

3 It was estimated in 1959 that property taxes accounted for 21 cents of every rental dollar for well-maintained urban rental structures and about 15 cents of every rental dollar for poorly maintained ones. C. RAPKIN, THE REAL ESTATE MARKET IN AN URBAN RENEWAL AREA 71-72 (1959); G. STERNLIEB, THE TENEMENT LANDLORD 17 (1966) [hereinafter cited as STERNLIEB].

Whenever a landlord undertakes construction or rehabilitation of an existing building, he must expect an increase in the assessed value of his property and a corresponding increase in taxes. To avoid this increase some landlords undoubtedly prefer to leave their rental structures in a dilapidated condition.[4] Property tax abatement has certain undesirable effects also. Granting tax abatement to some landlords necessarily results in the imposition of a greater tax burden on other landlords and other revenue sources if the governmental unit wishes to maintain the same level of revenue. Alternatively, a decrease in revenues may be accepted. For instance, the New York City tax exemption in the 1920's resulted in the loss of $191,387,000 of potential revenue.[5]

The property tax accounts for two-thirds of all general revenue raised by local governments from their own sources and over 40 percent of local government revenue from all sources.[6] About 50 percent of local government property tax revenue comes from housing.[7] With ever-increasing demand for government services and rising costs, the revenue lost as a result of tax abatement will have to be recouped from other sources.

The basic contemporary tax exemption does not leave untaxed the *entire value* of the new housing improvement, as the 1920 New York statute did, but rather defers reassessment. If a dilapidated building is rehabilitated or replaced by a new building, the assessment to which the tax rate is applied remains that of the prior structure; upward reassessment to reflect the new capital investment is deferred for the number of years specified by the statute.[8]

4 STERNLIEB, *supra* note 3, at 17. It is incorrect to call the property tax a "deterrent" to construction or improvement. It can be seen as just one of the costs the landlord must include in his calculation of the costs necessary to produce a certain level of rents. An increase in any cost, unless matched by an increase in rent, will discourage investment and may actually encourage disinvestment. *See also* Curran, *The General Property Tax and Urban Rehabilitation*, in NATIONAL TAX ASSOCIATION, 1964 PROCEEDINGS 250.

5 M. WALKER, URBAN BLIGHT AND SLUMS 287 (1938).

6 CONGRESSIONAL RESEARCH SERVICE FOR THE SUBCOMM. ON INTERGOVERNMENTAL RELATIONS OF THE SENATE COMM. ON GOVERNMENT OPERATIONS, 92D CONG., 1ST SESS., PROPERTY TAXATION: EFFECTS ON LAND USE AND LOCAL GOVERNMENT REVENUES 2 (Comm. Print 1971); D. NETZER, ECONOMICS OF THE PROPERTY TAX 9 (1966). Federal revenue sharing will reduce this reliance on the property tax, but it is too early to tell its precise effect.

7 D. NETZER, IMPACT OF THE PROPERTY TAX ON URBAN LAND USE, HOUSING AND LOCAL GOVERNMENT FINANCE 21 (1968).

8 Once new construction or rehabilitation has qualified for reassessment defer-

I. Reassessment Deferment as an Incentive to Improve Housing

A. *Unfairness of General Tax Abatement*

A tax abatement covering *all* new construction is an unjustifiable municipal subsidy of higher income tenants and their landlords. Only a tax exemption statute whose benefits would be limited to housing for lower and perhaps middle income tenants is justifiable. New construction or improvements for such tenants are unlikely in the absence of special incentives. Moreover, the burden of a tax abatement covering all new construction would probably fall more heavily on lower income tenants.

A municipality relies on normal replacement of its housing stock to maintain revenue levels. As the older housing deteriorates, tax revenue and overall assessments are normally maintained by taxing new housing and improvements.[9] Only that portion of new construction which increases the tax base can be exempted if revenue levels are to be maintained. Even this new construction will generate additional demands for public services and hence the need for more revenue. All other improvements and construction must be taxed or the tax burden will be shifted to those still paying the tax. Declines in actual revenue will undoubtedly be prevented by taxing nonexempt property owners more heavily, and landlords will pass on the tax increase to their tenants to the extent the market permits.

Historically, private new construction has been directed at high and middle income tenants. These tenants are willing and able to pay for something built at the high costs of modern construction.[10] Thus the benefits of the exemption flow to upper income tenants, who receive better apartments, and to their landlords. Since much of this improvement would have occurred without the exemption, the exemption clearly causes loss of replacement and improvement revenue to the municipality. Because new con-

---

ment, the freeze in assessed value would prevent reassessment to reflect inflation. Thus, an owner's property tax bill would only increase if the tax rate were increased. If the inflation increased the cost to state and local governments of goods and services, then the tax rate on all property might increase.

9 Abrams, *The Subsidy and Housing*, 22 J. LAND & P.U. ECON. 131, 138 (1946).

10 W. GRIGSBY, HOUSING MARKETS AND PUBLIC POLICY 23 (1963) [hereinafter cited as GRIGSBY].

struction in the low income housing sector is less profitable,[11] lower income tenants are less likely to receive any benefits from the tax exemption. In addition, the tax rate increase to offset lost revenue will be borne by all tenants, so the costs of providing higher income tenants already adequately housed with even better housing will be disproportionately borne by lower income tenants. These results of a general reassessment deferment make such statutes unjustifiable.

Even if higher income landlords and tenants are the immediate beneficiaries of a general tax exemption, arguably the positive effects would "filter" down to lower income tenants. As wealthier tenants move to new apartments or newly improved apartments, their former apartments become available to lower income tenants. As the demand for the older, perfectly adequate apartments declines, the rent for such housing should also decline.[12] Unfortunately, it is likely that "the price decline necessary to bring a dwelling unit within reach of an income group lower than that of the original tenant also results in a policy of under-maintenance"[13] by the landlord,

> so that, in addition to normal deterioration that occurs over time, the deterioration caused by disinvestment will lead to far more rapid declines in quality of housing than otherwise might occur. As a result, it is extremely unlikely that downward filtered dwellings will . . . provide satisfactory housing to occupants who obtain them at low rents or prices.[14]

Even if filtering caused by a general tax exemption really did supply satisfactory housing to tenants at low rents, the general tax exemption for new construction would be an inverted way to achieve this result. Low income tenants would be taxed to provide benefits for wealthier tenants, so that at some future date poorer tenants would receive somewhat comparable benefits.

---

11 Comment, *Programs to Encourage Private Investment in Low-Income Housing*, 81 HARV. L. REV. 1296 (1968).

12 *See generally* GRIGSBY, *supra* note 10, at 84-130.

13 Lowry, *Filtering and Housing Standards: A Conceptual Analysis*, 36 LAND ECON. 370 (1961).

14 Kristoff, *Federal Housing Policies: Subsidized Production, Filtration and Objectives: Part I*, 48 LAND ECON. 309, 318 (1972).

B. *The Mechanics of Reassessment Deferments*

Traditional real estate theory maintains that a landlord can change the rent levels of his building by "moving" it to a different quality level. By varying his maintenance and capital expenditures a landlord can alter the demand and thus the rents for his building. A landlord will increase his maintenance or capital expense only if it can be justified by the increase in rents made possible by such expenditure. The expected return after the property tax must exceed the cost of capital. A landlord seeking to improve his particular property will therefore choose as his first improvement expenditure that expenditure which results in the greatest ratio of rental return to cost. It is worthwhile for him to continue spending on less profitable improvements so long as another dollar of cost each year still induces enough rental increase after the property tax to match the opportunity cost of capital. When the ratio of rental return to cost is one, optimum quality of maintenance and capital investment for a particular building has been achieved. Further expenditure by the landlord would not be economical, just as failing to spend enough to reach that optimum would not be profit maximizing.[15]

A landlord calculating the value of a property tax exemption expects that his assessment would normally be increased by the amount of his rehabilitation expenditure, which should equal the increase in the value of the building. The annual savings thus would equal the tax rate times the increase in value, adjusted for the local assessment ratio. If the owner of a building discovers that his aftertax return will increase because of a reassessment deferment on an improvement, not only does his already contemplated improvement investment become more profitable, but additional improvement that would otherwise be unprofitable may become profitable.[16] A tax abatement limited to housing improve-

---

15 J. HEILBRUN, REAL ESTATE TAXES AND URBAN HOUSING 8-36 (1966); Heilbrun, *Reforming the Real Estate Tax to Encourage Housing Maintenance and Rehabilitation*, in LAND AND BUILDING TAXES 63, 64-69 (A. Becker ed. 1969) [hereinafter cited as *Reforming the Real Estate Tax*]; R. RATCLIFF, REAL ESTATE ANALYSIS 211-27 (1961).

16 J. HEILBRUN, REAL ESTATE TAXES AND URBAN HOUSING 85-104 (1966); *Reforming the Real Estate Tax*, *supra* note 15, at 73-77.

ments for low and moderate income residents thus should induce additional capital expenditure and provide more housing.

Even reassessment deferment limited to new construction on lower income housing will involve some unnecessary revenue loss to the municipality. This will be true to the extent that a landlord contemplating new construction or rehabilitation for low or moderate income tenants would have gone forward with the enterprise even without a reassessment deferment. But it would obviously be quite an administrative burden to require the tax assessor to review every rehabilitation expenditure to determine which investments are the marginal ones meriting tax exemption.

The practical consequences of such a tax abatement would not be as positive as the preceding theoretical discussion implies, at least for low income housing within urban slums. In slums a tax exemption would do little to upgrade the existing housing stock. Unless a landlord can expect an actual increase in rent to offset his rehabilitation expenditures, he will not rehabilitate. Tax abatement is only an incentive in so far as it supplements a rent increase. Mere abatement of additional taxes without any rent increases will never cover the rehabilitation costs and provide an incentive for rehabilitation. The crucial fact is that poverty area landlords are afraid to raise rents and thus cannot profitably rehabilitate. These landlords feel that the surrounding blighted neighborhood will vitiate any market desirability that their rehabilitation might create.[17] They are convinced they would be

---

17 STERNLIEB, *supra* note 3, at 223.

> *Vacancy rates are moving up and most forcefully in the hardcore slum areas. . . .*
>
> . . . .
>
> . . . [T]he high vacancy rate certainly inhibits rent increases. The fear of raising rents in a weak market is compounded of two elements: the possibility of ending up with substantial vacancies, and, perhaps even more significantly, the fear that in order to secure tenants at the increased rates the landlord must take in lower categories of tenantry.
>
> . . . *[T]he availability of housing . . . in better areas . . . as well as in the surrounding suburbs, limits the number of people with capacity and willingness to pay high rents in the slum areas. The willingness of tenement owners to make improvement, therefore, is substantially inhibited by the feeling that there would be limited demand for better, i.e., higher rent, apartments.*

Id. at 89, 93 (emphasis in original).

unable to find tenants who would prefer to pay for improvements in urban poverty area buildings rather than move to some other building where rents remain low or pay higher rents for housing in some better neighborhood.[18]

C. *Alternatives to Reassessment Deferments*

A reassessment deferment by itself would probably be an insufficient incentive to stimulate investment in slums. But if exemption from existing taxes were granted, or if the reassessment deferment were combined with other government subsidies, the tax incentive would contribute toward making even slum housing improvement profitable.[19] The question then becomes whether this additional subsidy should be given by a tax exemption or by creating or increasing a subsidy in a program of direct government expenditure.

Municipal property tax subsidies to industry are less efficient than direct government grants. The relevant rate of discount for both parties is the cost of capital. The municipality, because of the tax-exempt status of its bonds, will certainly have a lower borrowing cost than the corporation. Having money today rather than at some time in the future is therefore more important to the company than to the city; the company discounts the future at a higher rate than the municipality does. The present value to the municipality of the lost future stream of property taxes is thus larger than the present value to the corporation of the future stream of property tax savings; the benefit is not equal to its cost. On the other hand, if the municipality determined the present value of the future property taxes it was willing to forego and

---

18 *Id.*

19 Other possible federal government subsidies are mortgage interest subsidies, land cost writedowns, and rent supplements. The size of the subsidy determines its incentive effect. Thus a very small mortgage interest subsidy would not be worth as much as a large tax exemption. Based on existing programs, tax credit incentives exert more influence on landlord decisions than either writedown of land prices or tax abatement because of their greater savings for landlords. *See* Beck, *Urban Redevelopment: Influence of Property Taxation and Other Factors*, in NATIONAL TAX ASSOCIATION, 1964 PROCEEDINGS 239, 240; Goldston, Hunter & Rothrauff, *Urban Redevelopment — the Viewpoint of Counsel for a Private Redeveloper*, 26 LAW & CONTEMP. PROB. 118, 123 (1961).

then granted such an amount directly to the corporation, the corporation's benefit would equal the city's costs.[20]

One alleged inefficiency of tax exemption is the loss of the property tax deduction from federal income taxes. For every dollar of property tax exemption granted a corporation, 48 percent would go to the government in increased taxes. But a direct grant does not mitigate this loss. It does not directly eliminate a deduction, and would not be taxable income to the corporation, but rather a contribution to capital.[21] A reduction of the company's basis in its assets, equal to the contribution, would be necessary[22] (unless the contribution is to land costs); and this would reduce the depreciation deductions against ordinary income that the company could take in the future. A similar 48 percent transfer of benefit to the federal government would thus result.

Landlords do not want to be forced to invest lump-sum cash grants in low cost housing. The landlord may not be incorporated, since many investors in low income housing are either "small-time" owner-occupants or partnerships organized for tax shelter flow-through and "equity syndication." Even though the grant might exceed the added future profit that it would generate, it would be treated in the year of receipt as ordinary income for federal tax purposes.[23] This is hardly what those seeking tax shelters want. Even corporate landlords might not be happy with the lump-sum grant. A corporation investing in low income housing knows that depreciation creates tax-free dollars, both at the corporate level and to the shareholders.[24] The enactment of § 312(m) of the

---

20 Stober & Falk, *Property Tax Exemption: An Inefficient Subsidy to Industry*, 20 NAT'L TAX J. 386 (1967).

21 INT. REV. CODE OF 1954, § 118.

22 INT. REV. CODE OF 1954, § 362(c)(2); Treas. Reg. § 1.362-2 (1955). The Regulations specify that the basis reduction is first to be applied against the cost of the asset for whose purchase the cash contribution was given. Any remainder is then to be applied first against the basis of depreciable assets, making it almost certain that a reduction in otherwise available depreciation will result.

23 INT. REV. CODE OF 1954, § 61.

24 Depreciation gives the corporation deductions from ordinary income. Where a corporation invests primarily in low income housing, it is likely that such depreciation will more than offset net rental income. The corporation will thus have no current earnings. In addition, depreciation will reduce and eventually eliminate accumulated earnings and profits. Thus, cash distributions to shareholders are not going to be taxable to them as dividends. INT. REV. CODE OF 1954, § 362(c)(2); Treas. Reg. § 1.362-2 (1955).

Internal Revenue Code of 1954, which provides that only straight line depreciation will be permitted in the computation of corporate earnings and profits, reduced the amount of these benefits but did not eliminate them.[25] A direct cash grant would reduce the depreciation the corporation could take by reducing the basis of the asset.

The adverse tax consequences of *annual,* rather than lump-sum, direct grants would not be nearly as severe. But unless the annual grants were guaranteed for a period of years by statute or contract, the landlord could not depend on them as a source of funds for construction and rehabilitation. Also, because of the lower discount rate of the municipalities, payments over a number of years are worth less to the landlord than they cost the municipality. Finally, direct payments to landlords might prove politically unfeasible where constituencies are composed principally of tenants.

Landlords may also be subsidized by means of increased land cost writedowns, mortgage subsidies, and rent supplements. It will be equally difficult to determine the optimum length of the subsidy, whether tax exemptions or more direct methods are used. The danger that the guaranteed subsidy's size or duration will create a windfall or be insufficient to stimulate investment exists in both cases. The real issue is not which subsidy is better, but rather that *all* of these subsidies are necessary for private low income housing to be feasible. The federal housing program does build in some supplements;[26] but the working assumption is that some sort of local tax break will still be necessary and will be created, if necessary, by informal arrangement with the assessor.[27]

D. *Social Objections to the Tax Incentive Approach*

Tax incentives are criticized more in terms of social policy than pure economic efficiency. In concluding that advocates of

25 As long as all deductions, including straightline depreciation, exceed current earnings, a distribution by a corporation without accumulated earnings and profits will be tax free for the shareholders. INT. REV. CODE OF 1954, § 362(c)(2); Treas. Reg. § 1.362-2 (1955).

26 12 U.S.C. § 1701(s) (1970).

27 Streeter, Davies & Brooks, *State Legislative Response to the Housing Crisis,* 19 CLEV. ST. L. REV. 63 (1970).

federal income tax incentives rather than direct government expenditures have a heavy burden of persuasion, Professor Surrey made the following points, *inter alia,* about income tax incentives:

1. An income tax incentive (in deduction form) inequitably benefits high bracket taxpayers most.
2. It often results in windfalls to taxpayers by giving them a deduction for doing things they would do without any subsidy.
3. Income tax incentives distort normal markets and force higher tax rates by constricting the tax base.
4. They create administrative complications and problems in the budgetary process: controlling revenues and determining expenditure priorities become more difficult.
5. Every new income tax preference further confuses and endangers the basic structure of the income tax.[28]

Should this critique be applied to the property tax and reassessment deferment?[29]

1. The graduated nature of the federal income tax provides high bracket taxpayers with a greater benefit from tax incentives. But the property tax is not graduated, and a proper reassessment deferment statute would limit its benefits to lower income tenants.
2. A property tax exemption scheme limited to lower income housing is unlikely to create very many windfalls. In the absence of a wide range of government subsidies, such new improvement rarely takes place.
3. Property tax exemptions for low income housing may distort the housing market, but the market would be equally distorted by direct grants. Distortion in a market which does not meet human needs is not undesirable. The higher tax rates that result from property tax abatements or direct expenditures or both seem to be a justifiable social choice. If the primary beneficiaries of the tax exemption are low income tenants, then a dispropor-

---

28 Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures,* 83 HARV. L. REV. 705 (1970).

29 *Cf.* Nemann, *The Value of Tax Incentives as a Means of Encouraging the Rehabilitation of Low Income Housing,* 41 U. CIN. L. REV. 151 (1972) [hereinafter cited as Nemann]. Nemann applies Surrey's analysis to § 167(k) of the Internal Revenue Code of 1954, which allows accelerated depreciation for rehabilitation of low income rental housing.

tionate amount of the higher rates would effectively be shifted to middle and higher income residents. This should reduce the widely assumed regressivity of the property tax.[30]

4. Administrative and budgetary complications can be mitigated if the property tax exemption for low income housing is limited to designated slum areas. The municipality will then know that no increased assessments on residential property are to be expected from that area for the period of the reassessment deferment. Realizing that reassessment deferment alone will not improve the housing situation much in these blighted areas, the municipality should allocate its resources to housing as if there were no exemption. Whether the existing subsidy is an exemption or a direct grant, the municipality must make the same difficult determination of how much additional assistance is necessary and possible.

5. A reassessment deferment for low income housing does confuse the basic structure of the ad valorem property tax, certainly more than direct expenditures would. But structural clarity of the property tax is not a societal goal of the same rank as improving low income housing, and in any event reassessment deferment does not confuse the structure that much. The ad valorem property tax is basically directed at private, real property held for profit or personal use. Low income housing which only gets built or rehabilitated as a result of government subsidies is analogous to tax-exempt welfare-oriented or government-owned property. And since such new improvement does not normally occur without governmental assistance, the municipality never contemplated obtaining replacement revenue from such structures.

One of the claimed benefits of tax incentives over direct government expenditures, namely, private decisionmaking, may argue strongly against a property tax abatement program.

> Private decisionmaking might result in merely scattered rehabilitation of dwellings in areas that remain, for the most part, slums [negating any lasting impact for the improvement]. . . . [W]ith private decisionmaking the amount of

---

30 D. NETZER, ECONOMICS OF THE PROPERTY TAX 32-40 (1966). *But see* Gaffney, *The Property Tax Is a Progressive Tax*, in NATIONAL TAX ASSOCIATION, 1971 PROCEEDINGS 408.

> money spent on the rehabilitation of any particular dwelling is left to the taxpayer's determination, which might be controlled by [the] profit motive rather than the needs of the particular dwelling being rehabilitated.[31]

But if the tax exemption is limited to low or moderate income housing or to designated poverty areas, we can be fairly certain that nearly all the dwellings need rehabilitation. The profits generated by rehabilitating those few buildings that do not need improvement are unlikely to be very significant.[32] Further, the mere fact of public decisionmaking will not avoid scattered rehabilitation in areas that remain slums. It is the amount of money which the government is willing to pour into slum area housing which will determine whether only a few buildings or an entire neighborhood will be rehabilitated. If the municipality is not willing to undertake such massive expenditures on its own on behalf of privately owned housing, scattered or insubstantial improvement is as likely to result from direct expenditures as from a tax exemption. If this danger is considered real, then the tax exemption statute could require concurrent action by a certain proportion of landlords within an area before any received a tax exemption. Such a requirement would reduce utilization of the tax exemption.

Finally, some argue that an assessment freeze creates an incentive to let buildings become blighted so as to qualify for the freeze.[33] Since a landlord may not be able to increase or maintain his rents or even keep his tenants if his building deteriorates, it would not be rational for him to so ignore his buildings. Faced with massive blighted areas, one should not worry that an improvement incentive limited to blighted areas or deteriorated properties may postpone improvement of some buildings in other parts of the city not yet sufficiently deteriorated for the freeze. To discourage those who might be induced to let their buildings deteriorate, assessments could be statutorily frozen only for those improvements undertaken within the 3-year period following enactment of the freeze.

---

31 Nemann, *supra* note 29, at 157.

32 See note 17 *supra* and accompanying text.

33 Gaffney, *Property Taxes and the Frequency of Urban Renewal*, in NATIONAL TAX ASSOCIATION, 1964 PROCEEDINGS 272, 277.

E. *Conclusion*

Even if a property tax exemption for low income housing is not unquestionably a better approach than direct subsidies, neither is it a worse approach. Tax exemption is necessary in addition to these other approaches. Though government subsidies for low income housing are desirable, perhaps we should face the reality that hidden subsidies have always been politically more palatable than direct grants to profit motivated investors.

II. STATUTORY APPROACHES

A. *Urban Redevelopment Companies*

The most common vehicle for granting property tax exemptions to private for-profit housing landlords is the urban redevelopment company. The redevelopment company statutes require that the company formulate a complete plan for redeveloping a blighted area, rather than merely putting up one or even a few apartment buildings. Both commercial and residential improvements can be involved. The tax exemption is then part of a broader governmental assistance program, including land cost writedowns and use of the state's condemnation power for assembling sites. The redevelopment company contracts with a state or local housing authority to establish the terms on which the company will operate and is then subject to initial approval and continuing supervision by the authority.

Of the 13 states which provide any tax exemption for profit seeking landlords, eight give such exemptions to redevelopment companies; and in four of these, redevelopment companies are the only private for-profit landlords eligible for tax exemption.[34] Five of the eight states authorize reassessment deferment for pe-

---

34 The eight states with tax exemptions for redevelopment companies are Hawaii, HAWAII REV. STAT. § 53-38 (1968); Massachussets, MASS. GEN. LAWS ANN. ch. 121A, § 10 (1969); Michigan, MICH. COMP. LAWS ANN. § 125.912 (Supp. 1973); Minnesota, MINN. STAT. ANN. § 462.651 (1963); Missouri, MO. ANN. STAT. § 353.110 (Vernon 1966); New Jersey, N.J. STAT. ANN. § 55:14D-26 (1964); New York, N.Y. PRIV. HOUS. FIN. LAW § 211 (McKinney 1962) and N.Y. PRIV. HOUS. FIN. LAW § 125 (McKinney Supp. 1972); and Ohio, OHIO REV. CODE ANN. § 1728.10 (Page 1964).

In Hawaii, Massachusetts, Minnesota, and Missouri, redevelopment companies are the only private for-profit landlords that qualify for any tax exemption.

riods ranging from 10 to 25 years. Under a statute initially passed for the Metropolitan Life Insurance Company, New York permits a deferment for the life of any federally-aided mortgage, though not for more than 40 years.[35] In Massachusetts and Ohio the company's property is *completely* exempted from the ad valorem tax, but the municipality may require the company to pay a service charge or excise in lieu of taxes.[36] In Missouri, for the first 10 years after acquisition by the company, there is a reassessment deferment as to land, but a *complete* exemption as to improvements, with no excise. For the next 15 years, total assessment is not to exceed 50 percent of the true value of the property, including improvements.[37]

Redevelopment company advocates claim that despite such "temporary" tax exemptions, the companies actually increase municipal tax revenue. If they improve a large area, surrounding values will probably rise and thus generate new tax revenue even before the company's own tax exemption expires.[38] Unless the housing component of the redevelopment plan is limited by statute to low income housing, it can certainly be anticipated that more profitable, higher income housing will be built.[39] When this more profitable housing is built, the tax burden is shifted to everyone else, including low income landlords and tenants. In addition, there are persuasive arguments that even in the long run these "temporary" tax exemptions deprive the city of more tax revenue than they generate.[40] If the premise that such exemptions will eventually improve municipal revenue is false and the result of such exemptions is to improve the housing of middle income

35 N.Y. PRIV. HOUS. FIN. LAW § 125(1)(a) (McKinney Supp. 1972). *See* C. ABRAMS, THE CITY IS THE FRONTIER 95-98 (1965).

36 MASS. GEN. LAWS ANN. ch. 121A, § 10 (1969). The excise equals 5 percent of annual gross income and $10 per thousand of the fair cash value. Massachusetts retains as a floor under the excise the lesser of either the tax that would be received at current rates on the original post-redevelopment assessment or the three year average tax that would be levied on the pre-redevelopment assessment. OHIO REV. CODE ANN. § 1728.11 (Page 1964), establishes the pre-improvement taxes as the floor for an excise of 15 percent of annual gross income.

37 MO. ANN. STAT. § 353.110 (Vernon 1966).

38 *See* Neufeld, *Is Tax Exempt Property a Municipal Asset?*, 18 NAT'L TAX J. 415 (1965).

39 *See* Blum & Bursler, *Tax Subsidies for Rental Housing*, 15 U. CHI. L. REV. 255 (1948).

40 M. ANDERSON, THE FEDERAL BULLDOZER 172 (1964).

tenants at the expense of lower income tenants, then there is no justification for such programs. Perhaps this is one reason that all the redevelopment company statutes, except Ohio's, limit the annual dividend which the company may pay to between 5 and 10 percent of the investment. A limit on the profit that can be taken out would hopefully encourage lower rents, and hence make the buildings available to lower income tenants. Yet merely limiting the dividends that can be paid out is inadequate, especially if the company could accumulate profits not paid out as dividends[41] and then distribute them upon dissolution of the company.[42] Legislatures which recognized this possibility specified that upon termination of the special redevelopment company status any surplus is to go to the municipality.[43] Even so, a mere limit on the dividend is inadequate, for achievement of even a modest 5 to 10 percent annual return is far more certain with high rather than low income housing.

Unless the statute requires low income housing, that is not what will be built. The New York Constitution requires that state-assisted housing be provided only for "families of low income."[44] But the statutes have not been framed to accomplish this.[45] Minnesota does provide that the redevelopment company's contract with the local housing authority "shall regulate the rents to be charged for any property in the project during the period of

---

41 The accumulated earnings tax on corporations, INT. REV. CODE OF 1954, § 531, would make accumulations more costly, but would not totally undermine the scheme. Moreover, depreciation deductions might eliminate much of the company's earnings and profits, *see* notes 24 and 25 *supra*, so that the company would completely avoid § 531.

42 In Minnesota and New York a duration of only 20 years is required before dissolution. If a company dissolves or fails to meet its statutory requirements before 20 years have passed, it must repay the city the tax subsidy it has received. MINN. STAT. ANN. § 462.591(6) (1963) and N.Y. PRIV. HOUS. FIN. LAW § 96(1) (McKinney Supp. 1972).

43 *See, e.g.*, HAWAII REV. STAT. § 53-23(13) (1968); MINN. STAT. ANN. § 462.695(2) (1963); N.J. STAT. ANN. § 55:14D-24(1) (1964). Massachusetts uses a different approach. It prescribes that if income beyond that necessary for a 6 percent return is earned by the company, the excess is first to be applied toward payment of the normal property taxes that would be payable (beyond the excise payable in lieu of taxes), then any balance is to be applied to the reduction of indebtedness or renovation or development of additional property which will be subject to the redevelopment company law. MASS. GEN. LAWS ANN. ch. 121A, § 15 (1969).

44 N.Y. CONST. art. XVIII, § 1.

45 *See* note 47 *infra*.

any tax exemption."[46] If the rents are fixed sufficiently low, low income tenants will be able to afford the housing. Presumably if allowed only such low rents, the landlord will build only housing suited for lower income families, if he builds at all. Significantly the statute does not require that the rents be fixed at *low* levels. If a housing authority feels compelled to get housing built, it might fix rentals high enough to encourage developers who would only build high income housing.[47] Even if rents are fixed at low levels, there is no guarantee that needy tenants will benefit, since the statute places no limits on who may be tenants of the redevelopment company.

Michigan makes a more serious attempt to insure that the proper tenants benefit from the tax subsidy. Its statute requires that a representative council of residents of the blighted area where the redevelopment is to take place be established and consulted throughout. The company must describe both how the local residents will be able to afford the housing and how those displaced by the construction will have priority of occupancy.[48] Since the redevelopment is presumably taking place in a blighted area, these provisions, if enforced, should guarantee that only those previously inadequately housed will benefit from the tax subsidy. Some preference for those low income people displaced by the project also is justified.

If private developers are told they can get the subsidies only if they build and rent primarily for low income tenants, they may not build at all. But this result seems more equitable than having the poor pay for better housing for the nonpoor. Because nearly all redevelopment company statutes have no mechanism for insuring that the subsidies will help the poor rather than the nonpoor, and because in the absence of such a provision the nonpoor are much more likely to be the beneficiaries, the tax exemptions in most of these statutes are indefensible. It is possible that even without statutory mandate the housing authority in its supervisory

---

46 MINN. STAT. ANN. § 462.645(5) (1963).

47 The Mitchell-Lama program, though more accurately described as a limited dividend program, see part II(B) *infra*, demonstrates this danger. New subsidized Mitchell-Lama housing was being built for families with annual incomes up to $60,000. N.Y. Times, Jan. 30, 1973, at 41, col. 7.

48 MICH. COMP. LAWS ANN. §§ 125.904(1)(f)-(h) (Supp. 1973).

role will only approve genuinely low or middle income housing. But since the authority's performance will be measured by the amount of housing it causes to be built, it is not likely to be too vigilant. The policy of limiting subsidies to those that really need and deserve them seems sufficiently important that it should be put into the statutes and not left to administrative discretion.

B. *Limited Dividend Housing Companies*

Somewhat similar to the redevelopment company statutes are the statutory tax exemptions granted to limited dividend housing companies. These companies do not have to redevelop an entire area and are to build only housing. They are also subject to supervision by a governmental agency and generally qualify for the same state and municipal subsidies as redevelopment companies: condemnation for site assembly, land cost writedown, and tax exemptions. The dividends of these companies are limited to 6 to 8 percent on investment.

New York, New Jersey, and Delaware are the three states that provide some tax exemption to private for-profit landlords through this device; New York has two and New Jersey has three separate limited dividend plans under which a landlord can qualify for tax exemption.[49] In Delaware, limited dividend housing companies can apparently be exempted *completely* from property taxes by the municipality for whatever period the municipality wishes.[50] In New Jersey, complete exemption from all property taxes is available for up to 20, 50, or 60 years, depending on the plan. A service charge in lieu of taxes of 15 percent of gross rents may be exacted under the first two plans, and 12 percent under the third. For the first two plans, the tax bill based on the pre-redevelopment assessment is a floor under the property taxes that must be paid.[51] One New York plan provides that a simple reassessment deferment may be granted for up to 50 years.[52] The Mitchell-Lama

49 Delaware, DEL. CODE ANN. tit. 31, § 4116 (1953); New Jersey, N.J. STAT. ANN. §§ 40:55C-40, 55:16-18, 55:14E-11 (1964); New York, N.Y. PRIV. HOUS. FIN. LAW §§ 33, 93 (McKinney Supp. 1972).

50 DEL. CODE ANN. tit. 31, § 4116 (1953).

51 Note 49 lists the three New Jersey statutes in the order in which they have been discussed.

52 N.Y. PRIV. HOUS. FIN. LAW § 93(5) (McKinney 1962).

program provides for complete tax exemption for up to 30 years, but an excise of not less than 10 percent of the annual shelter rent (gross rent less cost of providing utilities) must be paid in lieu of normal property taxes.[53]

Once again, merely limiting dividends that may be paid out is insufficient to insure that the tax subsidies benefit the poor and inadequately housed. The Delaware statute specifies that the state is to fix maximum rentals,[54] although this still does not guarantee that rents will be low and that the inadequately housed poor will become tenants. New Jersey specifies that the municipality must approve the landlord's rent schedule, which is limited to achieve a 4 to 6 percent annual net return, with any excess to go to the municipality.[55] This still does not guarantee that low income tenants will be the beneficiaries. New York seeks to solve this by not only fixing the landlord's rents,[56] but also the income level of eligible tenants. The Mitchell-Lama statute specifies that its benefits are to be provided only for low income families.[57] Both New York limited dividend company statutes basically limit occupancy to families whose income does not exceed six times (seven times if the family has three or more dependents) the rental of the unit. If a family's income exceeds the prescribed maximum income by 25 percent, the family is subject to removal, though if hardship would result, the family may remain until its income exceeds the prescribed maximum by 50 percent. Surcharge payments are required whenever the family's income exceeds the prescribed maximum.[58]

Such formulas will insure that low income tenants are to benefit only if the rents are actually fixed at low levels, so that six times the rental does not equal an enormous figure. But despite the statutory mandate that benefits are to be provided only for families of low income, it is clear that New York has allowed rents higher than the poor can afford.[59] Even if the formula worked,

53 N.Y. PRIV. HOUS. FIN. LAW § 33 (McKinney Supp. 1972).
54 DEL. CODE ANN. tit. 31, § 4110 (1953).
55 N.J. STAT. ANN. § 55:14E-8 (1964).
56 N.Y. PRIV. HOUS. FIN. LAW §§ 31, 85 (McKinney Supp. 1972).
57 *Id.* § 31(2)(a).
58 N.Y. PRIV. HOUS. FIN. LAW § 85-a(2)(a) (McKinney Supp. 1972) does not articulate all of these provisions; but § 31, for the Mitchell-Lama program, does.
59 *See* note 47 *supra.* By 1968 it was clear that the Mitchell-Lama program re-

it would not necessarily allocate the new housing to low income tenants currently inadequately housed.

C. *Landlords Qualifying for Government Assistance*

A third sort of landlord eligible for tax exemption is one who is receiving government mortgage assistance or other major aid. Whether the enabling statute requires that a landlord receive mortgage subsidies or mortgage insurance is important, because in granting the latter the federal government reserves only the power to fix rents.[60] For mortgage subsidies there are the more stringent requirements of a 6 percent dividend limit, rent controls, and tenant income limits. Since the federal income levels are not based on multiples of rents, but on absolute income, the beneficiaries will more certainly be moderate income tenants. And the ceiling on rents and profits guarantees that the benefit of the subsidies will be more fully passed on to low income tenants.[61] A state granting the tax exemption only to landlords re-

quired a minimum annual income of $10,000, and a family of four with an income of $41,600 was eligible for a seven-room apartment in one of the major projects. *See* Quirk & Wein, *Homeownership for the Poor*, 54 CORNELL L. REV. 811, 857 & n.230 (1969). This is primarily attributable to rising costs.

60 12 U.S.C. § 1715z-1 (1970).

61 Housing and Urban Development Act of 1968, § 201(a), 12 U.S.C. § 1715z-1 (1970). In recent years federal mortgage subsidies (beyond insurance) to rental projects came primarily under § 201(a) of the Housing and Urban Development Act of 1968, 12 U.S.C. § 1715z-1 (1970), which added § 236, 82 Stat. 498 (1968), to the National Housing Act, 12 U.S.C. §§ 1707-15y (1970). The maximum subsidy authorized is the difference between amortization over 40 years at market interest rates and amortization at 1 percent.

A for-profit landlord could qualify for § 236 assistance only as a 6 percent limited dividend corporation or entity. 12 U.S.C. § 1715z-1(b) (1970). The § 236 income eligibility requirements are as follows: 80 percent of the apartments in a § 236 building are to go to families whose income does not exceed 135 percent of initial public housing admissibility income levels in the area. (In 1970 maximum eligible § 236 tenant income generally ranged from $6,000 to $8,000 for a family of five in major American cities. Some examples: Boston, $7,965; Cleveland, $8,100; New York, $10,095; Richmond, $4,995. C. EDSON & B. LANE, A PRACTICAL GUIDE TO LOW- AND MODERATE-INCOME HOUSING 2:3 (1972)). The remaining 20 percent of the apartments are to go to families whose income does not exceed 90 percent of the higher National Housing Act § 221(d)(3) limitations. 12 U.S.C. § 1715z-1(i)(2) (1970).

The Secretary of HUD is to determine for each dwelling unit a fair market rental, based on operating cost and payment of the market-rate mortgage, and a "basic rental charge," based on operating cost and payment of a 1-percent mortgage. *Id.* § 1715z-1(f). The tenant's rental is the "basic rental charge" or such greater amount, not exceeding the fair market rental charge, as represents 25 percent of the tenant's income. To determine the 25 percent of tenant's income, HUD is to review income at intervals of two years or less. *Id.* § 1715z-1(e).

ceiving federal mortgage subsidies will not have to spell out extensive rent and tenant income limits, and still will be certain that only moderate income tenants receive the benefits of its tax exemption.

Thus Vermont provides that any city may agree to payments in lieu of property taxes with any "person who owns or intends to acquire or seeks to construct a federally subsidized, low or moderate income housing project . . . where federal assistance would not be available in the absence of such an agreement. . . . [T]he term of the agreement shall not exceed forty years . . . ."[62] The Vermont statute not only avails itself of the federal rent and income ceilings, but also shifts much of the administrative burden of determining how large a tax exemption is necessary to the Department of Housing and Urban Development (HUD), which already has a bureaucracy and presumably the expertise to make such determinations.

Michigan combines a federally-aided or authority-aided eligibility test with a statutory description of the beneficiaries to establish who qualifies for tax abatement. "The benefits of any exemption granted under this section shall be allocated by the owners of the housing project exclusively to low income persons or families in the form of reduced housing charges."[63] Where the owner has tenants who are not in the low income category (as defined by the statute under which the other governmental assistance is being received or by the state housing authority), he must pay taxes on that portion of the housing as if the project were not exempt.[64] Hopefully this sanction and the federal type definition of income levels will limit Michigan's tax subsidy to low income tenants more successfully than New York's limited dividend housing programs.

Connecticut provides government-aided housing with an exemption from *all* property taxes, not merely reassessment deferment:

> Any municipality may by ordinance provide for the abatement in part or in whole of real property taxes on any housing

62 VT. STAT. ANN. tit. 32, § 3843 (Cum. Supp. 1973).

63 MICH. COMP. LAWS ANN. § 125.1415a(6) (Supp. 1973). The municipality may provide that the exemption is not to apply. *Id.* § 125.1415a(5).

64 *Id.* § 125.1415a(6).

> solely for low- or moderate-income persons or families. Such tax abatement shall be used for one or more of the following purposes: To reduce rents below the levels which would be achieved in the absence of such abatement and to improve the quality and design of such housing, or to effect occupancy of such housing by persons and families of varying income levels within limits determined by the [state] commissioner [of community affairs] by regulation, or to provide necessary related facilities or services in such housing. Such abatement shall be made pursuant to a contract between the municipality and the owner of any such housing, which contract shall provide the terms of such abatement, that moneys equal to the amount of such abatement shall be used for any one or more of the purposes herein stated, and that such abatement shall terminate at any time when such housing is not solely for low- or moderate-income persons or families.[65]

For the municipality to allow anyone but low or moderate income tenants to benefit from the tax subsidy would exceed the statutory authority. Neither Michigan nor Connecticut has specifically limited the beneficiaries to tenants currently inadequately housed. While tying eligibility to receipt of federal mortgage assistance does tend to exclude those tenants who could afford adequate housing, it also excludes those who have not sought federal mortgage assistance.[66]

D. *Landlords Not Qualifying for Direct Government Assistance*

All the tax exemption statutes considered so far almost completely exclude any benefits from reaching resident landlords of low income tenements, particularly those owners of the existing stock who may want to rehabilitate. These landlords do not undertake major area redevelopment, nor are they likely to be involved with limited dividend housing companies or HUD mortgage subsidies. Yet is is precisely this type of landlord who is most likely to maintain livable dwellings in poverty areas.

> *[T]here is no question of the significance of landlord residence . . . as insurance of proper maintenance of slum tenements. . . . It is the resident landlord, and only the resident landlord, who is in a position to properly screen and super-*

65 CONN. GEN. STAT. ANN. § 8-215 (1971).
66 *Opinion of the Attorney General*, 31 CONN. L.J., June 9, 1970, at 12.

> *vise his tenantry. No one-shot wave of maintenance and paint up-sweep up campaign can provide the day to day maintenance which is required in slum areas.*[67]

Clearly most of the abatement statutes are encouraging absentee forms of ownership at the expense of resident landlords. The lack of any limit on the profits of resident landlords should not deter grating them tax exemptions, since rehabilitation is unlikely to permit them to raise rents.[68] The more realistic concern would be that reassessment deferment alone would be insufficient to induce a rational profit motivated resident landlord to improve his poverty area property; he would not receive the other subsidies provided by government programs. Yet if a poverty area resident landlord or even an owner of a single family home does improve his property, he seems to deserve reassessment deferment as much as the more.heavily subsidized landlords.

Six states currently authorize tax exemptions for profit seeking landlords who do not operate under the broader government subsidy formats already discussed, although in Connecticut it is now too late for landlords to undertake improvements which would qualify.[69] Vermont, without any major blighted urban areas, authorizes its municipalities to grant two general tax exemptions. One is an exemption for up to three years on the first $15,000 appraised value of any newly constructed dwelling. This exemption does not apply to those taxes on the value of the land as distinct from buildings.[70] The second provides that when a person purchases land "unoccupied and neglected . . . for at least two years preceding such purchase and repairs or erects building thereon suitable for a home or otherwise improves such land,

---

67 STERNLIEB, *supra* note 3, at 228 (emphasis in original). *See* GRIGSBY, *supra* note 10, at 236. *See also* NEWSWEEK, Mar. 6, 1972, at 84, quoting Roger Starr, director of New York's Citizens' Housing and Planning Council, on how to run public housing in the South Bronx:

> One way . . . is to put a black, or Puerto Rican, manager or owner in charge of every black or Puerto Rican apartment building. He should have a real economic incentive — "a piece of the action" — to make the place livable and therefore profitable. And he should have the unquestioned right to reject or evict tenants.

68 *See* note 17 *supra* and accompanying text.

69 The six, in order of discussion, are Vermont, Indiana, Connecticut, Pennsylvania, Ohio, and New York.

70 VT. STAT. ANN. tit. 32, § 3836 (1970).

such buildings and improvements may be exempted from taxation for a period of five years, if the town so votes."[71] Clearly these benefits are not limited to low income residents. But at least the short duration of the tax exemption is not likely to cause a major inequitable shift in the tax burden.

The more urban states making available such exemptions more carefully define the eligible beneficiaries. Indiana achieves this by limiting the tax exemption to housing with a low market value, which is thus more likely to be occupied by low income residents. The statute, which applies only to rehabilitation and not new construction, provides a 5-year deferment for up to $2,500 of upward reassessment per dwelling unit rehabilitated in the following categories of housing: single family dwellings with an assessed valuation (exclusive of land) of less than $3,000 prior to the rehabilitation, two-family dwellings previously assessed (exclusive of land) at less than $4,000, and dwellings with three or more family units previously assessed (exclusive of land) at less than $1,500 per dwelling unit.[72] The Indiana assessment ratio is about one-quarter of market value.[73] As a result, rehabilitation expenditures or increases in market value of up to $10,000 per unit are exempted from increased taxes. The low initial value of the eligible property and the limitation on the value of the exemption make clear that rehabilitation of inexpensive housing is the aim of the statute. A 5-year exemption is not very long, but at least it is realistically geared to the crucial cash flow period of debt repayment likely to be involved in a poverty area rehabilitation; even when poverty area landlords can get bank financing for rehabilitation, repayment must generally be made in less than five years.[74] Since this statute affects many unsophisticated prop-

---

71 *Id.* § 3841.

72 IND. ANN. STAT. § 6-1-10.1-1 (Burns 1972). The exemption seems mandatory on municipalities.

73 ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, STATE AND LOCAL TAXES, SIGNIFICANT FEATURES 77 (1968). The Indiana median ratio has been shown to be actually 24.2 percent. 2 BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, 1972 CENSUS OF GOVERNMENTS, TAXABLE PROPERTY VALUES AND ASSESSMENT — SALES PRICE RATIOS, pt. 2, at 57 (1973) [hereinafter cited as TAXABLE PROPERTY VALUES].

74 STERNLIEB, *supra* note 3, at 192, 194. Under § 312(c) of the Housing Act of 1964, 42 U.S.C. § 1452b(c) (1970), and § 220(h)(2)(i) of the National Housing Act, 12 U.S.C. § 1715k(h)(2) (1970), property owners in an urban renewal or concentrated code

erty owners, the legislature properly imposed on county treasurers the duty to make property owners in their counties aware of this tax exemption.[75]

The four other states preliminarily require that the improvement take place within an area declared by a government agency or the local legislature to be a deteriorated, redevelopment, or urban renewal area. In Connecticut, towns were then able to give a private landlord up to a 15-year reassessment deferment on newly constructed rental housing projects.[76] Without more precise limitations, either on rentals or on income levels, higher income tenants could be the primary beneficiaries. A landlord could convert a portion of the deteriorated area into a haven for the rich.

Pennsylvania authorizes municipalities to defer reassessment for up to 10 years on a sliding scale for up to $10,000 of rehabilitation per unit in buildings located in "deteriorated" neighborhoods.[77] In theory high income landlords and tenants could be the beneficiaries; however, this is unlikely. Mere rehabilitation probably cannot create higher income housing in previously blighted neighborhoods; this would cost much more than $10,000 per unit. The Pennsylvania statute does apply outside "deteriorated neighborhoods" to "deteriorated property," defined as property certified by a government agency as unfit for human habitation, or subject to a vacate or demolition order for noncompliance with housing laws. Here again high income people may be the beneficiaries, but the nature of the property makes this less likely.

Ohio is more careful about who may benefit from its tax exemption. It provides reassessment deferment for rehabilitation or new construction in "rehabilitation areas," to be defined by the municipal legislature on the following terms: (1) a 5-year reassessment deferment on a dwelling of not more than two units on which the cost of remodeling is at least $2,500 or (2) 5-year deferral of reassessment for dwellings of more than two units on which the cost

---

enforcement area are eligible for direct federal rehabilitation loans of up to $12,000 per dwelling unit at 0 to 3 percent interest for up to a 20-year term.

75 IND. ANN. STAT. § 6-1-10.1-5 (Burns 1972).

76 CONN. GEN. STAT. ANN. § 12-65 (1972). In order for a project to qualify, its construction had to commence on or before April 1, 1971.

77 PA. STAT. ANN. tit. 72, §§ 4711-16 (Supp. 1973).

of remodeling is at least $5,000 and 25 percent of assessed value;[78] or (3) a 10-year reassessment deferment on construction of a new dwelling.[79] For a multiunit dwelling to qualify for the exemption, at least one-half of the household heads in the building must have resided in a rehabilitation or slum area at some time during the past five years.[80] Ohio thus seeks to delimit the beneficiaries not on the basis or rent and tenant income levels, but rather on the likelihood that the particular tenants have been inadequately housed. It is likely that recent residents of slum area housing are also in the low income category. By adequately limiting the beneficiaries without relying on rent controls, Ohio also avoids the discouraging effect formal rent controls have on landlord improvement decisions.[81]

Ohio even seeks to give the intended beneficiaries, slum area tenants and landlords, supervisory power over the way a particular tax subsidized landlord is maintaining his building. The statute requires that a housing committee of nine to 15 members be elected by tenants and landlords of tax subsidized buildings from among themselves. At least one-third of the committee members must be tenants. This committee is to make quarterly inspections of each building receiving the tax exemption. If it finds the owner is not properly maintaining his building, it can revoke his tax exemption. If it finds that some tenant is not properly maintaining his apartment, the committee can terminate his tenancy.[82] While this may work in a landlord's best interests — for if other tax subsidized properties near his own are well maintained, this will increase the value of his own property — an entrepreneur-landlord is probably not anxious to have a committee tell him how to run his building. In addition, the Ohio statute requires the landlord to agree to sell ("at market value, for cash") to the tenant the unit he has occupied for five years.[83] These requirements, along with further administrative complications which are condi-

78 The median assessment ratio in Ohio is 29.7 percent of market value. TAXABLE PROPERTY VALUES, *supra* note 73, at 71.

79 OHIO REV. CODE ANN. § 3735.67 (Page 1971).

80 *Id.* § 3735.68.

81 J. HEILBRUN, REAL ESTATE TAXES AND URBAN HOUSING 114 (1966).

82 OHIO REV. CODE ANN. § 3735.70 (Page 1971).

83 *Id.* § 3735.69.

tions precedent to the operation of the statute, make it questionable whether the Ohio statute will accomplish very much.[84]

New York allows 12-year reassessment deferment to any profit seeking landlord in a rehabilitation or urban renewal area for rehabilitation "to eliminate presently existing unhealthy or dangerous conditions in any such multiple dwelling, or to replace inadequate and obsolete sanitary facilities any of which represent fire or health hazards, except insofar as the gross cubic content of the building is increased thereby."[85] Because of these requirements and because the municipality may fix rents,[86] beneficiaries of the tax subsidies will probably be limited to lower income tenants and their landlords. In addition, since the resident landlord is not eligible for the additional assistance which would make rehabilitation profitable, New York uses tax abatement to reimburse for such expenditures.[87] Besides reassessment deferment, it also provides an abatement of existing taxes equivalent to 8⅓ percent of the cost of the rehabilitation for up to 12 years.[88] Alternatively, the municipality may spread this reimbursement of improvement expenditure over a 13 to 20 year partial abatement of existing taxes.[89] The landlord is thus at least reimbursed for his improvement expenditure, even if he cannot raise rents.

Abating *existing* taxes to reimburse for rehabilitation seemingly will decrease the municipality's existing tax revenues. This will also be true under the Connecticut government-aided housing statute, the Delaware Limited Dividend Company statute, and the Missouri Redevelopment Company statute, where not only reassessment deferment, but exemption from *all* property taxes was in-

84 The area housing committee must be elected and actually be making quarterly inspections of each property for the tax exemption to be effective. As a further condition precedent, a "housing rehabilitation council" of public officials from the entire metropolitan area must be created. It is to make an annual inspection of every property which has received the tax exemption. *Id.* § 3735.71. The effective date of the Ohio statute was December 2, 1969, but by August 1971 no Ohio city had taken the preliminary steps necessary under the statute. Knowledgeable persons in Cleveland in the summer of 1971 thought the statute unworkable and perhaps unconstitutional.

85 N.Y. REAL PROP. TAX LAW § 489(1)(a) (McKinney 1972).

86 *Id.* § 489(7).

87 *Id.* § 489(1). Unless "cost of the rehabilitation" takes into account financing cost, the reimbursement would not cover the full cost of the improvement.

88 *Id.* § 489(2).

89 *Id.*

volved.[90] That the municipality taxes others more heavily to make up this revenue loss may well be justifiable, so long as the beneficiaries of the tax subsidy are low income residents who were previously inadequately housed. The city may not even have to make up the exemption from existing taxes. The loss of revenue may be compensated for by a municipal cost saving: some of the low income public housing which the city would otherwise have to support and administer would be provided by private landlords. Despite all this, a city might hesitate to decrease existing taxes for private landlords. Certainly such tax exemption would be politically more troublesome than would mere reassessment deferment.

It is here that the Connecticut legislature alone, as part of its complete tax exemption to government-aided private housing, has taken a substantial step. Connecticut law provides:

> The state, acting by and in the discretion of the commissioner [of community affairs], may enter into a contract with a municipality for state financial assistance for housing solely for low or moderate income persons or families in the form of reimbursement for tax abatements [under § 8-215[91]]. . . . Such contract shall provide for state financial assistance in the form of a state grant-in-aid to the municipality equal to the amount of taxes abated by the municipality pursuant to section 8-215.[92]

Connecticut thus makes it possible for its cities to grant truly significant abatement by reimbursing the cities for revenue lost by abatement. Coincidentally, the state becomes involved in assisting local housing improvement, while the property tax is replaced to a limited degree by the other state revenue sources.[93]

---

90 Since those exemption statutes providing for a service charge in lieu of taxes almost universally retain the pre-improvement taxes as a floor under the excise that must be paid, existing tax revenues would not be lost under such statutes if they were limited to lower income housing.

91 Quoted in text at note 65 *supra*.

92 CONN. GEN. STAT. ANN. § 8-216(a) (1971). This reimbursement may continue for up to 40 years. Such reimbursement was suggested in 1 ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, THE ROLE OF THE STATES IN STRENGTHENING THE PROPERTY TAX 12 (1963). It has also been suggested that the federal government (HUD) reimburse cities which grant such tax abatement. *See* 5 HEARINGS BEFORE THE NATIONAL COMMISSION ON URBAN PROBLEMS 122 (1968).

93 This is deemed desirable because the property tax on housing is generally

E. *Conclusion*

The newly constructed or rehabilitated housing which benefits from the statute must be lower income housing. Perhaps large "deteriorated" or "redevelopment" areas can be defined by a local legislature or agency with sufficient precision so that the benefiting tenants would almost certainly be lower income persons. But a major developer could still convert some corner of the defined area into high income housing by new construction, even if not by rehabilitation. Despite the administrative burden it will create, the statute should specify that prospective tenants of the tax subsidized property offer proof that they have lived within designated deteriorated areas for the past year, or that their incomes do not exceed specified absolute income limits, such as the ones for HUD § 236 housing. If these tenant restrictions are included, "deteriorated property" outside the designated deteriorated areas should also qualify for the tax relief.

So that landlords do not feel that utilizing the tax exemption will preclude them from renting to any "reliable" tenants in the future, the statute might require that only 50 percent of the tenants at any one time need meet the income or prior residence test. Even if the 50 percent requirement were not met, only an amount of the exemption proportionate to the percentage of non-qualifying tenants would be lost, as long as at least 25 percent of the tenants qualified. There are innumerable ways that a sliding scale could be devised once more than 50 percent of the tenants failed the eligibility tests. For each percent of ineligible tenants above 50, the landlord could lose 4 percent of his exemption. Or he could lose an initial 50 percent plus two percent for each percent of ineligible tenants above 50. Or over the range of 25 percent to 49 percent of qualified tenants, there could be a 50 percent exemption. The first possibility would be most reasonable,

---

considered particularly pernicious. It is regressive and retards urban (re)construction by reducing demand for housing, since it is an inordinate excise on the consumption of housing. *See* D. NETZER, ECONOMICS OF THE PROPERTY TAX 32-36 (1966).

While nearly half of local government revenue comes from the property tax, only 2 percent of total state revenue comes from the property tax. *Id.* at 9. Thus the state would not merely be replacing city property tax dollars with state property tax dollars. Overall reliance on the property tax would be reduced.

since it would reduce the distortions caused by sharp changes in percentage of exemption.

A landlord could verify a tenant's income by examining the tenant's most recent federal income tax return upon initial occupancy and every three years thereafter during the duration of the tax exemption. Each tenant with income at the borderline should be required to submit his return annually. Prior residence could be demonstrated by the address on the income tax form, driver's license, or a rent receipt from the prior landlord. The landlord would declare upon applying for the tax exemption that his tenants meet the income level or prior residence standards, and he would be expected to notify the tax assessor if these circumstances changed. The assessor would be empowered to require landlords to present the tenant income tax return copies or evidence of prior residence; the landlord would have to reimburse the assessor for any violations discovered.

This might require a landlord with a vacant apartment to turn away willing tenants if he wanted to keep his exemption. Such a prospect certainly will not help sell the tax subsidy program to landlords. As long as the goal of such tax exemption is to encourage the construction and rehabilitation of low income housing, at least a majority of those who receive the improved housing must be low income persons or people who have previously been inadequately housed. If the building is located in a genuine poverty area, meeting the tenancy requirements should be no hardship for the landlord. Adequately housed middle class tenants will not be fighting to get into improved poverty area housing.

Once the eligibility of tenants has been established, low income landlords should be reimbursed for the cost of their major improvements as under the New York statute.[94] Because of the potential revenue hardship on the municipality, the state statute should couple such a provision with a Connecticut-type state reimbursement to cover this additional tax exemption.[95]

Rent controls seem unnecessary so long as the improvement is taking place within a designated deteriorated area and only tax

94 *See* text at notes 87-89 *supra.*
95 *See* note 93 *supra* and accompanying text.

relief is involved. Excessive landlord profits or rent increases are not likely in such blighted areas. Formal rent control provisions would only further discourage landlords from taking advantage of the tax exemption. Rent or profit limits become necessary only when the low income housing landlord receives additional types of government assistance (mortgage subsidies, land cost write-down, rent supplements, or exemption from all taxes). Controls are then justifiable because the probability of excessive profits is much higher. While it is fairly certain that landlords operating under these other subsidies will be heavy users of the tax exemption, the tax statute should not be limited to such government subsidized landlords. Resident landlords play too vital a role in maintaining low income property to be excluded.

Finally, the question remains whether there is any need for such statutes, since the assessor will often either overlook rehabilitation or grant an informal abatement.[96] The problem is that only the major developer has the necessary bargaining power to secure informal abatement, and he is usually not building low income housing. The poverty area resident landlords do not have this power. They are unconvinced that the assessor will overlook their improvements.[97] Statutory provisions are essential to provide certainty and thereby encourage poverty area resident landlords to improve their property.[98]

---

96 D. NETZER, ECONOMICS OF THE PROPERTY TAX 83 (1966).

97 *See* STERNLIEB, *supra* note 3, at 212.

98 The above discussion assumes that there would be no state constitutional problems in the passage of reassessment deferment legislation. This is not completely accurate, but the desirability of such legislation is not altered by potential constitutional problems. *See* Oldman, Cobb & Oosterbuis, *Problems Under State Law of Federal Residential Property Tax Relief Proposals*, in ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, FINANCING SCHOOLS AND PROPERTY TAX RELIEF — A STATE RESPONSIBILITY 86-90, 203-22 (1973); W. NEWHOUSE, CONSTITUTIONAL UNIFORMITY AND EQUALITY IN STATE TAXATION (1959).

CONGLOMERATE MERGERS: PROPOSED GUIDELINES

SHELBY BRYAN*

Introduction

The courts, given a mandate[1] by the antitrust laws to guard against corporate concentration, are ill-equipped to deal with the ultimate concentrators, conglomerates.[2] Although the Supreme Court has stated[3] that conglomerate mergers are within the reach of § 7 of the Clayton Act,[4] the courts have not fully considered the broad social and economic changes resulting from conglomeration. As a result the conglomerate movement in the United States has fallen far short of a maximization of social utility.

The purposes of this article are to examine the alleged harms and benefits of conglomeration, to describe briefly how antitrust laws are being interpreted, and to suggest an alternative to present enforcement standards. This alternative would allow conglomerate mergers only where they produce a substantial economic benefit to society.

I. CONGLOMERATE MERGERS

A. *Background*

A brief discussion of terms is necessary to establish the metes and bounds of the proposed guidelines. The designation "con-

* Member of the Texas State Bar. B.A., 1968, J.D., 1970, University of Texas; M.B.A., 1973, Harvard Graduate School of Business.

The author wishes to acknowledge the assistance of Kermit Kubitz, a third-year student at Harvard Law School.

1 The Senate Report, in promoting passage of the Celler-Kefauver Act, noted "the purpose of the proposed bill . . . is to limit future increases in t level of economic concentration resulting from corporate mergers and acquisitions." S. REP. No. 1775, 81st Cong., 2d Sess. 3 (1950).

2 The staff of the Cabinet Committee on Price Stability reported that the Celler-Kefauver Act appears "inadequate to cope with the massive industrial restructuring resulting from current conglomerate merger activity." STAFF OF CABINET COMM. ON PRICE STABILITY, STUDIES 86 (1969).

3 FTC v. Procter & Gamble Co., 386 U.S. 568 (1967).

4 15 U.S.C. § 18 (1970).

glomerate" is usually given to a corporation operating in a number of different, unrelated markets. The courts and the Bureau of Economics of the Federal Trade Commission distinguish mergers as horizontal,[5] vertical,[6] and conglomerate. Conglomerate mergers are divided into subcategories of product extension, market extension, and "other" (or pure) conglomerate.[7]

Geographic market extension mergers are those in which the acquired and acquiring companies manufacture the same products but sell them in different geographic markets.[8] Product extension mergers are those in which the acquired and acquiring companies are functionally related in production and/or distribution but sell products which do not compete directly with each other.[9] "Other" or pure conglomerate mergers involve the union of two noncompeting companies having neither a buyer-seller relationship nor a functional relationship in manufacturing or distribution. This article is concerned primarily with the pure conglomerate merger, although in any given merger the conglomerate acquistion may not be described precisely by any of the definitions.

Rapid growth in conglomeration began after the Second World War;[10] that growth continued until 1969 when Justice Department opposition combined with reduced capital markets to restrict conglomerate growth.[11] In 1950 there were 219 manufacturing and mining acquisitions. By 1960 the number had grown to 844. In 1965 this group of mergers reached 1,008; by 1968 it was 2,442. In terms of acquired assets the amount grew from $2.3 billion annually in 1960 to $15 billion in 1968.[12]

The most significant development during the 1960's was the increasing number of large acquisitions. The FTC defines large

5 *See, e.g.*, Brown Shoe Co. v. United States, 370 U.S. 294 (1962); United States v. Bethlehem Steel Corp., 168 F. Supp. 576 (S.D.N.Y. 1958).

6 *See, e.g.*, United States v. E.I. du Pont de Nemours & Co., 353 U.S. 586 (1957).

7 FTC, ECONOMIC REPORT ON CORPORATE MERGERS, in *Hearings on Economic Concentration Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 91st Cong., 1st Sess., pt. 8A, at 59 (1969) [hereinafter cited as ECONOMIC REPORT ON CORPORATE MERGERS].

8 *See, e.g.*, United States v. Falstaff Brewing Co., 410 U.S. 526 (1973).

9 FTC v. Procter & Gamble Co., 386 U.S. 568, 577 (1967).

10 *Hearings on Investigation of Conglomerate Corporations Before the Antitrust Subcomm. of the House Comm. on the Judiciary*, 91st Cong., 1st Sess., pt. 1, at 4-5 (1969) (statement of Representative McCulloch).

11 *See* notes 27 & 92 *infra*.

12 ECONOMIC REPORT ON CORPORATE MERGERS, *supra* note 7, at 667, table 1-3.

acquisition as one in which the acquired firm has assets of $10 million or more.[13] In 1960 there were 62 large acquisitions, involving assets of $1.7 billion; in 1968 a total of 205 large acquisitions involved assets of $12.8 billion.[14] Conglomerate mergers have played a significant role in the merger movement since the Second World War. Of the 1,653 large acquisitions of mining and manufacturing firms made between 1948 and 1971, conglomerate mergers accounted for 72.8 percent of the acquisitions.[15]

In spite of this active level of acquisition, it is not clear whether asset concentration has caused market concentration.[16] Professor Donald Turner disagreed with the FTC Staff Report's finding that the increase in aggregate concentration of business assets resulted in market concentration: "In brief, my 'subjective arithmetic' is this: ... there is no demonstrably significant correlation between aggregate concentration of business assets and undue market concentration — that is, market concentration unrelated to efficiency or performance considerations . . . ."[17]

Under the Celler-Kefauver Act[18] the Justice Department's attack on mergers has been primarily concerned with market concentration rather than aggregate concentration. Perhaps as a result, market concentration has not worsened significantly and may indeed have decreased.[19] It has declined in producer goods industries over the postwar years.[20] On the other hand there is evidence that it has recently increased in consumer goods industries.[21]

---

13 STAFF OF THE ANTITRUST SUBCOMM. OF THE HOUSE COMM. ON THE JUDICIARY, 92D CONG., 1ST SESS., REPORT ON INVESTIGATION OF CONGLOMERATE CORPORATIONS 1 (Comm. Print 1971) [hereinafter cited as HOUSE REPORT].

14 *Id.*

15 BUREAU OF ECONOMICS, FTC, LARGE MERGERS IN MANUFACTURING AND MINING 1948-71, at 7, table 2 (Statistical Report No. 9, 1972) [hereinafter cited as FTC REP. I].

16 "'Market concentration' refers to the share of business held by the leading firms in a single definable market . . . . 'Aggregate concentration' measures the position that the largest enterprises occupy in total manufacturing activity." HOUSE REPORT, *supra* note 13, at 20.

17 *Hearings on Economic Concentration Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 91st Cong., 2d Sess., pt. 8, at 4756 (1970) (statement of Donald Turner) [hereinafter cited as *1970 Hearings*].

18 15 U.S.C. §§ 18, 21 (1970).

19 HOUSE REPORT, *supra* note 13, at 48.

20 STAFF OF CABINET COMM. ON PRICE STABILITY, STUDIES 81 (1969).

21 Miller, *Conglomerates, Conglomerate Mergers and the Federal Antitrust Laws*, 44 ST. JOHN'S L. REV. 613, 625 (spec. ed. 1970).

Whatever the trend in market concentration, many foresee serious consequences from increased aggregate concentration per se. A report by the staff of the House Antitrust Subcommittee indicated that the growth in aggregate concentration may result in weaker competitive markets:

> Growth of these vast corporate structures, even though, at the same time, they are accompanied by an increase in number of the much smaller and less powerful corporate organizations that operate under the umbrella of the major companies in markets served by the major companies, presages imposition of a cartel-like structure to American business. Some observers foresee a situation where the American economy will be dominated by a few hundred business suzerainties, under whose influence a multitude of small, weak, quasi-independent corporations will be permitted a subsidiary and supplemental role.[22]

Conglomerate growth during the past two decades has been facilitated by the increased importance investors have placed on growth in earnings[23] and the conglomerate's ability to acquire companies with its own stock, sometimes called "funny money." If an acquisitive company has a higher price-earnings multiple than the prospective acquisition and the latter will accept the acquirer's stock as payment, then the acquirer can purchase cheaply a company and its stream of earnings.[24] However, in order

---

22 HOUSE REPORT, *supra* note 13, at 49.

23 Harry Lynch, in commenting on what conglomerates hope to obtain from an acquisition, has written: "Information regarding these companies suggests that (1) the principal financial objective is growth in earnings per share, (2) an immediate contribution to earnings per share is sought in acquisition transactions, (3) the price-earnings multiple is viewed as an important resource for growth." H. LYNCH, FINANCIAL PERFORMANCE OF CONGLOMERATES 280 (1971).

24 Consider this example, in which everybody makes money when a conglomerator uses a high p/e to buy a low p/e. A conglomerate whose stock sells at $45 a share and is earning $1 a share makes a deal to acquire a company that has the same number of shares outstanding, and a stock selling at $10 and also earning $1. The conglomerate offers one of its shares for every three of the other company's — an irresistible 50% premium to the other's shareholders. When the merger is complete, the conglomerate (which has issued a third as many new shares as it already had outstanding) can combine the earnings and restate them for the diluted equity. Now, where three shares of the parent's stock used to earn $3, four shares earn $6, for a per-share profit of $1.50. Its stock, based on the p/e of 45, rises to $67.50.

Conglomerates, BUS. WEEK, Nov. 30, 1968, at 76.

to maintain a high price-earnings multiple, it is necessary for a company to produce a consistent growth in earnings; a company will only command a high price-earnings multiple if the investing public believes that there will be an increasingly large stream of earnings from which it will benefit. Since many of the companies purchased by conglomerates have a relatively small growth rate in earnings — hence their lower price-earnings multiple — they cannot be counted on to produce significant earnings growth. Therefore more pressure is created for the conglomerate to acquire in order to produce growth in earnings. Since most managers are judged on earnings and stock price performance, once a company starts the acquisition process there is a built-in incentive to continue it with increasing voracity. As a result, when a conglomerate is unable to buy larger amounts of earnings, the decline in earnings growth will be followed by an unusually sharp decline in the stock price, which in turn will retard further acquisitions.[25]

A general reduction in merger activity was precipitated in 1969-70 by a lack of investor confidence in the security markets, a credit crunch, and antitrust actions brought against a few highly visible conglomerate mergers.[26] Although there was a startling reduction in the number of acquisitions during this 2-year period,[27] a few conglomerates came through the period as well as their nondiversified counterparts.[28]

In addition to the desire for growth in earnings, there have been other built-in incentives for corporate acquisitions. Certain tax laws,[29] which allow a choice of taxed or tax-free acquisition,

---

25 Max Shapiro calculated the decline of 10 major conglomerates from their post-1968 highs to 1971. The average decline was 86 percent. Litton dropped 86 percent; Gulf & Western dropped 87 percent; Ling-Temco-Vought dropped 95 percent. Shapiro, *The Great Crash in Growth Stocks*, DUN'S REV., Jan. 1971, at 30.

26 *See* note 92 *infra*.

27 Large acquisitions in mining and manufacturing dropped from 155 in 1969 to 98 in 1970 and 66 in 1971. FTC, CURRENT TRENDS IN MERGER ACTIVITY, 1971, at 13, table 6 (1972).

28 In mid-1970 12 of 57 companies actively engaged in acquisitions showed increases in stock price levels as compared with the end of 1969. MERGERS AND ACQUISITIONS, May-June 1970, at 64.

29 *See* Sinrich, *Tax Incentives and the Conglomerate Merger: An Introduction*, 44 ST. JOHN'S L. REV. 1009 (spec. ed. 1970).

and accounting practices,[30] which permit undervaluation of the acquisition's assets and thus inflate its performance, have encouraged what might otherwise have been uneconomical acquisitions. Though it is outside the scope of this article, a strong argument might be made that such artificial stimuli to mergers should be reduced or eliminated.

Even without those incentives another merger movement is probable. That a number of conglomerates did well during a rather difficult period seems to indicate that at least some are strong and well managed. Such firms will doubtless again be drawn to the merger market. This article proposes a method whereby such conglomerates may be permitted mergers economically beneficial to society and denied those lacking this virtue. First it is necessary to discuss in some detail the alleged virtues and vices of the conglomerate movement.

B. *Benefits and Harms of Conglomeration*

Arguably, the daily operation of a company acquired by a conglomerate may benefit from manufacturing economies, pooled or increased research and development, increased efficiency in general management functions, or availability of specialized management talent. A larger and more broadly based company may find it easier to penetrate new markets, reduce its operational risk, or acquire capital at a lower cost. It is also said that a conglomerate's move toward acquiring another company may infuse new life into the target firm's management. Some mergers may even have procompetitive effects.

Since a conglomerate merger is neither horizontal nor vertical, manufacturing economies of scale are generally not obtainable.[31] Only in product or market extension acquisitions, sometimes called concentric mergers, is it possible to realize certain economies. The most significant economies will follow if it is possible

---

30 Briloff, *Financial Motives for Conglomerate Growth*, 44 ST. JOHN'S L. REV. 872 (spec. ed. 1970).

31 "In many industrial processes, when you double all inputs, you may find that your output is more than doubled; this phenomenon is called '*increasing* returns to *scale*.'" P. SAMUELSON, ECONOMICS 25 (8th ed. 1970). For a discussion of economies of scale in conglomerate mergers, see *1970 Hearings*, *supra* note 17, at 4652 (statement of Dr. Hogarty).

to reduce redundant capacity by incorporating manufacturing operations or by integrating marketing operations into present distribution channels. However, as the character of the acquisition approaches pure conglomeration, opportunities for such savings diminish. The pure conglomerate, by definition, has control over such a diverse range of products and companies that only "negligible economies of scale can be realized in performing the functions of product-development, purchasing, production, or marketing. Thus it differs from multi-plant, multi-product, or multi-industry firms that do achieve these economies."[32]

Acquisition may enable the conglomerate to commit management skills of a highly talented management team over a large, wide-based sales area. This argument assumes, however, that the conglomerate can both identify and attract management superior to that found in the acquired firm. Since the conglomerate managers will be in charge of many companies, it also assumes that their managerial superiority is such that they can do a better job even though they can devote only a fraction of their time and talent to any one company. Whether they can manage better will depend as much on the nature of the industry as on their abilities.

Conglomerate management might provide a broad overview and long-term perspective while leaving the day-to-day operations to the acquired company's management. In a case where the acquired company lacked this broad perspective and the conglomerate management possessed it, conglomeration might be beneficial. On the other hand, in how many cases will the old management lack this skill, or even need this skill, and how often will the conglomerate have the insight or the time to provide it?

One clear and not particularly beneficial result of conglomeration is that the number of independent decisionmakers is reduced.[33] In a conglomerate situation, a few people make major strategic decisions affecting a whole portfolio of companies. One

32 Jacoby, *The Conglomerate Corporation*, THE CENTER MAGAZINE, July 1969, at 42.

33 For example, Gulf & Western had by 1971 acquired 92 companies, whose previously independent managements thereby became subordinate to Gulf & Western's; Litton had made 103 acquisitions; and ITT had 331 subsidiary corporations, not including 708 lower-tier subsidiary firms. HOUSE REPORT, *supra* note 13, at 78, 164, 361.

might question what the costs in management innovation will be from the reduction in decisionmakers. "The greatest danger in diversification is that it tends to separate management talents and interests from the everyday content of a particular business environment."[34]

This theory seems to be supported by the practice of conglomerates to organize into what Professor Williamson has argued is the best organization for a diversified firm,[35] namely, a multidivisional rather than a unitary form. In a recent study of nine leading conglomerates,[36] the FTC noted that the firms are organized into a series of operating divisions, rather than on a functional basis, with manufacturing, sales, and financial divisions spanning several operating entities. The FTC report asked the question, "If there are limits to the detailed control which headquarters can exert over the acquired subsidiaries, is there really that much hope for improving efficiency after acquisition?"[37] One answer might be that the conglomerate could install better management at the operational level. Yet the FTC study indicated that the majority of management officials of the acquired companies stayed on indefinitely. An additional 39 percent remained initially, but left within three years of the acquisition. Only 10 percent of the management officials left immediately after the acquisition.[38]

Nonetheless it may be true that in certain cases conglomeration will allow small acquired companies to benefit from highly specialized management talent. The possibility exists "that the conglomerate, with its larger and more diverse activities, can utilize efficiently specialized experts in operations analysis, computer science, behavioral science, incentive systems, international business, and so on. The scale of operations of the smaller firms it acquires is often too small to justify their cost."[39] Yet is is not clear that most conglomerate mergers provide this benefit. Most of the firms acquired by conglomerates are already of a substantial size; during

---

34 S. Miller, The Management Problems of Diversification 140-41 (1963).

35 *See* O. Williamson, Corporate Control and Business Behavior 115-19 (1970).

36 Bureau of Economics, FTC, Conglomerate Merger Performance: An Empirical Analysis of Nine Corporations (1972) [hereinafter cited as FTC Rep. II].

37 *Id.* at 44.

38 *Id.* at 59.

39 Jacoby, *supra* note 32, at 48.

1971, 71.6 percent of assets acquired involved firms with over $100 million in assets.[40]

An FTC study did discover some beneficial administrative changes in companies acquired by conglomerates, though they did not necessarily result in significant cost reduction:

> A number of changes were made in various administrative functions after acquisition. Changes most generally occurred in those functions more or less essential for control of the acquired units, such as auditing and legal services. In addition, the majority of acquired companies reported changes in the administration of insurance policies and in the borrowing functions. The consolidation of insurance policies could result in some real economies, although of a rather minor nature. Consolidation of borrowing could result in economies if acquired units were too small to obtain adequate funds from banks at the lowest rates. The administration of credit and borrowing is also a control device on the part of the conglomerate, even if no real economies result.[41]

Conglomerate mergers are often defended on the ground that they provide the acquired company with financial support for capital intensive research facilities necessary for the development of complex technological products.[42] However, most who have studied[43] this assertion have concluded that technological advances are not dependent upon economic concentration, huge size, or substantial market power. "Indeed, some of the most careful studies find that, if anything, market power and the security of bigness, with the concomitant vested interest in the status quo, may have a stultifying effect."[44] Still one must concede, despite anecdotal evidence to the contrary and the fact that most acquisitions have concerned large companies, that a company with limited

40 FTC REP. I, *supra* note 15, at 10, table 5.

41 FTC REP. II, *supra* note 36, at 85.

42 Bruce Wasserstein characterizes this technological need theory as the Schumpter-Galbraith thesis in his article *British Merger Policy from an American Perspective*, 82 YALE L.J. 656, 659-60 (1972), but notes that "American merger policy candidly exposes its prejudices by using fairly mechanical guidelines and spurning most 'expert' evidence about the efficiency effects of individual mergers." *Id.* at 662.

43 *See, e.g.*, J. JEWKES, D. SAWERS & R. STILLERMAN, SOURCES OF INVENTION (2d ed. 1969).

44 Address by Richard W. McLaren to the Federal Bar Association, Council on Antitrust and Trade Regulation, Sept. 17, 1970, *quoted in* HOUSE REPORT, *supra* note 13, at 58.

resources could benefit by receiving financial support from a large acquirer.

Related to the ability of a conglomerate to provide research and development assistance is the deep pocket theory, which claims that a conglomerate can provide the acquired company with money during the unprofitable stages of new product development.[45] However, Neil Jacoby maintains that cross-subsidization, in which a subsidiary is financed through a period of temporary losses, does not commonly occur.[46] This conclusion is supported by an FTC study which discovered that there "was virtually no change in the administration of the research and development, advertising and promotion, or purchasing functions" of the firms studied.[47]

Related to the cross-subsidization theory is the ability of a conglomerate to reduce the risk of any one operation by diversifying into a variety of product lines. One-product-line companies, especially those in cyclical industries,[48] may experience certain periods in the product life cycle in which they are less profitable. Conglomerate mergers are defended on the ground that companies with either different risk profiles or different profitability cycles can be combined in such a way that there will be a relatively smooth flow of earnings. The combination of irregular earnings patterns will allow those product lines with temporarily unprofitable earnings performance to be supported by those products with profitable earnings. The argument supporting conglomeration on this basis would insist that but for the combination of such temporary periods of unprofitability, development of potentially profitable product lines would throw the company into bankruptcy. This argument rests on several assumptions which may not always be valid. First is the premise that the one-product

---

45 Another version of the deep pocket theory suggests that large firms can engage in predatory pricing. *See, e.g.*, Reynolds Metal Co. v. FTC, 309 F.2d 223, 229-30 (D.C. Cir. 1962).

46 *Hearings on Investigation of Conglomerate Corporations Before the Antitrust Subcomm. of the House Comm. on the Judiciary*, 91st Cong., 2d Sess., pt. 7, at 7-328 (1970) (statement of Neil Jacoby).

47 FTC REP. II, *supra* note 36, at 85.

48 A cyclical industry may experience expansion and contraction of sales in some pattern ranging in length from six months to 15 or more years. For a more complete discussion of business cycles, see P. SAMUELSON, ECONOMICS 234-52 (8th ed. 1970).

company could not build up either reserves of capital or credit commitments during profitable periods to support it during leaner times. Second, it is assumed that the combined companies within the conglomerate will have counter-cyclical earnings profiles or cash flow configurations which will enable gains to offset losses. Only after analyzing both past and expected future cash flows of a company and the anticipated availability of capital could it be determined whether a conglomerate merger would benefit the acquired company.[49] A weak or highly leveraged[50] conglomerate might actually harm the acquired company rather than benefit it if difficult economic conditions required the conglomerate to drain the acquired company of earnings.

Similar to the diversified risk argument is the idea that conglomerates can better deal with the problem of a company undergoing liquidation. It is assumed that a large diversified organization can reduce the economic dislocation and minimize unemployment problems by allocating workers and transferable assets to other operations within the conglomerate. However, most conglomerates, rather than being fully integrated operationally, are autonomous in terms of division operation.[51] The lack of communications and functional similarity may make it difficult to transfer production resources from one division to another. Therefore in many conglomerate situations where an acquired firm is liquidated the result will be little different, in terms of its impact on efficient utilization of assets or employees, from what would have occurred in the absence of merger.

It is generally believed that a conglomerate can attract capital more easily than a small undiversified concern.[52] The rationale is

---

49 Conglomerates quite often estimate how much cash they can take out of proposed acquisitions. Gulf & Western estimated a total of $105 million of pretax income was available from Paramount's film library, represented before acquisition by capitalized costs of $12 million on a balance sheet. Leasco estimated that Reliance Insurance had $125 million of redundant capital which was an important reason for seeking acquisition of the company. HOUSE REPORT, *supra* note 13, at 171, 242.

50 Leverage is the process of combining minimum amounts of equity with debt, preferred stock, warrants, and other noncontrolling shares to maximize return on equity. For example, in 1960 ITT's long-term debt was 36 percent of its net worth. In 1968, the same ratio was 56 percent, indicating that ITT had increased its leverage during the period. *Id.* at 140.

51 *See* text accompanying note 35 *supra.*

52 "It is reasonable to expect the price of common-stock capital to be lower for

that since conglomerates are large and diversified, they are less risky; hence investors will contribute more for a given level of earnings. Presumably, conglomerates also have a lower cost of capital because they tend to produce a smooth earnings pattern by combining counter-cyclical earnings streams. If two companies over a period of time report the same total amount of earnings, the company with a less radical variation in its reported earnings will probably command a higher price-earnings multiple.

It is argued finally that a conglomerate, as a result of its great size, can attract capital better than its smaller parts could if they were unconsolidated. There is a belief that in the capital markets large firms receive preference over small ones. However studies have indicated that only very small, newly emerging companies have difficulty obtaining comparably priced capital.[53] Professor Turner noted:

> [W]hatever may be true as to availability of funds, the discrepancy between large and small firms' capital costs seems to decline rapidly as one moves out of the category of very small business. . . . the overall threat to small businesses from ineconomies in capital costs is not very serious: the continued numerical significance of small businesses indicates that capital costs are not an important factor in many lines of endeavor, and that savings in capital costs are not of decisive importance in others.[54]

Perhaps the reason that small single-product firms pay little more for equity capital than their diversified counterparts is that the capital markets provide for a risk reduction. Rather than purchase conglomerate stock, the investor can create a paper conglomerate by purchasing the shares of a number of single-product

---

a big company, but there is little empirical evidence to support this belief." *1970 Hearings*, *supra* note 17, at 5259 (statement of Joel Dean).

53 In 1957, the average interest rate on bank loans to businesses with assets of less than $50,000 was 6.5 percent; corresponding asset/interest rate figures were as follows: $50,000 to $250,000, 5.7 percent; $250,000 to $1 million, 5.4 percent; $1 million to $5 million, 5.1 percent; $5 million to $25 million, 4.8 percent; and over $100 million, 4.4 percent. FEDERAL RESERVE SYSTEM, FINANCING SMALL BUSINESS: A REPORT TO THE COMMITTEES ON BANKING & CURRENCY AND THE SELECT COMMITTEES ON SMALL BUSINESS, 85TH CONG., 2D SESS. 338 (Comm. Print 1958).

54 Turner, *Conglomerate Mergers and Section 7 of the Clayton Act*, 78 HARV. L. REV. 1313, 1338 (1965).

companies. His risk is then spread much as it would have been had he bought conglomerate stock.

Present accounting rules have made it quite diffiicult to assess the individual performance of the managers and the companies controlled by a given conglomerate.[55] Under those rules almost all conglomerates fail to report on a product or even on a company basis, but rather fully consolidate their financial statements.[56] This practice may cause two serious problems. First, it may create informational barriers to entry. High profits of a given product line could be hidden from the public and therefore fail to encourage the entry of potential competition. Second, as an FTC study noted, consolidated statements may result in a misallocation of resources:

> Conglomerates may retain investment in low profit activities without stockholders detecting their errors. In other instances, managers of lower quality may be engaged in the operation of some part of the company. In any case, the perpetuation of the ignorance of owners or the public at large, including potential entrants, can lead to misallocation of resources.[57]

These problems are more indicative of shortcomings in the Accounting Principles Board's rules than of an evil inherent in conglomerates. And indeed, many who have considered the problem have urged full product line disclosure.[58]

There are those who maintain that the threat of a takeover of a company by a conglomerate will give the management of the target company an incentive to do well.[59] This theory is supported by evidence that although conglomerates generally acquire prof-

---

55 *See* A. RAPPAPORT & E. LERNER, A FRAMEWORK FOR FINANCIAL REPORTING BY DIVERSIFIED COMPANIES 45-55 (1969).

56 "When a company is absorbed by a conglomerate, it generally disappears as a statistical entity, even though it may continue doing business. . . . Its earnings are simply thrown into a common pool, and there is no way of telling whether its profits are higher or lower under the bigger corporate tent." *Conglomerates*, BUS. WEEK, Nov. 30, 1968, at 84.

57 FTC REP. II, *supra* note 36, at 189.

58 *See id.* at 138.

59 One possibility suggested to Chemical Bank's management in resisting the Leasco takeover attempt of 1967 was to "release some statement or . . . discuss the growth of the bank's earnings and its imaginative approach to neew [*sic*] areas for growth." HOUSE REPORT, *supra* note 13, at 261.

itable firms, the acquired firms tend to be less profitable than the industry average.[60] However it is not clear that management would necessarily fear a takeover since, according to an FTC study noted earlier, only 10 percent of the management studied immediately left the acquired companies.[61]

It is possible that in making certain types of acquisitions a conglomerate can actually improve competition in a given market. This effect would occur if the conglomerate were to acquire a small company, called a "toehold,"[62] competing with larger rivals in a concentrated industry. A supportive conglomerate might supply a timid competitor with the resources and will to compete aggressively with less fear of retaliation from larger rivals. Yet in cases studied by the FTC, there were no indications of procompetitive toehold effects. "Looking specifically at product classes the conglomerates added through acquisition between 1963 and 1969, it does not appear that conglomerates followed a 'toehold' strategy of making small acquisitions in concentrated industries."[63] Toehold situations accounted for only 22 of 222 product classes acquired by conglomerates, and in most of the few cases in which conglomerates did take a toehold position, they did not commit to the acquired company the resources needed to enable it to expand its market share.

> In the "toehold" class for concentrated industries, 13 of the 22 market shares declined. In sum, these data provide no support for the toehold hypothesis. More generally, they show no evidence that conglomerates aggressively expand market shares after acquisition, either in a "good" toehold sense or a "bad" deep-pockets-predatory sense.[64]

---

60 "The average return for the 401 acquired companies was 9.9% (p. 58) or 133 percentage points [*sic;* should presumably be 1.33] lower than the average for manufacturing companies between 1950 and 1968 reported by FTC-SEC." Backman, *An Analysis of the Economic Report on Conglomerate Merger*, in *1970 Hearings*, *supra* note 17, at 4722.

61 FTC Rep. II, *supra* note 36, at 59.

62 A "toehold" acquisition is one possessing less than 5 percent of the market in an industry with a concentration ratio for the four leading firms of over 60 percent. *Id.* at 198.

63 *Id.*

64 *Id.*

Against the questionable virtues of conglomeration must be weighed several substantial drawbacks. Reciprocal dealing is one danger of conglomeration. In its simplest form, reciprocity is an arrangement whereby one party agrees to buy from another if the second party will reciprocate by buying from the first.[65] Reciprocity is anticompetitive because it enables a company to sell its products based not on their superiority but rather on the firm's buying power. As a conglomerate increases in size and enters new markets, the opportunities for reciprocity increase.

Reciprocity as a factor in a conglomerate's power to injure competition is in many ways a hypothetical rather than an immediate effect of a proposed merger. It is hard to predict and harder to prove before the fact. Thus the choice is either to permit the merger and then police the conduct of the merged firm, or to strike down the merger based on the opportunity for reciprocity.

Theoretically, large conglomerates facing each other in different competitive markets will realize their interdependence and abstain from competing. This "spheres of influence" hypothesis[66] has received some support in the food industry. One report concluded:

> The evidence suggests a growing prevalence of forebearance in competition between large conglomerate firms. The conglomerate character of the largest food manufacturers creates a multiplicity of contacts among these same firms which tends to blunt the edge of their competition. Such firms give careful consideration to the prospective advantages of vigorous competition in one market compared with the disadvantages of an unfavorable retaliatory response by a conglomerate competitor in another market. The resulting cautiousness may lead to a live-and-let-live type of behavior and a diminution of vigorous competition.[67]

---

65 For an example of reciprocity as a restraint of trade, see United States v. General Dynamics Corp., 258 F. Supp. 36 (S.D.N.Y. 1966). The Justice Department claimed, among other things, that General Dynamics had violated § 1 of the Sherman Act by engaging in a reciprocity program to obtain carbon dioxide purchases.

66 *See Hearings on Economic Concentration Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 88th Cong., 2d Sess., pt. 1, at 45 (1964) (statement of Dr. Edwards).

67 FTC, THE STRUCTURE OF FOOD MANUFACTURING 217 (National Commission on Food Marketing, Technical Study No. 8, 1966).

II. Present Approach to Conglomerate Mergers

A. *Legislative History Regarding Conglomerates*

Although there are no laws directly addressing the problem of conglomerate mergers,[68] there has been a history of opposition to concentration in this country, beginning with the era of railroad expansion.[69] There has been a desire to promote numerous small competing units in order to benefit from a pool of decisionmakers rather than a few economic dictators.[70] There has also been concern with the ability of a large economic unit to obtain political power sufficient to influence, if not corrupt, government.[71] And finally, there is concern with the effects of concentration on competition. Although the Sherman and Clayton Acts were passed to solve the problems associated with concentration,[72] they could only retard concentration if it resulted from a vertical or horizontal merger. Congress became quite concerned with the increase in the level of economic concentration during the 1940's. Relying heavily on a 1948 FTC report which indicated that concentration had increased substantially from 1940 to 1947,[73] Congress amended

---

68 Professor Harlan M. Blake of Columbia Law School argues otherwise in *Conglomerate Mergers and the Antitrust Laws*, 73 Colum. L. Rev. 555 (1973), suggesting that § 7 of the Clayton Act is properly interpreted to include considerations other than market power. Professor Blake argues that conglomerate financial power is susceptible to a judicially determined presumption that mergers increasing aggregate concentration beyond some stated size are anticompetitive. This article seeks to have the legislature place such a presumption on the antitrust scales, given the Supreme Court's probable unwillingness to make so radical a departure from traditional interpretations of the antitrust laws, laid down as early as 1920, that mere size is no offense. *See, e.g.*, United States v. United States Steel, 251 U.S. 417, 451 (1920).

69 *See* Sherman Act of 1890, ch. 647, 26 Stat. 209, *as amended*, 15 U.S.C. §§ 1-7 (1970); Clayton Act of 1914, ch. 232, 38 Stat. 730, *as amended* (in 1950 by the Celler-Kefauver Act), 15 U.S.C. §§ 12-27 (1970).

70 *See, e.g., Hearings on H.R. 515 Before Subcomm. No. 2 of the House Comm. on the Judiciary*, 80th Cong., 1st Sess., ser. 3, at 7 (1947) (statement of Representative Kefauver).

71 See Kaysen, *The Corporation: How Much Power? What Scope?*, in The Corporation in Modern Society 85 (E.S. Mason ed. 1959).

72 One of the principal purposes of § 7 was to stem the "'rising tide' of concentration in American business . . . . " United States v. Pabst Brewing Co., 384 U.S. 546, 552 (1966).

73 FTC, Report of the Federal Trade Commission on the Merger Movement: A Summary Report 25-28 (1948). *See* Bok, *Section 7 of the Clayton Act and the Merging of Law and Economics*, 74 Harv. L. Rev. 226, 231 (1960).

the Clayton Act in 1950 with the Celler-Kefauver Act,[74] which provides in part that "no corporation engaged in commerce shall acquire . . . where . . . the effect of such acquisition may be substantially to lessen competition, or to tend to create a monoply."[75]

B. *Current Guidelines*

The Justice Department published merger guidelines for conglomerates in 1968.[76] Although the stated purpose of the 1950 amendment is "to limit future increases in the level of economic concentration resulting from corporate mergers and acquisitions,"[77] the guidelines consider the effect of a conglomerate merger only on market concentration rather than on the more encompassing aggregate concentration.[78] This failure to distinguish between increases in the market shares of leading firms in an industry and increases in the total assets or value added of the nation's largest firms is the basic problem of antitrust enforcement when dealing with conglomerates.

The guidelines detail the approach to mergers which involve either potential entrants, a danger of reciprocal dealing, or barriers to entry. They also generally describe enforcement action that will be taken against mergers "which for one or more of several reasons threaten to entrench or enhance the market power of the acquired firm . . . ."[79]

Barriers to entry or a danger of entrenchment may follow in a case in which a larger firm merges with a dominant firm operating in a concentrated market of small, single-line companies. The substitution of the powerful acquiring firm for a smaller but already dominant firm would likely raise barriers to entry and

74 Act of Dec. 29, 1950, ch. 1184, 64 Stat. 1125, *as amended*, 15 U.S.C. §§ 18, 21 (1970).

75 15 U.S.C. § 18 (1970).

76 Dep't of Justice, *Merger Guidelines*, 1 TRADE REG. REP. ¶ 4510, at 6881-89 (1968) [hereinafter cited as *Guidelines*].

77 S. REP. No. 1775, 81st Cong., 2d Sess. 3 (1950).

78 "As with other kinds of mergers, the purpose of the Department's enforcement activity regarding conglomerate mergers is to prevent changes in market structure that appear likely over the course of time to cause a substantial lessening of the competition that would otherwise exist or to create a tendency toward monopoly." *Guidelines, supra* note 76, at 6887.

79 *Id.*

dissuade competitors of the smaller firms from competing aggressively because of fear of retaliation. Such an acquisition may also trigger defensive mergers by other firms in the concentrated market, thereby compounding an already bad situation. The guidelines indicate that the Justice Department will investigate the possibility of the creation of barriers to entry in mergers which include:

> (i) a merger which produces a very large disparity in absolute size between the merged firm and the largest remaining firms in the relevant markets, (ii) a merger of firms producing related products which may induce purchasers, concerned about the merged firm's possible use of leverage, to buy products of the merged firm rather than those of competitors, and (iii) a merger which may enhance the ability of the merged firm to increase product differentiation in the relevant markets.[80]

In determining whether a given merger raises barriers to entry, the courts have gone as far as to suggest that efficiencies resulting from the merger might invalidate it. In *Brown Shoe Co. v. United States*,[81] the Court noted that "[t]he retail outlets of integrated companies, by eliminating wholesalers and by increasing the volume of purchases from the manufacturing division of the enterprise, can market their own brands at prices below those of competing independent retailers."[82]

Where an industry is concentrated, potential competition, *i.e.*, the possibility that someone not currently in the market might enter it either through internal expansion or acquisition of a toehold, may be the only competitive limitation on price. Consequently, the Justice Department's guidelines provide that any merger between a leading firm and a potential entrant will be challenged. The guidelines define a "leading firm" in terms of the proportion of the relevant market the firm occupies; in defining potential entrant, "the Department accords primary significance to the firm's capability of entering on a competitively significant scale relative to the capability of other firms . . . and to the firm's

80 *Id.* at 6889.
81 370 U.S. 294 (1962).
82 *Id.* at 344.

economic incentive to enter [the market] . . . ."[83] Buttressing these guidelines is the Court's decision in *United States v. Penn-Olin Chemical Co.*,[84] which held it unnecessary to show that a potential entrant will actually enter or that it had attempted to do so earlier; all that need be shown is that the firm is one of the most likely entrants.[85]

Although the mere possibility of reciprocal dealing does not invalidate a merger under § 7 of the Clayton Act,[86] it may be found illegal if it can be shown that (1) the merger creates a substantial probability of reciprocal dealing or (2) where the *probability* of reciprocity is in doubt, the *effect* of reciprocity would be substantially anticompetitive. This was the conclusion of the Court in the leading conglomerate case under § 7 involving reciprocal dealing, *FTC v. Consolidated Foods Corp.*[87] In that case, Consolidated Foods, which owned food processing plants and food stores, acquired Gentry Co., the nation's second largest producer of onion and garlic, that market being highly concentrated.[88] Consolidated Foods was a substantial purchaser of foods from food processors, and many of its supplying processors were substantial purchasers of dehydrated onions and garlic which they acquired for preparing and packaging their products. In the Court's view, the merger was illegal because it gave Consolidated Foods the advantage of a mixed threat and lure of reciprocal buying in its competition for business and "the power to foreclose competition from a substantial share of the markets for dehydrated onion and garlic."[89] Under *Consolidated Foods* the existence of possibilities for reciprocal dealing on a statistical basis can now be used to invalidate some conglomerate mergers while the practicalities of the situation[90] or company policies

---

83 *Guidelines, supra* note 76, at 6888.

84 378 U.S. 158 (1964).

85 *Id.* at 173.

86 Mr. Justice Stewart, in his concurring opinion in FTC v. Consolidated Foods Corp., 380 U.S. 592 (1965), stated: "Clearly the opportunity for reciprocity is not alone enough to invalidate a merger under § 7. The Clayton Act was not passed to outlaw diversification." 380 U.S. at 603.

87 380 U.S. 592 (1965).

88 At the time of the suit, Gentry by itself held about 35 percent of the market and, together with the largest producer, held 90 percent. *Id.* at 595.

89 *Id.* at 593 (quoting FTC).

90 *See, e.g.*, Professor Milton Handler's hypothetical examples of insubstantial

which might prevent such possibilities from ever coming into reality[91] are overlooked.

These three tests, barrier analysis, potential entry, and reciprocity, are the complete arsenal presently available to the FTC and the Justice Department in opposing conglomerate mergers. In recent years the Justice Department has unsuccessfully assumed a broader approach in attacking not only market concentrations, but also aggregate concentrations.[92] In an attack on "bigness per se," then Attorney General John Mitchell announced that the Justice Department "may very well oppose" any merger that involved one of the top 200 manufacturing firms with a firm of comparable size in another industry, or with a leading producer in any concentrated industry.[93] However, in spite of sympathetic pronouncements,[94] the courts have continued to strike down mergers only where evidence shows that the merger may in some manner substantially lessen competition.[95]

In *United States v. Northwest Industries, Inc.*,[96] the district

---

reciprocities. Handler, *Twenty-Fourth Annual Antitrust Review*, 72 COLUM. L. REV. 1, 62 (1972).

91 Professor Handler notes that, according to the trial court, ITT had an "explicit policy against reciprocal dealing and, indeed, did not permit the exchange of information between its sales and purchasing departments that would have made reciprocity possible." *Id.* at 54.

92 In 1969 the Antitrust Division filed five principal suits challenging major conglomerate acquisitions: Jones & Laughlin Steel by LTV, Canteen Corp. by ITT, B.F. Goodrich by Northwest Industries, and Hartford Fire Insurance Co. and Grinnell Corp., both by ITT. Blake, *supra* note 68, at 559.

93 Address by Att'y Gen. Mitchell to the Georgia Bar Ass'n, Savannah, Ga., June 6, 1969, in *1970 Hearings*, *supra* note 17, at 5125.

94 The desirability of preserving the maximum number of competing units in any given line of commerce so long as they can compete effectively, the desirability of keeping entry barriers as low as possible, the increased potential for anti-competitive practices which may result from bigness, all are factors which may warrant a prohibition based on size alone.

United States v. Northwest Industries, Inc., 301 F. Supp. 1066, 1096 (N.D. Ill. 1969).

95 Thus the court refused to grant a preliminary injunction against the proposed acquisition of the Hartford Fire Insurance Co. by ITT, stating:

> Since the record at this stage of the proceedings does not establish either the extent to which the proposed merger will create a market structure conducive to reciprocal dealing or the extent to which reciprocal dealing will occur if the merger were to create an opportunity for such dealing, the Court holds that the government has not demonstrated a reasonable probability of success in establishing the factual basis for its claim....

United States v. ITT, 306 F. Supp. 766, 790 (D. Conn. 1969).

96 301 F. Supp. 1066 (N.D. Ill. 1969).

court held that although there may be good reason to invalidate mergers based on size alone, § 7 requires a showing that the merger will adversely affect one or more lines of commerce in a specified section of the country.[97] Similarly in *United States v. ITT*,[98] the court held that the applicable standard was one of competition and not mere trend toward concentration: "[E]vidence that a merger may increase economic concentration, without more, is not sufficient to halt a merger under Section 7 without a specific showing that it may have anti-competitive effects."[99]

Nor are the benefits achievable by conglomerates considered in reaching a decision as to a merger's legality. That point was made by the Supreme Court in *United States v. Philadelphia National Bank*:[100] "[A] merger the effect of which 'may be substantially to lessen competition' is not saved because, on some ultimate reckoning of social or economic debits and credits, it may be deemed beneficial."[101]

The antitrust laws have rested on the premise that "unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress . . . ."[102] This premise, supported by the courts, is valid to the extent that it holds that society is benefited by market competition; however, it fails to consider the noncompetitive harms associated with aggregate concentration. Left unaddressed are such harms as a reduction of multiple decisionmakers[103] and the antidemocratic effects to be feared from economic concentration.

Perhaps the ideal solution would be to examine mergers on a case-by-case basis and allow those mergers which are procompetitive or result in a more efficient operation and disallow those

---

97 *Id.* at 1096.

98 306 F. Supp. 766 (D. Conn. 1969).

99 *Id.* at 796.

100 374 U.S. 321 (1963).

101 *Id.* at 371.

102 Northern Pac. Ry. v. United States, 356 U.S. 1, 4 (1958).

103 This is true in spite of the language in Brown Shoe Co. v. United States, 370 U.S. 294 (1962), which pointed out the importance of preserving multiple decisionmakers: "[W]e cannot fail to recognize Congress' desire to promote competition through the protection of viable, small, locally owned businesses." *Id.* at 344. The concentration increase in that case was only prohibited after it was shown that competition, not competitors, was harmed.

mergers which produce the evils associated with concentration. This is unfortunately impossible, since both of these elements may be present in a given merger. And any attempt to balance two such unlike quantities on a case-by-case basis would create an administrative and judicial nightmare. Yet a per se rule against concentration, though it would be easy to apply, would deny society the benefits of mergers which result in increased efficiency.

One compromise to the seemingly irreconcilable problem would be to disallow concentration unless it could be shown that there would be no probable anticompetitive effects, that the merger would result in efficiencies that would not otherwise be obtained, and that these efficiencies would be of substantial economic value to society. As the decisions in *Northwest Industries, ITT,* and *Philadelphia Bank* indicate, such a merger standard would require new legislation.[104] Congress should specifically condition the approval of future conglomerate mergers larger than a given size on the provision of substantial economic benefit. It should base new legislation on the premise that harm to society is inherent in any increase in aggregate concentration. Society should not have to suffer these evils unless they are accompanied by significant compensating gains. In order that the Justice Department and the FTC better understand "substantial economic benefit," Congress should adopt a new set of conglomerate merger standards. Some proposals for those guidelines follow.

III. The Proposed Guidelines

A. *The Acquisition Impact Statement*

Whenever a company of a defined size wishes to make a conglomerate acquisition, it should be required to file an acquisition impact statement with both the FTC and the Justice Department at least 60 days before the acquisition is to be made. The acquirer will have the burden of proving in this statement that the acquisition does not violate present antitrust tests and that a substantial economic benefit, as defined *infra,* will result from the merger.

In cases in which the filing is uncomplicated or in cases of

104 *See* text accompanying notes 93-102 *supra.*

national importance, the 60-day preacquisition period will give the FTC or Justice Department an opportunity to enjoin the proposed merger. However, since most filings will be of considerable length and complexity, the FTC and the Justice Department will have 12 months to review them to determine whether to require divestiture. Twelve months after the filing, the conglomerate acquisition will be immune from either an injunction or divestiture based on the net benefit test. The Justice Department and the FTC will retain power to require divestiture in light of subsequent developments, *e.g.*, if the acquisition proves to be anticompetitive.

If a conglomerate makes an acquisition and is later required to divest, it must put the acquired company in substantially the same condition as before the merger. This requirement is needed primarily to counteract the large upstream cash flows which have occurred in many conglomerate mergers.[105] The acquirer will have to make the acquired company whole not merely to the extent of returning it with an unchanged balance sheet, except for normally occurring depreciation, but also to the extent of returning both earnings and cash flows that were withdrawn from the acquisition.

These proposals do not apply to all conglomerates, but rather to the limited class known as "pure" conglomerate mergers. The proposed guidelines require a filing of this class while exempting the other types of mergers because operational efficiencies are much less likely to be seen in pure conglomeration,[106] while the negative effects of increased aggregate concentration still follow. In many cases it will be difficult to distinguish between a pure conglomerate merger and an extension merger. In light of that problem a broad interpretation should be given to "pure" conglomerate in order to insure full consideration of potentially harmful mergers.

The proposed guidelines do not relate to horizontal or vertical mergers. Although horizontal and vertical mergers can also pro-

105 National General, after taking over General American Insurance, made a withdrawal of $174 million. Leasco, after taking over Reliance Insurance, took out $39 million. *1970 Hearings*, *supra* note 17, at 4887 (statement of Dr. Blair).

106 *See* note 32 *supra* and accompanying text.

duce aggregate concentration effects, the present antitrust laws tend to restrict their growth within a given industry.[107] In contrast, conglomerates, in spite of restrictions concerning reciprocity, new entrant, and entrenchment, can potentially obtain much greater levels of aggregate concentration without running afoul of either the Sherman or Clayton Acts.[108]

The filing requirements presently employed by the FTC[109] provide a guide in determining the size a conglomerate must reach before it will be required to file an acquisition impact statement. A filing is now required any time a company with assets over $250 million makes an acquisition. The proposed guidelines will require a filing when a company with assets of $250 million or sales of $500 million[110] makes a conglomerate acquisition which is not predominately of a product or market extension type. The proposed guidelines will also require a filing when a pure conglomerate acquisition is made of a leading firm in a concentrated industry as defined by paragraph 18 of the Justice Department guidelines.[111]

The approach taken is similar to that described by Wasserstein in the British handling of a diversified merger case:

> If no clear efficiency benefit could be shown, a sizeable conglomerate merger would be banned because of its negative impact on *aggregate* concentration. If the presumption were rebutted, the normal analysis in diversified cases would be used: The merger would be accepted so long as excessive market concentration or reciprocity were not threatened. . . . [This approach] introduces considerations of aggregate concentration into the analysis and does so by means of a rough presumption rather than through an exacting balancing test.[112]

---

107 "Fearful of running afoul of antitrust if they expand their market shares, big companies often find that the only way to grow is to move into other product lines." Rose, *Bigness Is a Numbers Game*, FORTUNE, Nov. 1969, at 115.

108 *See* text accompanying notes 92-99 *supra*.

109 FTC News Release (Apr. 13, 1969).

110 These are the size levels recommended in the Report of the White House Task Force on Antitrust Policy (Neal Task Force Report), July 5, 1968, in *1970 Hearings*, *supra* note 17, at 5070.

111 *See Guidelines*, *supra* note 76, ¶¶ 18(a)(i)-(iv), at 6888.

112 Wasserstein, *supra* note 42, at 683 (emphasis in original).

The burden is that of producing evidence of significant economic benefit sufficient to rebut the legislative judgment that increased aggregate concentration is presumptively bad. The government will assume — not without reason — that acquisition by a conglomerate does not generally promote efficiency.[113] The conglomerate ought to bear the burden of proof because it has much more information about the potential and planned effects of the acquisition than the government or the public. Shifting to the conglomerate the burden to justify the merger will force the management of an acquisition-minded company to think about how they will improve the acquired company's operation rather than merely what effect the acquisition will have on the conglomerate's earnings per share.

B. *Areas of Consideration*

The acquisition impact statement will require information in two general areas: effect on market competition and resulting economic efficiencies. In each area an estimate of the immediate impact of the merger and a prediction of future effects will be required. Admittedly, in assessing certain effects the management of the acquiring company may not be expert enough to make foolproof judgments. In such cases they need include only such information as they have available, since the government will be able to draw upon its own knowledge and experience in its consideration of the merger.

With respect to market competition, the acquirer will have a burden of proving a negative proposition, that the acquisition will not produce anticompetitive effects. The same tests that the Justice Department has relied on during the last several years will be used: potential entrant, reciprocity, and barriers to entry.[114] Though often quite confusing, these concepts are well known in the legal departments of acquisitive companies; and the acquirer

---

113 On the basis of three generally accepted management profitability ratios — net income to assets, net income to sales, and sales to assets — most acquired companies studied by the House Antitrust Subcommittee staff were operated less efficiently after acquisition. House Report, *supra* note 13, at 408.

114 *See* text at notes 76-91 *supra*; *Guidelines*, *supra* note 76. *See also* Disner, *Barrier Analysis in Antitrust Law*, 58 Cornell L. Rev. 862 (1973).

should be counted on to submit statements supporting a lack of adverse competitive effects.

Another anticompetitive effect possible in any conglomerate merger is mutual forbearance.[115] It is one of the reasons that the proposed guidelines require that conglomerates show a compensating benefit. However, since this is an unquantifiable harm and a prospective violation is almost impossible to prove (or disprove), mutual forbearance will not be included in the proposed guidelines.

The market competition tests are individual hurdles, each of which the conglomerate must clear in order to proceed to the next. There may of course be instances, such as in a toehold merger, where competition is actually improved. If the conglomerate is making a toehold acquisition and can demonstrate that the merger will improve the competitive nature of the market, the conglomerate should be given credit for providing an economic benefit.

After the acquirer has demonstrated the effect of the merger on market competition, it will have the burden of showing that the merger will result in improved efficiency. It will not be adequate for an acquiring company simply to assert that previous management has not done a "good job" and that new management will improve operations. Efficiency will be measured against the performance of the company before acquisition.[116] For acquisitions of more than $10 million,[117] the acquiring firm should show that the acquired company's return on investment will be at least 10 percent greater than the average of the acquired firm over the previous five years. The acquired firm should be required to perform at this level for two full years under threat of possible divestiture. The conglomerate should also be required to report on the performance of the acquired firm for a total of five years. A decline in performance during the reporting period should be evidence of the conglomerate's inability to achieve efficiencies in future proposed acquisitions.

Thus another measure that may be given some weight in judg-

115 *See* text accompanying notes 66 & 67 *supra*.
116 *See* note 113 *supra*.
117 *See* text at notes 13 & 14 *supra*.

ing the likelihood of improved operations of the acquired company is how well or poorly other acquisitions by the conglomerate have performed in the past. And in judging performance the government will not only consider earnings and return on investment but also assess the total health of an acquisition, including modernization of equipment, development of new products, and financial stability. A predatory manager, one who is willing to make no new investments in the acquired company and who squeezes out all the profit he can in the short run, will usually produce the highest earnings.[118]

In demonstrating how performance will be improved, the company will have to begin with an analysis of the past performance trends of the target company. Not only will the conglomerate have to project what the improved performance will be, it will also be required to submit a detailed plan outlining how this improved performance will be achieved and why it could not be achieved without acquisition. There are at least three ways in which a company could institute change which would increase efficiency: strategy, structure, and operations.

The claim that management can make beneficial strategic changes rests on the supposition that acquiring management is more talented, has better "vision," and can better direct the affairs of the concern than can the incumbent management. To support this assertion the acquirer must not only fault the incumbent management's direction but also propose alternative plans demonstrably more profitable. For example, the acquirer could suggest new markets that the company could profitably enter. The market would have to be one for which the present management had no plans. The acquirer would also have to indicate how this market could be developed and what the likely profits would be. In general, the less specific the strategic proposal, the less weight it would be given.

As previously described, there is not much probability that a conglomerate will improve the organizational structure of an ac-

---

118 "There were many instances in which the sample companies changed accounting practice of acquired companies. The companies contend that the reason for such changes is to make the acquired companies' accounting practices consistent with the parent. Such changes, however, in most instances resulted in an increase in reported earnings." HOUSE REPORT, *supra* note 13, at 412.

quired firm.[119] Nonetheless there may be cases in which a target company's organizational structure is such that there is a loss of control or information. If the acquirer could institute a better organizational structure, the acquired company could enjoy a real benefit.

There are also operational economies that might be made, depending upon the organization and industry of the acquired company. A conglomerate may be able to provide a range of economies of scale in general management functions for a target company. Though the conglomerate can often reduce the acquired company's costs in performing specialized management functions, such as legal, insurance, computer, and capital raising operations, the savings in these areas are often minimal.[120] However, if the acquirer can demonstrate that there will be substantial savings for the acquired company in the administration of these services or in other areas, such as the administration of research and development, advertising and promotion, or purchasing functions, then this contributes to the showing of improved performance.

These additional considerations in examining conglomerate mergers are intended to supplement present antitrust approaches. By legislating a presumption against bigness, they remove the need for the strained "competition" arguments which the Justice Department has been forced to create to control conglomeration. The rules on which the Justice Department presently relies with respect to entry barriers should be retained for the most part.[121] However, in determining if entrenchment has actually resulted from a merger, Congress should overrule the Court's holding that increased efficiencies per se may create illegal barriers to entry.[122] If a conglomerate can improve the efficiency of an acquired company, this should not be grounds for disallowing the merger.

Nonetheless, mergers which create *unfair* barriers to entry should be disallowed. Unfair barriers, for the purposes of the proposed guidelines, are those which provide product advantages regardless of inherent product worth. For example, if a firm is able greatly to increase its advertising budget as in *FTC v. Procter*

---

119 *See* notes 35-37 *supra* and accompanying text.

120 *See* text at note 41 *supra.*

121 *See Guidelines, supra* note 76, at 6888-89.

122 *See* FTC v. Procter & Gamble Co., 386 U.S. 568 (1970). *See also* Disner, *supra* note 114, at 885.

& Gamble,[123] or if a firm as a result of its strength and size in the market place can command benefits such as preferred shelf space, unfair barriers have been placed in the path of potential competitors.

The Justice Department's test concerning new entrants should be maintained.[124] That test, as enunciated in *Penn-Olin*,[125] makes it unnecessary to show that a potential entrant will actually enter a new market or that it had attempted to do so earlier; all the Justice Department need show is that the acquiring firm is one of the most likely entrants. This test will require more from the acquirer than a mere disclaimer of plans to enter the market by internal expansion. The Justice Department or the FTC will have to make an independent determination, in light of the activities of the company and its product lines, whether the acquirer might have entered the acquired company's market without benefit of a merger. In the impact statement the acquirer must explain why it chose to enter the given market by acquisition rather than by startup.

The conglomerate must also describe the possibilities for reciprocal dealing and reasons why it will not occur. For example, the conglomerate will have to reveal whether there are any companies with which the newly acquired company deals which also buy or sell to other companies owned by the conglomerate.[126] Yet the mere possibility of reciprocal dealing will not of itself invalidate the acquisition. The conglomerate could counter the accusation of possible reciprocal dealing by showing virtuous behavior concerning reciprocity in the past. Although one would expect a self-serving disavowal of intentions to engage in reciprocal arrangements, historical opposition by the acquirer to reciprocal dealing would be supportive.

IV. Administrability

The criterion for selection of new conglomerate merger guidelines to replace present Justice Department guidelines should be

---

123 386 U.S. 568, 579 (1970).

124 *See* text at note 80 *supra*; *Guidelines*, *supra* note 76, at 6887-88.

125 United States v. Penn-Olin Chemical Co., 378 U.S. 158, 173 (1964).

126 *See, e.g.*, FTC v. Consolidated Foods Corp., 380 U.S. 592 (1965).

the degree to which the new guidelines facilitate selection of economically beneficial conglomerate mergers and rejection of harmful conglomerate mergers as compared with present tests. A less important, but still considerable, factor is the increase in bureaucratic and economic costs of administering the proposed guidelines in comparison with costs under present tests.

Because of the segregation by size of companies required to report and file under these proposed guidelines, only the largest firms will be required to comply. They are most likely to have the resources and the financial competence to supply the necessary information without undue strain. Much of the information required will be necessarily incident to bargaining for the acquisition or already contained in company procedural manuals or control systems.

Consideration of the economic benefits previously mentioned often has been available to the courts, but under present law has been rejected.[127] Even post-acquisition evidence that anticompetitive effects hypothesized before culmination of the merger did not come into being has been rejected as irrelevant to the determination of the merger's legality. The proposed guidelines legitimize, even require, the presentation of such cogent evidence. And the burden of production of that evidence is placed on the acquirer.

Government transaction costs for administering the new standards should be no barrier. If these costs do increase sharply, one of the conglomerators has proposed a 2 percent merger tax on the value of acquired assets or the consideration exchanged in a merger.[128] The total cost to all parties involved under the proposed guidelines is probably well below this figure.

The type of disclosure required would probably lift some of the veil around conglomerate earnings, which have mystified sophisticated analyst and average investor alike. The disclosure might stimulate competition within an industry or attract new entrants. The procompetitive effects accomplished by disclosure of achiev-

---

127 United States v. Philadelphia Nat'l Bank, 374 U.S. 321 (1963).

128 This proposal, forwarded by Ling-Temco-Vought to the House Ways and Means Committee, was for a 2 percent merger tax, based on "the value of assets involved or the market value of securities used in the merger." According to Mr. Ling, the tax would be nondeductible and charged directly to earned surplus "so as not to 'disturb the earnings statement.'" Wall Street Journal, Apr. 18, 1969, at 10, col. 3.

able efficiencies may offset much of the alleged harm caused by merging conglomerate lines of business for financial reporting purposes.

Though ideally mergers should be analyzed on a case-by-case basis, there has been a fear that the courts would be unable to make the economic judgments necessary to determine the presence of a substantial benefit. Professor Bok's views, describing the pitfalls of discriminating on a case-by-case basis between those mergers which threaten substantial anticompetitive consequences and those which do not, were summarized by Professor Turner:

> With limited enforcement resources, few cases could be brought. With a wide variety of fact situations, the precedential value of particular decisions — their value as guides to the legality of other mergers — would be limited. Inevitably, the number of mergers with substantial anticompetitive effects would tend to increase.[129]

Other criticisms of such a policy are that the volume of cases and the length of a given case would swamp the courts.

Yet the necessity that a judge be a sophisticated economist could be avoided if the merger guidelines are both specific and descriptive. It is also not clear that judges, in deciding a merger's effect on competition in a given market, are not making some very difficult economic decisions pursuant to current standards. One could argue that it is much more difficult to assess the future competitive impact of a merger on a given market than it would be to assess the impact a merger has on the acquired company's operating efficiencies.

The proposed guidelines should limit the problem of inadequate enforcement resources since the defendant has the burden of submitting a great deal of the evidence. The volume of cases to be considered will also be limited by the focus of the guidelines. First, the size test places a limit on the number of cases to be considered. Second, a conglomerate will have the burden of showing a substantial net economic benefit, and if it fails to meet that burden the presumption against aggregate concentration will automatically invalidate the merger. Given the limits on achievable efficiencies, the necessity of fulfilling the burden of production,

---

129 Turner, *supra* note 54, at 1318-19.

and the threat of divestiture, the deterrence effect of these new guidelines would probably cause the abortion of a good many conglomerate mergers which are attempted (and succeed) under present standards.

Similar systems have already been employed in this country and in England. The British Board of Trade examines mergers on a case-by-case basis, giving consideration to the quality of management and the likely effect of the merger on operations efficiencies and technological advance.[130] In this country the Justice Department, in exercising its authority over bank mergers, is required by statute to consider the "effect of the transaction in meeting convenience and needs of the community to be served."[131]

Although the absolute number of cases brought to trial should be small, the complex nature of the cases will result in long trials and, in terms of time, judicial expense. Yet the judicial costs incurred should be more than counterbalanced by the value to society of allowing only those mergers which result in substantial economic benefit.

Conclusion

Whenever a conglomerate merger takes place, there is a general but unquantifiable loss to society. This loss takes the form of a reduction in the number of decisionmakers and a concentration of economic power which may result in the ability to corrupt government, both local and national. The anticompetitive phenomenon of mutual forbearance may also arise. Because of these inherent societal harms resulting from conglomeration, mergers should not be allowed unless significant compensating benefits can be shown.

If these guidelines are adopted, not only will the negative effects of concentration be reduced, but these standards are flexible enough to preserve those acquisitions which result in a substantial benefit to society. Hopefully the tests will compel the management of an acquisitive conglomerate to consider the larger economic effects of an acquisition as well as its short-run impact on earnings per share.

130 BOARD OF TRADE, MERGERS: A GUIDE TO BOARD OF TRADE PRACTICE 12 (1969).
131 12 U.S.C. § 1828(c)(5)(B) (1970).

TAX EFFORT AS A DETERMINANT OF REVENUE SHARING ALLOTMENTS

JAMES A. MAXWELL*

The State and Local Fiscal Assistance Act of 1972[1] contains a tax effort factor by which governments receiving revenue sharing grants are penalized or rewarded for tax effort below or above average.[2] General tax effort is expressed as the ratio of tax collections to the personal income of the relevant government,[3] and *relative* tax effort is the ratio of this figure to *average* tax effort. For example, since the tax collections of the state government and the local governments of Arkansas in fiscal 1970-71 were $522.9 million,[4] and its personal income in calendar 1970 was $5,376 million,[5] its general tax effort was 9.7 percent; and, since the average of all state and local governments was 11.9 percent,[6] its relative tax effort was 81.5 percent.

General tax effort is meant by Congress to be a major determinant of (1) the share of the aggregate of yearly grants to be allotted to each *state* ($30.2 billion for the 5-year period ending December 31, 1976)[7] and (2) the intrastate distribution to *local* governments in each state (two-thirds of the total).[8] What is the justification for use of tax effort?[9] The hearings on the revenue sharing

*Professor of Economics, Emeritus, Clark University.

1 31 U.S.C. §§ 1221-63 (Supp. II, 1972) (enacted as Pub. L. No. 92-512, 86 Stat. 919 (1972)).

2 *Id.* §§ 1225(b), 1227(b).

3 *Id.* § 1228(c).

4 BUREAU OF THE CENSUS, DEP'T OF COMMERCE, GOVERNMENTAL FINANCES IN 1970-71, SERIES GF71-No. 5, at 31 (1972).

5 *Id.* at 52.

6 *Id.* at 31, 52.

7 31 U.S.C. § 1224(b) (Supp. II, 1972).

8 *Id.* § 1226(a).

9 General tax effort is only one of several determinants of the state share. For 31 states the allocation depends on three factors: population, inverse relative income, and general tax effort. *Id.* § 1225(b)(2). For 19 states the allocation depends on five factors: population, urbanized population, inverse relative income, relative state individual income tax collections, and general tax effort. *Id.* § 1225(b)(3). The intrastate distribution to localities depends on three factors: population, general tax effort, and inverse relative income. *Id.* § 1227(a). Obviously these factors do not all

bills offered to the Congress do not provide a satisfactory answer. The intuitive beliefs prevailed that a tax effort provision would (1) deter governments from reducing their tax efforts, (2) penalize governments which made a low tax effort at the time of allocation and reward those which made a high one, and (3) induce state and local governments to expand their efforts to meet their own needs. Nowhere on the record can one find any critical examination of these intuitions and I shall argue that only one of them is clearly valid.

The first belief, that a government should be penalized when it uses grant receipts to reduce taxes, *does* seem to be intuitively persuasive. The grant money is secured through federal taxes levied over the nation; its use for uncoordinated and piecemeal tax reduction by particular state and local governments would be at the expense of taxpayers over the nation. If *general* tax relief were the objective, this could best be provided through federal tax reduction rather than by grants. The direct and obvious way to guard against substitution of grants for state and local taxes would be through a *maintenance of tax effort* clause.[10] Unlike the State and Local Fiscal Assistance Act of 1972, such a clause would not reward or penalize for a high or low effort which existed at the time the grants were provided, and it would not mean a bonus for

pull in the same direction; they reflect the diverse objectives of proponents of revenue sharing. As Wilbur D. Mills told the House of Representatives, the Ways and Means Committee "ran through computers every conceivable suggestion that could be made by any and all members of the committee for the distribution of these funds in a formula" in its search for results which would be supported by a majority of the members. 118 CONG. REC. H5877 (daily ed. June 21, 1972).

The important influence of relative tax effort is on the allocations to *particular* jurisdictions. For example, the per capita income of Mississippi in 1971 was about 10 percent lower than that of Alabama. *See* BUREAU OF THE CENSUS, DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES, 1972, at 319 (1972). But the per capita grant allocation for the state government of Mississippi for the period Jan. 1, 1972 to June 30, 1972 (a retroactive payment) was more than 50 percent larger ($19.71 versus $13.02). *See id.* at 12; 37 Fed. Reg. 27,805, 27,912 (1972). The result is mainly because the tax effort of Mississippi exceeded that of Alabama. The per capita allocation of New York City for the first half of 1972 was greater than that of any other large city within the state, apparently because of its high tax effort. *See id.* at 27,937-45; BUREAU OF THE CENSUS, DEP'T OF COMMERCE, COUNTY AND CITY DATA BOOK, 1972, at 738, 741 (1973).

10 The Act does require each state government to maintain its *aid* to local governments at the level of the fiscal year 1972, subject to a dollar-for-dollar reduction of its grant. 31 U.S.C. § 1226(b) (Supp. II, 1972).

achievement of a high effort subsequent to receipt of grants. In short, a maintenance of tax effort provision would seem to be an acceptable feature of revenue sharing because it would bar the use of grants to reduce tax effort.

More questionable is the belief that governments which made a *below*-average tax effort prior to receipt of the grant should be penalized by a reduction in grants related to the deficiency. The argument for this proposition asserts that a low tax effort connotes a lack of need for grants, and that grants should not be provided to finance state and local expenditures which might well be met through a more adequate tax effort. On the other hand, if a low tax effort indicates frugality and care in government spending, or a modest taste for public as compared with private goods, or a relative scarcity of taxable resources, a penalty seems inappropriate. Reconciliation or compromise of these conflicting positions cannot be attempted here. Enough has, perhaps, been said to indicate that application of a penalty for a low tax effort is a questionable step.

Still more questionable is the proposition that a government which makes an *above*-average tax effort should be rewarded by a larger allotment of grants. Sometimes a high tax effort means simply that the citizens of this government have a high preference for public goods. While this choice may well carry its own reward, it would not appear to deserve a bonus from the nation as a whole. Sometimes a high tax effort arises out of past fiscal errors, in which case a federal bonus surely is not indicated. Analysis to discover the reasons for the high tax effort of any particular government would be difficult to make as well as politically useless. The conclusion seems indicated that a bonus for a high tax effort is a mistake.

Another opinion expressed during congressional consideration of revenue sharing was that a tax effort bonus and penalty would "provide inducements for States to increase their tax effort . . . ."[11]

11 H.R. REP. No. 1018, 92d Cong., 2d Sess. 7 (1972). Walter Heller declared that tax effort provisions could be designed to discourage governments from reducing their taxes after receipt of grants, and also to "provide a positive stimulus to greater and more equal tax effort." W. HELLER, NEW DIMENSIONS OF POLITICAL ECONOMY 155 (1966). And President Nixon, in his message to Congress on revenue sharing, said: "The revenue effort adjustment is designed to provide the States with some incen-

This is more than doubtful. The gist of the argument offered below is that the chief effect will be to reward or penalize the position that existed when revenue sharing became operative.

The record shows that tax effort, measured state by state, has been quite stable over time. A high tax effort tends to stay high; and a low one, low. Modest shifts up and down, autonomous and induced, take place from year to year; but tax changes are usually marginal and economic growth or decline operates slowly. States with a low tax effort would seem to be in the best position to secure a bonus; but such states are likely to be fiscally conservative, or poor, or both, and these circumstances are not subject to quick alteration. The revenue sharing act expires on December 31, 1976, and a significant increase in effort will hardly be induced so soon. Again, raising the tax effort of a state cannot be done through a single and coordinated decision. In Ohio, for example, the state with the lowest tax effort in fiscal 1971,[12] the taxes raised by the state government were only 45 percent of the total state and local collections;[13] the rest was raised by the diverse decisions of over 3,000 local units.[14]

The most formidable reason why the bonus (or penalty) will have a weak and diffused effect over time is the *relative* nature of tax effort. If increased effort by state X merely keeps pace with that of all states, state X will not secure a bonus. Like Alice in *Through the Looking Glass,* when she ran a race with the Red Queen, the state will find that its running has served simply to keep it in the same place. In order to gain, it will have to increase its tax effort *more* than the tax efforts of governments in all states. Slackening of effort will bring a loss of position only if its peers slacken less. In short, the bonus for taxing more and the penalty for taxing less are reduced by the uncertainty of the outcome; the process will often seem like a zero-sum game.

---

tive to maintain (and even expand) their efforts to use their own tax resources to meet their needs." *Hearings on S. 2483 and S. 2048 Before the Subcomm. on Intergovernmental Relations of the Senate Comm. on Government Operations,* 91st Cong., 1st Sess. 155 (1969).

12 BUREAU OF THE CENSUS, *supra* note 4, at 50.

13 *Id.* at 33.

14 1 BUREAU OF THE CENSUS, DEP'T OF COMMERCE, 1972 CENSUS OF GOVERNMENTS 28 (1973).

The main impact of the tax effort bonus and penalty will, therefore, be the first and immediate impact. States and local governments with a high effort figure at the outset will secure a bonus, and this will be retained through 1976; states and local governments with a low figure will suffer, and continue to suffer, a penalty. Such an outcome is not praiseworthy.

STATUTE

AN ACT TO REGULATE GROUP LEGAL SERVICES PLANS

GARRICK F. COLE*

Introduction

Thousands of group legal services plans[1] exist in the United States.[2] Bar associations and private entrepreneurs are increasingly interested in developing group legal services plans,[3] and labor unions are pursuing their long standing commitment to help their members achieve access to the legal system.[4] Both the number of group legal services plans and the growing consumer interest in them have prompted the American Bar Association, state bar associations, and state governments to take an active interest in their development.[5]

State bar associations have generally opposed group legal services plans as unethical methods of providing legal services.[6] However, the United States Supreme Court has helped spur the development of group legal services plans by providing them with broad constitutional protection against state interference on the

---

*Staff Attorney, National Consumer Law Center, Boston, Massachusetts 02108. B.A., 1968, Harvard College; J.D., 1973, Boston College Law School. Many people have contributed to the development of the statute. Charles Baron, Robert Segal, and Donald Stern, all members of the faculty of the Boston College Law School, have made many suggestions. Tony Winsor of the Massachusetts Law Reform Institute has spent substantial time working on the statute. Michael Meyer, a classmate, has contributed much in his unique way. The author thanks all of them and many others besides.

1 For a definition of this term, see § 3(k) of the Act.

2 GROUP LEGAL SERVICES NEWS, Aug. 1972, at 1; Meserve, *Our Forgotten Client: The Average American*, 57 A.B.A.J. 1092, 1094 (1971).

3 GROUP LEGAL SERVICES NEWS, Mar. 1972, at 4; Meserve, *supra* note 2, at 1095.

4 Bernstein, *Legal Services, the Bar and the Unions*, 58 A.B.A.J. 472 (1972).

5 *See* GROUP LEGAL SERVICES NEWS, July 1972, at 7; *id.*, June 1972, at 1; *id.*, Feb. 1972, at 1.

6 United Transp. Union v. State Bar, 401 U.S. 576 (1971); UMW v. Illinois State Bar Ass'n, 389 U.S. 217 (1967); Brotherhood of R.R. Trainmen v. Virginia *ex rel.* Virginia State Bar, 377 U.S. 1 (1964); NAACP v. Button, 371 U.S. 415 (1963).

basis of traditional notions of professional responsibility.[7] The usual complaints regarding professional responsibility lodged against the plans were that they constituted the unauthorized practice of law, introduced lay intermediaries into the attorney-client relationship, solicited business for attorneys, compromised the ability of associated attorneys to exercise their independent professional judgment, and tended to encourage unnecessary litigation.[8] State supreme courts generally received complaints like these favorably and enjoined the operation of a great variety of group legal services plans[9] during the 30 years prior to *NAACP v. Button*.[10]

I. Supreme Court Cases

Button was the first United States Supreme Court case to provide group legal services plans with some constitutional protection from invidious state interference. In *Button* the Supreme Court considered the constitutionality of a Virginia statute[11] that amended existing law prohibiting the "solicitation of legal business by a 'runner' or 'capper' to include, in the definition of 'runner' or 'capper,' an agent for an individual or organization that retains a lawyer in connection with an action to which it is not a party and in which it has no pecuniary right or liability."[12] The petitioner complained that the statute, as construed by the Virginia Supreme Court of Appeals, abridged its first amendment freedoms.[13]

The Court held the activities of the petitioner to be "modes of expression and association protected by the First and Fourteenth Amendments, which Virginia may not prohibit, under its power to regulate the legal profession, as improper solicitation of legal business . . . . "[14] *Button* seemed to be a case limited to protecting

7 *See* cases cited note 6 *supra*.
8 *See* cases cited note 6 *supra*.
9 *See* cases collected in *Bibliography*, 12 U.C.L.A.L. Rev. 456, 457 (1965).
10 371 U.S. 415 (1963).
11 Acts of 1956, Ex. Sess., ch. 33, *amending* Va. Code Ann. §§ 54-74, 54-78, 54-79 (1950). The session law was codified in the 1958 replacement volume.
12 371 U.S. at 423.
13 *Id*. at 428.
14 *Id*.

political and civil rights. But a case decided the next year made it appear that such a narrow reading of *Button* was wrong.

In *Brotherhood of Railroad Trainmen v. Virginia ex rel. Virginia State Bar*,[15] the Virginia State Bar secured an injunction prohibiting the Brotherhood from operating a group legal services plan. The bar complained that the Brotherhood's arrangement was a solicitation of legal business and an unauthorized practice of law.[16] The union's plan divided the United States into regions in which the Brotherhood selected a lawyer or firm with a good reputation for representing railroad employees in personal injury litigation. "When a worker was injured or killed, the secretary of the local lodge would go to him or his survivors and recommend that the claim not be settled without first seeing a lawyer and that, in the Brotherhood's judgment, the best lawyer to consult was the counsel selected by it for that area."[17] The Court held that the first and fourteenth amendments protected the right of the Brotherhood members to organize a program to advise workers to obtain legal advice and to recommend specific lawyers.[18]

Three years later, in *United Mine Workers of America v. Illinois State Bar Association*, [19] the Court considered the Illinois Supreme Court's affirmation of a trial court injunction prohibiting the UMW from "employing attorneys on salary or retainer basis to represent its members with respect to Workmen's Compensation claims and any and all other claims which they may have under the statutes and laws of Illinois."[20] In responding to the bar association's complaint that the plan involved the introduction of a lay intermediary (the union) into the attorney-client relationship, and to the argument that the attorney owed his alligiance to the union, not the client, Mr. Justice Black wrote that

> the attorney is actually paid by the union, [and is] not merely the beneficiary of its recommendations. But in both situations [*Trainmen* and this case] the attorney's economic welfare is dependent to a considerable extent on the good will of the

15 377 U.S. 1 (1964).
16 *Id.* at 2.
17 *Id.* at 4.
18 *Id.* at 8.
19 389 U.S. 217 (1967).
20 *Id.* at 218.

> union, and if the temptation to sacrifice the client's best interests is stronger in the present situation, it is stronger to a virtually imperceptible degree. In both cases, there was absolutely no indication that the theoretically imaginable divergence between the interests of union and member ever actually arose in the context of a particular lawsuit....
>
> ....
>
> The decree at issue here thus substantially impairs the associational rights of the Mine Workers and is not needed to protect the State's interest in high standards of legal ethics.[21]

In *United Transportation Union v. State Bar of Michigan*,[22] the Supreme Court again considered a bar association's attack on the Brotherhood of Railroad Trainmen's[23] group legal services plan. Once again the complaint was that the plan involved the illegal solicitation of legal business. Again the Court held that enjoining the plan would deny first amendment rights to the union.[24] The Court took care to indicate that the time had come for bar associations to cease attempting to restrict the rights of citizens to organize group legal services plans. Although these remarks are dicta, it seems reasonable to conclude that they represent the Supreme Court's attitude toward group legal services. The Court said:

> [T]he principle here involved cannot be limited to the facts of this case. At issue is the basic right to group legal action, a right first asserted in this Court by an association of Negroes seeking the protection of freedoms guaranteed by the Constitution. The common thread running through our decisions in *NAACP v. Button, Trainmen,* and *United Mine Workers* is that collective activity undertaken to obtain meaningful access to the courts is a fundamental right within the protection of the First Amendment. However, that right would be a hollow promise if courts could deny associations of workers or others the means of enabling their members to meet the costs of legal representation. That was the holding in *United Mine Workers, Trainmen,* and *NAACP v. Button.* The in-

---

21 *Id.* at 224-25. This point was strongly contested by Justice Harlan in his dissent. *Id.* at 225.

22 401 U.S. 576 (1971).

23 The United Transportation Union was formed by merger after this litigation began and succeeded the Brotherhood of Railroad Trainmen as the party of record.

24 401 U.S. at 581.

junction in the present case cannot stand in the face of these prior decisions.[25]

Commentators generally consider the *Button* line of cases to provide group legal services plans with broad protection against state interference based on traditional notions of professional responsibility.[26] Thus the proposed statute's legality, as regards questions of legal ethics, appears clear. The difficult problem is with principles of state constitutional law related to the separation of powers doctrine.

II. State Constitutional Law

The statute's constitutionality appears to depend on whether it is considered to regulate the practice of law in a permissible manner, that is, as an aid to the court in performing its responsibilities, and not as an attempt to usurp the judiciary's inherent power to govern the activities of lawyers. The basic principle used by the Massachusetts Supreme Judicial Court to judge the validity of statutes affecting the practice of law is that legislative enactments in aid of the court's jurisdiction over the practice of law are permissible.[27] This is a vague principle, but the Massachusetts court has provided a few examples to guide its application. The legislature may enact statutes which impose minimal qualifications for admission to the bar.[28] Statutes designed to help the court protect the public against professional malpractice and unethical behavior through the exercise of the state's police power are also valid.[29] However, the legislature cannot require any individual's admission to the bar,[30] and it is settled in Massachusetts that the legislature cannot enact a statute prescribing the method by which the court shall determine the qualifications of individuals for

25 *Id.* at 585-86

26 *E.g.*, Bartosic & Bernstein, *Group Legal Services as a Fringe Benefit: Lawyers for Forgotten Clients Through Collective Bargaining*, 59 VA. L. REV. 410 (1973).

27 Opinion of the Justices, 279 Mass. 607, 180 N.E. 725 (1932).

28 *Id.* at 611, 180 N.E. at 727.

29 *Id.* at 610, 180 N.E. at 727.

30 *Id.* at 611, 180 N.E. at 727.

admission to the bar.[31] Also, the legislature cannot, as a general matter, authorize a corporation to "practice law."[32]

Arguably the proposed statute regulates the practice of law in a permissible manner since it does not attempt to interfere with the court's control over the practice of law. The statute is designed to aid the court in regulating activities of persons involved in providing group legal services, activities which in general are constitutionally protected from state interference,[33] but in particular cases are undoubtedly subject to state regulation. Since the statute is an aid to the court's remaining jurisdiction over the practice of law and does not contradict any constitutionally sound rule, it is a valid exercise of the legislature's police power.

The basic problem with this argument is the inference that, because certain activity is constitutionally protected from state prohibition and certain kinds of state interference, the legislature becomes competent to regulate it. However, if the legislature can impose minimal qualifications for admission to the bar[34] and exercise its police power to help the court protect the public from injury at the hands of incompetent attorneys,[35] it should also be able to regulate group legal services plans. The Iowa Supreme Court has implied that such regulation would be acceptable under the Iowa Code of Professional Responsibility.[36] However, a state supreme court may not be persuaded that such an assertion of regulatory power does not undesirably infringe upon the court's hegemony. The decision to hold the statute constitutional is a question of the division of power between the judiciary and the legislature, and courts may diverge in their responses to this basically political problem.

A question posed by the separation of powers argument is whether a statute or a court rule is the proper way to regulate. There are reasons why a statutory approach to the regulation of group legal services plans is desirable. First, rules of court have

31 *Id.* at 612, 180 N.E. at 727.

32 Opinion of the Justices, 289 Mass. 607, 612-13, 194 N.E. 313, 316-17 (1935).

33 United Transp. Union v. State Bar, 401 U.S. 576 (1971).

34 Opinion of the Justices, 279 Mass. 607, 611, 180 N.E. 725, 727 (1932).

35 *Id.* at 610, 180 N.E. at 727.

36 IOWA SUP. CT. DR 2-103 (D), printed in IOWA CODE ANN., vol. 58 (Supp. 1973).

traditionally applied only to attorneys. Since many of the persons to be regulated will not be attorneys and many of the activities in which they will engage will be remote from the practice of law, a statutory approach seems appropriate. Second, rules of court generally are not used to create and control regulatory mechanisms. The exceptions to this rule are those disciplinary structures created by the courts to administer codes of professional responsibility, and recent studies have revealed serious weaknesses in these mechanisms.[37]

Whether or not a court could expand its traditional role and reach nonlawyers and activities only remotely related to the practice of law, there are good reasons for its not doing so. Courts are designed for adjudication, and the task of regulation is best performed by administrative agencies. Administrative agencies are able to investigate, study, gain experience, and develop expertise in their fields. Investigation and prospective rulemaking are within their field of competence. An argument can be made that, given the desirability of statutory regulation, the Act's administration should be entrusted to an agency within the judicial branch. This possibility would quell any doubts about the problem of legislative encroachment upon judicial prerogatives. It is, though, rejected for the reasons discussed in the comment to the definition of "administrator."[38]

While still limited in size and coverage, the literature analyzing the growth and problems of group legal services has increased substantially.[39] Empirical studies of operating group legal services

---

37 ABA SPECIAL COMM. ON EVALUATION OF DISCIPLINARY ENFORCEMENT, PROBLEMS AND RECOMMENDATIONS IN DISCIPLINARY ENFORCEMENT (Final Draft, 1970).

38 § 3(c) of the Act *infra.*

39 ABA SPECIAL COMM. ON PREPAID LEGAL SERVICES, HANDBOOK ON PREPAID LEGAL SERVICES (rev. ed. 1972); ABA SPECIAL COMM. ON PREPAID LEGAL SERVICES, PREPAID LEGAL SERVICES (1972) (Transcript of Proceedings National Conference on Prepaid Legal Services) [hereinafter cited as TRANSCRIPT]; B. CHRISTENSEN, LAWYERS FOR PEOPLE OF MODERATE MEANS (1970); Bartosic, *supra* note 26; Standing Comm. of the Calif. State Bar on Group Legal Services, *Group Legal Services,* 39 CALIF. ST. B.J. 639 (1964) [hereinafter cited as Standing Comm.]; *Symposium on Group Legal Services,* 12 U.C.L.A.L. REV. 279 (1965); *see* Bernstein, *supra* note 4; Llewellyn, *The Bar's Troubles, and Poultices—and Cures?,* 5 LAW & CONTEMP. PROB. 104 (1938); Meserve, *supra* note 2; Stolz, *Insurance for Legal Services: A Preliminary Study of Feasibility,* 35 U. CHI. L. REV. 417 (1968); Weihofen, *"Practice of Law" by Non-Pecuniary Corporations: A Social Utility,* 2 U. CHI. L. REV. 119 (1934); *Symposium, Group Legal Practice,* 18 CLEV.-MAR. L. REV. 1 (1969); Note, *Group Legal Services,* 79 HARV. L. REV. 416 (1965). *See also* works cited note 40 *infra.*

plans are still few in number and limited in usefulness.[40] However, a substantial literature, including significant empirical research, exists in the health services field.[41] While the analogy between systems for delivering legal and health services is not exact,[42] many commentators agree that the health services experience may be used as a guide in developing group legal services.[43]

---

40 *E.g.*, S. BRAKEL, WISCONSIN JUDICARE: A PRELIMINARY APPRAISAL (1972); Shreveport Bar Ass'n, Laborers Local Union 229 Prepaid Legal Service Plan (1973) (available from the plan's administrator); Hallauer, *The Shreveport Experiment in Prepaid Legal Services*, 2 J. LEGAL STUDIES 223 (1973).

41 THE KAISER-PERMANENTE MEDICAL CARE PROGRAM — A SYMPOSIUM (A. Somers ed. 1971); W. MACCOLL, GROUP PRACTICE AND PREPAYMENT OF MEDICAL CARE (1966); O. SERBEIN, PAYING FOR MEDICAL CARE IN THE UNITED STATES (1954); P. WILLIAMS, THE PURCHASE OF MEDICAL CARE THROUGH FIXED PERIODIC PREPAYMENT (1932); Greenlick, *The Impact of Prepaid Group Practice on American Medical Care: A Critical Evaluation*, 399 ANNALS 100 (1972); Note, *The Role of Prepaid Group Practice in Relieving the Medical Care Crisis*, 84 HARV. L. REV. 887 (1971) [hereinafter cited as *Prepaid Group Practice*]; *see* THE PHYSICIAN AND GROUP PRACTICE (E. Jordan ed. 1958); H. SOMERS & A. SOMERS, DOCTORS, PATIENTS AND HEALTH INSURANCE — THE ORGANIZATION AND FINANCING OF MEDICAL CARE (1961); Andersen & May, *Factors Associated with the Increasing Cost of Hospital Care*, 399 ANNALS 62 (1972); Donabedian, *An Evaluation of Prepaid Group Practice*, 6 INQUIRY, Sept. 1969, at 3; Kramer, *Medical Care: As Costs Soar, Support Grows for Major Reform*, 166 SCIENCE 1126 (1969); Leland, *Contract Practice*, 98 J.A.M.A. 808 (1932); Vohs, Anderson & Straus, *Critical Issues in HMO Strategy*, 286 NEW ENG. J. MED. 1082 (1972); Note, *Group Health Plans: Some Legal and Economic Aspects*, 52 YALE L.J. 162 (1943); Comment, *The Health Care Crisis and National Health Insurance*, 13 B.C. IND. & COM. L. REV. 60 (1971). *See also* United States v. Oregon State Medical Soc'y, 343 U.S. 326 (1952); AMA v. United States, 317 U.S. 519 (1943).

42 The most significant differences are between the nature of medical and legal services. For instance, the provision of medical services is not an adversary process, that is, no one stands to be harmed by a doctor's helping an ill or injured person. In contrast, a lawyer's services are often used by one individual against another. As a result, employers, while willing to provide health insurance as a fringe benefit, are reluctant to contribute to the support of group legal services plans which may enable their employees to sue them. Thus, financing the provision of group legal services and protecting attorneys from unethical limitations on their activities are problems which afflict group legal services plans and have no analog in the health services field. Another difference between the systems is the public's conception of the relative importance of medical and legal services. Generally speaking, most people believe that people need medical services more than they need legal services.

43 *See, e.g.*, TRANSCRIPT, *supra* note 39, at 185, 200, 225; Segal, *A Preliminary Report on Prepaid Legal Services*, 17 BOSTON B.J. 7, 14-15 (1973).

AN ACT TO REGULATE GROUP LEGAL SERVICES PLANS

TABLE OF CONTENTS

Section 1. Statement of Findings and Purpose
Section 2. Applicability and Scope
Section 3. Definitions
Section 4. Rules of the Administrator
Section 5. Short Title

Title I: Registration of Group Legal Services Plans

Section 101. Registration Required
Section 102. Information Required

Title II: Group Legal Services Corporations

Section 201. Formation of a Group Legal Services Corporation
Section 202. Authorization for Preexisting Corporations to Sponsor Plans
Section 203. Investigation of Foreign Corporations
Section 204. Status of Group Legal Services Corporations; Liability for Negligence
Section 205. Judicial Review of Administrator's Refusal to Certify Documents

Title III: Regulation of Group Legal Services Plans

Subtitle A: Legal Services Cost Insurance Plans

Section 301. Applicability and Scope
Section 302. Authorization to Sponsor Insurance Plans
Section 303. Conditions of Operation
Section 304. Insurance Certificate
Section 305. Books and Records of Sponsors and Insurers
Section 306. Regulation of Premiums and Fees — In General
Section 307. Regulation of Premiums
Section 308. Insurance Company Groups
Section 309. Investment of Funds
Section 310. Annual Statement
Section 311. Inspection and Review of Sponsors and Insurers
Section 312. Authorization to Self-Insure

Subtitle B: Legal Services Delivery Plans

Section 313. Applicability and Scope
Section 314. Authorization to Sponsor Delivery Plans
Section 315. Conditions of Operation
Section 316. Membership Certificate
Section 317. Books and Records of Sponsors
Section 318. Regulation of Membership Fees — In General
Section 319. Regulation of Membership Fees
Section 320. Annual Statement
Section 321. Inspection and Review of Sponsors

Subtitle C: Other Group Legal Services Plans

Section 322. Authorization to Sponsor a Nonidentified Group Legal Services Plan
Section 323. Regulation and Exemptions

Subtitle D: Miscellaneous Provisions

Section 324. Grievance Procedures Required
Section 325. Authorization to Sponsor More than One Type of Plan
Section 326. Status of Noncorporate Sponsors of Group Legal Services Plans
Section 327. Determination of Status
Section 328. Procedure for Determination of Status
Section 329. Alteration of a Determination of Status
Section 330. Review of Administrator's Action

Title IV: Miscellaneous Provisions

Section 401. Resolution of Disputes
Section 402. General Powers and Duties of Administrator
Section 403. Investigatory Powers
Section 404. Limitation of Rule Against Corporate Practice of Law
Section 405. Conduct of Attorneys
Section 406. Conduct of Sponsors and Insurers
Section 407. Partial Invalidity
Section 408. Effective Date

Section 1. *Statement of Findings and Purpose*

The legislature finds that a substantial unmet need for legal services exists among the moderate and low income citizens of the state, that this need cannot be met by existing methods for providing

legal services, and that new approaches to the delivery of legal services should be developed to enable all citizens of the state to achieve effective access to the legal system. The legislature further finds that developing new approaches to providing legal services can best be accomplished by permitting responsible experimentation with different techniques for organizing and delivering legal services, that such experimentation should offer the citizens of the state the greatest possible choice among responsible new approaches, and that, because of the dangers associated with uncontrolled development of new methods for providing legal services, exertion of the state's police power is necessary to protect its citizens.

The purposes of this Act are to provide for registration of group legal services plans, to promote access to quality legal services at the lowest possible price, and to regulate the development and operation of group legal services plans to protect the citizens of the state against fraud and deception, professional incompetence, unprofessional arrangements, and price inflation. This Act shall be liberally construed to promote its purposes and policies.

COMMENT: This section has two purposes: to set forth the factual basis and substantive philosophy of the Act and to protect the Act from constitutional attack. The findings enumerated in the first sentence of the section are generally accepted by commentators.[44] Encouraging responsible experimentation, while somewhat more controversial, is the soundest approach to developing new methods for delivering legal services. A narrow perception of the interests of the legal profession,[45] coupled with a restrictive reading of applicable United States Supreme Court cases,[46] might suggest that experimentation with certain types of group legal services plans, *e.g.*, "closed panel" plans, should be precluded.[47] Labor and

44 *E.g.*, B. CHRISTENSEN, *supra* note 39; TRANSCRIPT, *supra* note 39; Meserve, *supra* note 2; Standing Comm., *supra* note 39.

45 Some members of the bar believe that group legal services plans pose a threat to the professional independence and economic viability of attorneys in private practice. *See, e.g.*, TRANSCRIPT, *supra* note 39, at 185; G. Cole, Freedom of Choice and Group Legal Services, May 15, 1973, at 25-29 (unpublished paper on file with *Harvard Journal on Legislation*); Bartosic, *supra* note 26.

46 United Transp. Union v. State Bar, 401 U.S. 576 (1971); UMW v. Illinois State Bar Ass'n, 389 U.S. 217 (1967); Brotherhood of R.R. Trainmen v. Virginia *ex rel.* Virginia State Bar, 377 U.S. 1 (1964); NAACP v. Button, 371 U.S. 415 (1963).

47 Indeed, the Massachusetts Bar Association has adopted this position. *See* GROUP LEGAL SERVICES NEWS, Jan. 1973, at 6; *Record of the Sixty-Fourth Annual Meeting of the Massachusetts Bar Association*, 58 MASS. L.Q. 265, 268 (1973); Segal, *supra* note 43.

consumer groups have made clear their opposition to legislation restricting the development of "closed panel" plans,[48] and such restriction has been rejected by the American Bar Association.[49]

The Act concentrates on promoting access to quality legal services at the lowest possible price while protecting the public from fraud, professional incompetence, unprofessional arrangements, and price inflation.[50] It is submitted that this flexible approach to regulation, which emphasizes performance and effect and avoids prejudging types of group legal services plans, holds the greatest promise for protecting the public interest while simultaneously considering the legitimate concerns of the legal profession over the effect group legal services plans may have on the integrity of the attorney-client relationship and the independence of lawyers. However, this Act's unique subject matter, necessarily immersed in the morass of professional activity referred to as "the practice of law,"[51] creates the possibility that a court may feel that the statute infringes impermissibly upon the judiciary's responsibility to supervise the activities of lawyers.[52] Therefore the Act was drafted to avoid unnecessary incursions into fields not related to improving access to high quality legal services through the development and regulation of group legal services plans.

Section 2. *Applicability and Scope*

This Act shall apply to any person who operates, proposes to operate, or participates in operating a group legal services plan. The provisions of this Act shall supersede all provisions of the law of the state in conflict with them.

48 *See, e.g.*, TRANSCRIPT, *supra* note 39, at 300; Bernstein, *supra* note 4; Segal, *supra* note 43.

49 *Marijuana and Citizens' Suits on Environment Are Debated by House of Delegates in San Francisco*, 58 A.B.A.J. 1073, 1082-83 (1972).

50 Group legal services plans may create problems in these four areas. The professional responsibility difficulties have long occupied the attention of the bar and the courts. *See, e.g.*, cases cited note 46 *supra*; TRANSCRIPT, *supra* note 39, at 131. It seems safe to suspect that fraud and professional incompetence will infect this type of activity just as they do current methods for providing legal services. Based upon the health services experience, the introduction of legal services cost insurance may be expected to induce inflation in legal services prices. *See* Andersen, *supra* note 41; Newman, *Medicare and Medicaid*, 399 ANNALS 114 (1972).

51 The Massachusetts Supreme Judicial Court, for example, has had difficulty defining "the practice of law." *See, e.g.*, Collins v. Godfrey, 324 Mass. 574, 87 N.E.2d 838 (1949); Opinion of the Justices, 289 Mass. 607, 194 N.E. 313 (1935).

52 For an example of such a statute and one which involved group legal services, see Opinion of the Justices, 289 Mass. 607, 194 N.E. 313 (1935).

COMMENT: This section defines the scope of the Act. The intention is to bring within the Act any person or organization directly associated with a proposed or operating group legal services plan. It is left to the courts and to the definition of "group legal services plan" to distinguish between delivery systems which are intended to be regulated by the Act and traditional activities of law firms, individual clients, and lawyers which are excluded from regulation. In cases where a clear line cannot be drawn on the basis of the criteria set forth in the definitions section,[53] or from the underlying purpose of the Act, the statute should be construed as inapplicable to avoid constitutional questions.

The section's last sentence is the statute's general supremacy clause. The Act's provisions supersede all state law in conflict with them regardless of the law's source (whether legislative or judge-made) or its form (whether statutory or common law or rule of court). Various other sections contain additional clauses designed to abrogate particular rules of law.[54] The presence of those specific provisions is no basis for limiting the intended scope of this general supremacy clause. The Act's policies and underlying logic require setting aside provisions of the Code of Professional Responsibility and restricting the application of the common law rule prohibiting corporate practice of law.[55] A court could not avoid choosing between upholding the statute and maintaining the preeminence of existing rules of court and common law if asked to interpret the statute or consider its validity. Thus, the preferable course is to establish the intent of the legislature clearly and avoid ambiguity concerning the Act's relationship to existing law. Such an approach presents the court with a clear choice and removes the possibility of an undesirable interpretation resulting from inadequate textual guidance.

---

53 § 3 *infra*.

54 *See* §§ 302, 314, 322, 404, and 405.

55 For example, ABA CODE OF PROFESSIONAL RESPONSIBILITY DR 2-103(D)(5) prohibits attorneys from participating in a group legal services plan unless certain conditions are met, but the Act permits the sponsoring of group legal services plans and the participation of attorneys in them without regard to these conditions. Title II and § 404 recognize the advantages of permitting corporations to sponsor group legal services plans and permit their formation and operation by corporations.

Section 3. *Definitions*

(a) "Acquisition costs" means those expenses considered by generally accepted accounting principles to represent the cost of marketing a group legal services plan or analogous business activity.

(b) "Administrative costs" means those expenses considered by generally accepted accounting principles to represent the cost of managing a group legal services plan or analogous activity.

(c) "Administrator" means the state's [commissioner of insurance or other appropriate officer].

(d) "Advent group legal services corporation" means an organization which is not a corporation de jure but is in the process of formation pursuant to title II of this Act.

(e) "Aggrieved party" means a person injured in fact by the action of an official agency or tribunal.

(f) "Benefit" means any service, right, privilege, or money provided or promised to be provided to a subscriber to or member of a plan by a sponsor or insurer in return for payment of the required premium or membership fee.

(g) "Benefits package" means the set of benefits to which a subscriber or member of a plan is entitled.

(h) "Certificate of compliance" means a statement issued by the administrator certifying that a person has complied with specific provisions of this Act.

(i) "Certificate of noncompliance" means a statement issued by the administrator certifying that a person has not complied with specific provisions of this Act.

(j) "Entity" means any aggregate of two or more individuals, natural or legal, having a common organizational purpose whether recognized as existing in law or not, including, but not limited to, corporations, partnerships, unincorporated associations, and similar bodies.

(k) "Group legal services" means those services performed by or under the supervision of an attorney for individual members of a group. Groups formed for the sole purpose of providing their members with group legal services, and in which the members have no other common interest or characteristic, are included.

(l) "Group legal services corporation" means a corporation organized pursuant to title II of this Act.

(m) "Group legal services plan" means any system for providing

group legal services. "Plan" is synonymous with group legal services plan.

(n) "Insurance rating" means the practice of calculating risks and charges for insurance coverage.

(o) "Insurer" means a person in the business of underwriting.

(p) "Legal services" means those professional services usually rendered by or under the supervision of members of the bar of any jurisdiction of the United States.

(q) "Legal services cost insurance" means a method for providing indemnity against the expenses related to the use of legal services.

(r) "Legal services cost insurance plan" means a system for providing legal services cost insurance. A legal services cost insurance plan is a group legal services plan. "Insurance plan" is synonymous with legal services cost insurance plan.

(s) "Legal services delivery plan" means a system for providing legal services through staff attorneys employed or retained by the sponsor of the plan. A legal services delivery plan is a group legal services plan. "Delivery plan" is synonymous with legal services delivery plan.

(t) "Member" means a person who belongs to a delivery plan.

(u) "Membership fee" means the sum of money paid as consideration for a membership contract with a delivery plan.

(v) "Nonidentified group legal services plan" means a plan other than an insurance or delivery plan. "Nonidentified plan" is synonymous with nonidentified group legal services plan.

(w) "Participating attorney" means a member of the bar of any jurisdiction of the United States who agrees with the sponsor or insurer of an insurance plan to provide legal services to plan subscribers.

(x) "Person" means any entity or individual, natural or legal.

(y) "Premium" means the sum of money paid as consideration for an insurance contract.

(z) "Professional relationships" means those relationships between persons essential to and developed as a part of the proper interaction of attorneys and clients and governed by the [Code of Professional Responsibility or analogous rule of court].

(aa) "Reasonable fees, reasonable costs, reasonable time" means those fees, costs, or time which, in the context of group legal services plans, are neither unjust nor unfair and are normal, usual, or customary.

(bb) "Reserve fund" means an amount of money set aside for protection against unforeseen contingencies or occurrences.

(cc) "Sponsor" means a person who or which offers and manages a plan.

(dd) "Staff attorney" means a member of the bar employed by the sponsor of a delivery plan to render legal services to plan members.

(ee) "Subscriber" means a person who pays a premium to the sponsor of an insurance plan.

COMMENT: Section 3 defines 31 terms used in the Act. This comment discusses those definitions which are novel or perform a particularly important function.

(a) Acquisition costs. This term is borrowed from the Massachusetts General Laws.[56] In health services cost insurance it refers to those costs generated by marketing activities and the recruitment of plan subscribers. Included among these costs are advertising expenses, salaries of salesmen, and similar expenditures.

(b) Administrative costs. The statute regulates the administrative costs associated with the operation of plans in title III. The health services experience indicates that the cost of managing a health services cost insurance plan like Blue Cross-Blue Shield can vary substantially from plan to plan depending upon allowed expenses and management efficiency.[57] Administrative costs are to be distinguished from expenses related to the actual delivery of legal services, *e.g.*, the salaries of staff attorneys or funds expended to pay insurance claims.[58]

(c) Administrator. The choice of an administrator for the statute may vary. A state's commissioner of insurance and its attorney general are likely candidates.[59] The advantages of the commissioner of insurance are his professional experience with a variety of insurance plans and his separation from the legal profession. The attorney general has the advantage of greater familiarity with the needs of lawyers and clients. The major concern is that

---

56 MASS. GEN. LAWS ANN. ch. 176A, § 15 (1958); *cf.* CAL. GOV'T CODE § 12539.4 (West Supp. 1973).

57 *See* Weiss, Wiese & Kleinman, *Trends in Health-Insurance Operating Expenses*, 287 N. ENG. J. MED. 638 (1972).

58 *See also* MASS. GEN. LAWS ANN. ch. 176A, § 15 (1958). *But see* CAL. GOV'T CODE § 12539.4 (West Supp. 1973).

59 In Massachusetts the regulation of health services cost insurance plans is the responsibility of the commissioner of insurance. MASS. GEN. LAWS ANN. ch. 176A, § 6 (1958). In California the task is performed by the attorney general. CAL. GOV'T CODE § 12530 (West Supp. 1973).

the administrator have a staff of sufficient size and expertise to implement and supervise the regulatory program.

A different approach is to place responsibility for the Act in the hands of an administrative agency within the judicial branch. Operating similarly to the Administrative Office of the United States Courts, this agency could implement the Act under the supervision of the state supreme court. It seems likely that placing administrative responsibility in the judicial branch would strengthen the statute's claim to constitutionality.

Unfortunately, this approach has several serious problems. There is the substantial financial commitment states would be required to make to establish a separate administrative agency with sufficient staff to perform the required adminstrative functions. It is doubtful that any but the largest states have the financial resources and sufficient business to make such a commitment feasible. This is a problem in all approaches to regulation. It is more acute with this approach because a new agency must be created. Another problem is the desirability of continuing to permit professionals to regulate themselves. In the health services field, government, business, and consumer groups are seriously questioning the medical profession's traditional self-regulation. They argue that the lack of public accountability has permitted doctors and hospitals to increase their fees and indulge in practices at odds with the public interest.[60] These critics of professional self-regulation might raise similar objections to a proposal to permit the legal profession to regulate group legal services plans. Finally, the judiciary's historically unfriendly attitude toward group legal services plans also must be considered. Proponents of plans might be reluctant to support placing their programs under the supervision of judges who, unlike a commissioner of insurance, may oppose the development of group legal services because of personal conceptions of proper professional activity.

For the majority of states, creating a separate administrative agency within the judicial branch probably will not be possible. For those states with greater financial resources, the idea should receive serious consideration. If that approach is adopted, the Act

---

60 *See* Faltermayer, *Better Care at Less Cost Without Miracles*, FORTUNE, Jan. 1970, at 80.

should be restructured to reflect the reduction in tension between the legislative and judicial branches. However, care should be taken to include explicit safeguards to protect plans from hostile administration.

(f) & (g) Benefits and benefits package. These words are used in a broad manner which accords with general usage and should not be limited to narrower trade definitions or court interpretations.[61]

(j) Entity. Since plans may be sponsored by a variety of organizations, this term is introduced to provide the statute with a generic term for organized groups of individuals. Since the law may or may not recognize such organizations for certain purposes,[62] the definition treats legal recognition as irrelevant. Thus an entity is to be distinguished from a "legal entity," since the latter term requires legal recognition.

(k) Group legal services. This definition is adapted from that developed by the California State Bar and discussed in the report of the Standing Committee on Group Legal Services.[63] The term establishes the scope of the Act and is one of the most crucial terms. Its purpose is to distinguish between legal services provided by an attorney to an individual client independently of any group association the client may have and legal services secured through a group to which the individual client belongs. An attorney who provides legal services to a union member through a prior arrangement with the union is providing group legal services, regardless of the type or amount of legal services actually rendered; but an attorney retained by a union member independently of his union's activities is not providing group legal services, regardless of the type or amount of services actually rendered. An attorney who represents a union entity, as distinguished from the individual union members, is not providing group legal services.

A separate consideration is the inclusion of services performed

---

61 *See, e.g.,* MASS. GEN. LAWS ANN. ch. 176A, §§ 6, 10 (1958); *id.* ch. 176B, § 4; *cf.* Schweigert v. Beneficial Standard Life Ins. Co., 204 Or. 294, 303-04, 282 P.2d 621, 625 (1955).

62 For instance, labor unions are recognized as entities for purposes of suit under the Labor-Management Relations Act (Taft-Hartley Act), § 301(b), 29 U.S.C. § 185(b) (1970), but not under the common law.

63 Standing Comm., *supra* note 39, at 661; *cf.* B. CHRISTENSEN, *supra* note 39, at 230-50.

under an attorney's supervision. The statute is meant to apply to the increasingly large number of services provided by paralegal assistants, social workers, and other nonlawyers as part of a client's use of legal services.[64] Because of the economic and professional benefits associated with the use of nonlawyers to help meet the needs of middle and low income clients, it is anticipated that a substantial amount of group legal services will be rendered by nonlawyers. Their activities, as well as those of supervising attorneys, are regulated by the statute.

(m) Group legal services plan. This definition brings within the statute's scope all organized methods of arranging for the delivery of group legal services. A great variety of such methods exists. Insurance and delivery plans, defined in §§ 3(r) and 3(s), are two major types. However, other types of plans exist;[65] and this definition, in conjunction with the definition of group legal services, brings all such methods within the Act's purview.

At some point, the statute may require amendment to include plans which provide legal services to individuals on a nongroup basis. The question is an academic one at this point because the danger of adverse selection, *i.e.*, the development of a client population composed chiefly of frequent users of legal services, has deterred most sponsors from exploring the marketability of such a program.[66] Traditionally adverse selection is avoided by selecting members or subscribers on the basis of a preexisting group membership. However, health services experience indicates that a market can develop for nongroup or so-called "direct" professional services cost insurance. If it appears that sufficient interest exists in marketing nongroup insurance or delivery plans, the statute should be amended to bring such offerings within the regulatory framework.[67]

64 *See generally*, Brickman, *Expansion of the Lawyering Process Through a New Delivery System: The Emergence and State of Legal Paraprofessionalism*, 71 COLUM. L. REV. 1153 (1971).

65 *See, e.g.*, United Transp. Union v. State Bar, 401 U.S. 576 (1971).

66 Nongroup insurance plans do exist, *e.g.*, American Legal Aid, Inc.

67 Dr. Lee Morris, Vice President of the Insurance Company of North America, is reported to have said that the marketing of direct legal services cost insurance is several years off. S. Meltzer & D. Minkin, Prepaid Legal Services: A Study of Effective Marketing and Regulation, Apr. 30, 1973, at 43 (unpublished paper on file with *Harvard Journal on Legislation*). Since the problems associated with writing and selling direct legal services cost insurance seem to be different from those

(q) Legal services cost insurance. The development of some types of plans has been retarded by confusion over the applicability of existing insurance laws to plans patterned after the Blue Cross-Blue Shield health services model. Some commentators have expressed doubt that a system for paying legal expenses which lacks the traditional characteristic of insurable costs — fortuitous or unpredictable risk of occurrence — can properly be considered insurance.[68] According to this view, everyone needs legal services at one time or another; and a plan for paying the cost of legal services is nothing but a forced savings or budgeting program. The Massachusetts Commissioner of Insurance, however, has said that a plan for providing indemnity against expenses related to the use of legal services constitutes insurance within the meaning of existing Massachusetts insurance law and cannot be filed in the state without statutory authorization.[69]

The reasoning of the commentators cited above would lead to the conclusion that health services cost insurance also should not be considered insurance, and this view has indeed been accepted by some courts.[70] However, whether or not considered "insurance" under state law, Blue Cross-Blue Shield and similar health services cost insurance plans are regulated.[71] In this statute, any method for providing indemnity[72] against legal expenses is classified as legal services cost insurance.

(s) Legal services delivery plan. Legal services delivery plan means any plan which provides for the financing and delivery of legal services to members of a group through attorneys employed

---

characteristic of group legal services cost insurance, no attempt has been made to incorporate provisions dealing with this type of plan. Persons interested in including appropriate provisions should consult existing insurance laws regulating direct health services cost insurance.

68 *See* R. KEETON, BASIC TEXT ON INSURANCE LAW § 8.2(b) (1971); Bartosic, *supra* note 26, at 459; *cf. Prepaid Group Practice, supra* note 41.

69 Segal, *supra* note 43, at 19; *cf.* Bartosic, *supra* note 26, at 460 n.164.

70 *E.g.,* Michigan Hosp. Serv. v. Sharpe, 339 Mich. 357, 63 N.W.2d 638 (1954); State *ex rel.* Fishback v. Universal Serv. Agency, 87 Wash. 413, 151 P. 768 (1915): The reasoning of these cases has been criticized. R. KEETON, *supra* note 68, § 8.2(b).

71 *See, e.g.,* MASS. GEN. LAWS ANN. ch. 176A (1958); N.Y. INS. LAW §§ 250-60 (McKinney 1966), *as amended,* (McKinney Supp. 1973).

72 "Indemnity is a contract by which one engages to save another from a legal consequence of the conduct of one of the parties, or of some other person." CAL. CIV. CODE § 2772 (West 1954). *But cf.* N.Y. INS. LAW § 41 (McKinney Supp. 1973) (meaning of "insurance contract" and "doing an insurance business"); R. KEETON, *supra* note 68.

or retained by the group. The paradigm legal services delivery plan is structurally identical to a medical prepaid group practice.[73] Under such a model, a group would collect a membership fee and use it to hire or retain staff attorneys who agree to provide legal services to the group's members for a fixed salary or retainer. This basic pattern is subject to substantial variation. The significant practical question is how the statute's administrator should distinguish between insurance plans and those plans which, while sharing some of the attributes of an insurance plan, should be regulated as delivery plans.[74]

In determining whether a plan is a delivery or an insurance plan, the following basic difference should be remembered. A delivery plan contracts with its members to provide legal services through particular staff attorneys who are responsible to their employer, the group, for their performance and have agreed to look only to the group for their remuneration. In contrast, an insurance plan need have no contractual responsibility for the provision of legal services. Its contracts with its subscribers merely provide that the plan will indemnify the subscribers for incurred legal expenses.

Similar in some respects to delivery plans are those plans which arrange only for the provision of legal services to members of a group at a reduced rate or on some other basis advantageous to the group.[75] Such plans should not be considered delivery plans for purposes of regulation under title III, subtitle B. They are the appropriate subject of subtitle C.

(u) Membership fee. This definition includes any consideration

---

73 A typical medical prepaid group practice is described in *Prepaid Group Practice*, *supra* note 41, at 902-10.

74 The characteristic of a delivery plan which makes it seem similar to legal services cost insurance is the assumption of the risk of unanticipated utilization. Since delivery plans contract to provide legal services to a group for a fixed fee in advance and the incidence of need for legal services cannot be accurately known, a plan may have to provide more services than it estimated would be necessary. However, the possibility of unanticipated utilization is not considered sufficient to warrant the conclusion that delivery plans are equivalent to insurance plans. *Cf. id.* at 971-74.

75 *E.g.*, the plans sponsored by the United Transportation Union and discussed in United Transp. Union v. State Bar, 401 U.S. 576 (1971), and Brotherhood of R.R. Trainmen v. Virginia *ex rel.* Virginia State Bar, 377 U.S. 1 (1964).

paid for a membership contract with a delivery plan. It is irrelevant that such a payment may be part of a larger payment, perhaps referred to as "dues," or that it cannot be specifically allocated to the support of a delivery plan. The burden of identifying the payment for benefits under a delivery plan is placed upon the plan's sponsor.

(w) Participating attorney. This concept is adapted from health services cost insurance legislation.[76] Since legal services cost insurance often covers services rendered by a foreign attorney, the definition permits a participating attorney to be a member of the bar of any jurisdiction of the United States.

(y) Premium. The considerations here are similar to those in the definition of membership fee. In particular, the fact that a premium may be merged into the "dues" of a group is irrelevant and should not prevent the application of regulatory provisions to that portion of such "dues" as the sponsor of the insurance plan identifies as related to the financing of legal services.

(bb) Reserve fund. This term is borrowed from existing insurance statutes and is intended to refer to funds accumulated in preparation for losses, both anticipated and unanticipated.[77]

(cc) Sponsor. This definition encompasses those persons who or which have only an indirect interest in the operation of a plan once the basic arrangements are established.[78] It also covers those persons who or which take an active interest or perform a substantial role in the promotion and operation of a plan.[79]

Section 4. *Rules of the Administrator*

A reference to a requirement imposed by this Act includes any rule of the administrator adopted pursuant to this Act.

Section 5. *Short Title*

This Act may be cited as the "Group Legal Services Act of 19____."

---

76 *E.g.*, MASS. GEN. LAWS ANN. ch. 176A (1958); N.Y. INS. LAW §§ 250-60 (McKinney 1966), *as amended*, (McKinney Supp. 1973).

77 *See, e.g.*, MASS. GEN. LAWS ANN. ch. 176A, § 24 (1958); *id.* ch. 176B, § 10 (Supp. 1973); CAL. GOV'T CODE § 12539.1 (West Supp. 1973).

78 *See* cases cited note 75 *supra*.

79 *See* UMW v. Illinois State Bar Ass'n, 389 U.S. 217 (1967).

TITLE I: REGISTRATION OF GROUP LEGAL SERVICES PLANS

Section 101. *Registration Required*

Any person who proposes to sponsor a plan shall file a statement of intent with the administrator. This statement shall be filed no less than 90 days prior to the date of the proposed plan's commencement of operations. Any person who, at the time of the enactment of this statute, is sponsoring a plan shall file a statement of sponsorship with the administrator within 60 days of enactment. Statements required by this section shall contain the information described in § 102 and such other information as the administrator by regulation may reasonably require. Such statements shall be considered public information and shall be maintained by the administrator in a manner which permits reasonable inspection.

COMMENT: The statute imposes a registration requirement for several reasons. The administrator will need information concerning existing plans at the time of the statute's enactment. This information will be valuable even if the regulatory sections of the Act are held invalid. Second, a registration requirement often restrains people from behaving in an undesirable manner. Forced public disclosure may deter activity which privacy fosters. Third, the required registration will provide the public with valuable information upon which to base comparisons among different types of plans.

The 90-day advance filing requirement is imposed to provide the administrator with sufficient opportunity to evaluate a proposed plan. It does not seem that the time period is too far in advance of a plan's commencement of operations to prevent a sponsor from supplying the required information.

Section 102. *Information Required*

Statements filed pursuant to the requirements of § 101 shall include the following information:

(a) Name and address of person or persons filing the statement. If the person filing the statement is an entity, the following additional information shall be provided:

(1) names and addresses of all officers and directors of the entity or persons holding similar positions;

(2) a description of the entity's composition;

(3) copies of the entity's organic documents, including its bylaws, articles of organization if a corporation, and similar documents.

(b) Documents or statements describing, to the administrator's satisfaction, the operation of the proposed or existing plan, including but not limited to, the following:

(1) the plan's benefits package;

(2) the plan's financial structure, including a statement of the premium or membership fee to be charged and a projection of anticipated income and expenditure for a period commencing with registration and ending three years later;

(3) rules concerning the utilization of the plan's benefits;

(4) rules providing for the maintenance of proper professional relationships between plan subscribers or members and attorneys providing legal services;

(5) procedures for resolving disputes pursuant to § 324;

(6) an estimate of the administrative costs to be incurred by the plan, including anticipated acquisition costs, for the initial 3-year operational period as well as any preoperational planning period or, in the case of an existing plan, for the following 3-year period;

(7) a copy of any advertising material, whether prepared as part of the plan's acquisition effort or for other purposes, provided that, if the advertising material is not in print form, a written description of its contents, format, and purposes may be filed instead of the material itself; and

(8) a copy of any agreement concerning legal services between the plan sponsor or its insurer and law firms, private or staff attorneys, bar associations, law schools, unions, or similar organizations and any agreement between the plan sponsor and an insurer.

If the information required by this section is not available at the time of the filing required by § 101, the administrator shall accept the statement for filing but shall require the submission of the information required by this section within a reasonable time. A proposed plan shall not commence operations until the statement required by § 101 has been completed and on file for 90 days. In the case of incomplete filings, the plan shall not begin operations until a determination by the administrator that the plan may do so, but in no event sooner than 90 days after the filing. All information provided pursuant to the requirements of this title shall, to the best knowledge of the persons providing it, be current and accurate in-

formation and shall be kept up to date by supplemental filings in such form and at such intervals as the administrator may direct.

COMMENT: The substantive requirements of this section are similar to those of existing registration requirements.[80] Omitted from this section is any reporting requirement pertaining to client service activities of an operating plan. The submission of such information on a yearly basis is required by §§ 310 and 320.

TITLE II: GROUP LEGAL SERVICES CORPORATIONS

Section 201. *Formation of a Group Legal Services Corporation*

Any person who wishes to sponsor a plan in corporate form shall incorporate under the provisions of either subsection (a) or subsection (b) of this section. No corporation other than a corporation created pursuant to this section or authorized by § 202 shall sponsor a plan in this state.

(a) Nonprofit group legal services corporation. Subject to the exceptions contained in subsection (c) of this section, a nonprofit group legal services corporation shall be created pursuant to the provisions of [the state nonprofit corporation act]. The primary purpose of a nonprofit group legal services corporation shall be to sponsor a group legal services plan, but such a corporation may have such other additional purposes as are permitted by [the nonprofit corporation statute] and are required by its primary purpose. The organization and management of a nonprofit group legal services corporation and the extent of its powers shall be governed by the provisions of [the nonprofit corporation statute] except to the extent those provisions conflict with the provisions or policy of this Act.

(b) Group legal services corporations organized for profit. Subject to the exceptions contained in subsection (c) of this section, a group legal services corporation organized for profit shall be created pursuant to the provisions of [the appropriate business or insurance corporation statute]. The primary purpose of a group legal services corporation organized for profit shall be to sponsor a group legal services plan, and the organization and management of such a corporation and the extent of its powers shall be governed by the provisions of [the appropriate business or corporation statute] except

80 *Cf., e.g.*, CAL. BUS. & PROF. CODE, following § 6076, R. 20 (West Supp. 1973); Order 3572 approving Rule 23 of the Rules of Prof. Conduct Cal. Sup. Ct., June 28, 1973; WIS. STAT. ANN. § 256.294 (West Supp. 1973).

to the extent those provisions conflict with the provisions or policy of this Act.

(c) Exceptions to incorporation procedures contained in [statutes referred to in subsections (a) and (b)]. Notwithstanding the requirements of [the referenced statutes], the articles of organization and the records and bylaws of a group legal services corporation shall be submitted to the administrator prior to their submission to the Secretary of State [or other appropriate official]. The bylaws of a group legal services corporation shall, in addition to the provisions required or authorized by [the referenced statutes], contain provisions protecting the ability of participating or staff attorneys to exercise independent professional judgment on behalf of their clients; protect the integrity of the attorney-client relationship; provide a procedure for resolving disputes between the sponsor and the subscribers or members, including recourse to arbitration by the administrator or an independent panel of attorneys and nonattorneys; and contain such other provisions as the administrator by regulation may reasonably require to effectuate the purposes of this Act. Prior to the issuance of a certificate of incorporation by the Secretary of State [or other appropriate official], the administrator shall examine the articles of organization, records, and bylaws of the advent group legal services corporation submitted to him. If the administrator finds that these documents comply with this Act, and if, by asking for the assistance of the state police [or other appropriate police authority], he finds that the incorporators have not been convicted of a felony, and if attorneys, are not currently under professional discipline, and intend to sponsor a plan in good faith, he shall execute a certificate of compliance and attach this certificate to the articles of organization prior to their filing with the Secretary of State [or other appropriate official]. The Secretary of State [or other appropriate official] shall not issue a certificate of incorporation to the incorporators of an advent group legal services corporation unless the incorporators file with their articles of incorporation the certificate of compliance provided for by this subsection. If the administrator finds that the articles of organization, bylaws, records, or other documents, including the report of the state police [or other appropriate police authority], submitted to him do not comply with this Act, he shall so certify in a certificate of noncompliance giving his reasons therefor. The administrator shall attach this certificate to the articles of organization, and return the documents to the incorporators within 30 days of their submission.

COMMENT: While appropriate corporations probably could be created under existing law in most states, there are several reasons for specifically providing for the formation of group legal services corporations in the Act. It is desirable for administrative purposes to encourage the uniform formation of group legal services corporations. Rather than requiring the administrator to supervise corporations governed by a variety of statutes, it is preferable to limit the choice of legal authorizations and seek to develop a uniform case law dealing with the Act's provisions and the particular needs of group legal services corporations. Second, the common law rule prohibiting the corporate practice of law needs to be restricted, and it seems more likely that a state supreme court will look favorably upon a statute which sets up particular standards for and controls the formation of group legal services corporations than it would upon a statute which simply abrogated the common law rule. *Cf.* § 404 *infra.* Third, while many states, either by statute or rule of court, authorize the practice of law in corporate form by "professional corporations,"[81] such corporations are not suitable vehicles for all group legal services plans since only licensed professionals may be members of their boards of directors.[82] The Act enables consumers of group legal services and nonlawyers to organize and manage a group legal services corporation.

It may be that some states will prefer to permit the formation of group legal services corporations under their existing corporation statutes. This would permit deletion of much of the material contained in this title. Should a state choose such a policy, it is suggested that §§ 201(c), 202, 203, 204, and 205 be maintained, since their purpose is to allow the administrator to control and define the legal status of group legal services corporations.

At this point in the development of plans, potential sponsors seem to be interested in using both nonprofit and profit corporations as sponsoring entities.[83] It seems likely that consumer groups and bar associations will choose nonprofit corporations, while insurance companies and private entrepreneurs will be attracted to profit making ones. Assuming the availability of satisfactory cor-

81 *See, e.g.*, MASS. GEN. LAWS ANN. ch. 156A (1970): MASS. SUP. JUD. CT. R. 3:18.
82 *See, e.g.*, MASS. GEN. LAWS ANN. ch. 156A (1970); MASS. SUP. JUD. CT. R. 3:18.
83 *See* GROUP LEGAL SERVICES NEWS, Mar. 1972, at 4.

poration statutes, the Act prescribes the use of the incorporation procedures provided in those statutes subject to the exceptions in subsection (c). The Act incorporates the law governing nonprofit and profit corporations, but only to the extent that this existing law is not in conflict with the Act's policies and provisions.

Subsection (c) requires the bylaws of a group legal services corporation to contain provisions to protect the interests of clients and attorneys associated with the corporation. These requirements are introduced in response to the criticism that plans introduce lay intermediaries into the attorney-client relationship and that, because of this, the quality of legal services they provide is low.[84]

The Supreme Court has indicated that the mere possibility of lay intermediary interference is an insufficient reason for precluding the operation of group legal services plans.[85] It seems clear, however, that such arrangements do offer the possibility of abuse.[86] It is reasonable for a state to reduce the danger involved by requiring group legal services corporations to include appropriate guarantees and procedures in their internal law. Including these provisions should help persuade a state supreme court that the interests of the public and the legal profession will be adequately protected by the statute's regulatory scheme.

Requiring the administrator to determine the existence of criminal records through the state police is meant to preclude his direct access to criminal records. It is unnecessary to enlarge the set of persons with direct access.

Section 202. *Authorization for Preexisting Corporations to Sponsor Plans*

Any corporation existing prior to the enactment of this Act may sponsor a plan if it amends its articles of organization and bylaws to conform to the requirements of § 201 as well as to the regulations the administrator shall promulgate under this section to insure that preexisting corporations operate in substantially the same manner as those corporations formed under § 201. A preexisting corporation

84 *See* TRANSCRIPT, *supra* note 39, at 185.

85 UMW v. Illinois State Bar Ass'n, 389 U.S. 217, 223-24 (1967); Brotherhood of R.R. Trainmen v. Virginia *ex rel.* Virginia State Bar, 377 U.S. 1, 8 (1964); NAACP v. Button, 371 U.S. 415, 442 (1963).

86 *See* UMW v. Illinois State Bar Ass'n, 389 U.S. 217, 232-33 (1967) (Harlan, J., dissenting).

shall petition the administrator for permission to sponsor a plan and shall provide him with such evidence as he may reasonably require that it has complied with this Act. On the basis of the evidence submitted to him and such other evidence as he may obtain, the administrator shall make the findings required by § 201(c) and shall issue a certificate of compliance or noncompliance. A certificate of compliance shall be attached to the corporation's articles of organization and bylaws and these documents shall be filed with the Secretary of State [or other appropriate official]. Any person aggrieved by final action of the administrator under this section shall have the right to review thereof according to § 330.

COMMENT: This section authorizes existing corporations, including foreign ones, to sponsor plans if they meet certain conditions designed to insure that they operate in substantially the same manner as corporations created under § 201. The Act's administrator should use his rulemaking authority to secure this outcome.

Section 203. *Investigation of Foreign Corporations*

In addition to satisfying the other requirements of this title, a foreign corporation shall submit to the administrator a list of its directors and stockholders and a financial report for its most recent fiscal year. The administrator may require submission of such additional material as he considers necessary to enable him to make the findings required by § 201. The Secretary of State shall not permit an agent of a foreign corporation which proposes to sponsor a group legal services plan to register with him and shall revoke the registration of any previously registered agent of such a foreign corporation unless the corporation complies with this Act and has filed with him a certificate of compliance issued by the administrator.

COMMENT: This section enables the administrator to ascertain the financial stability of a foreign corporation and the character of its directors and stockholders. This additional supervisory effort is required to prevent improperly operated or under-capitalized foreign corporations from sponsoring plans.

Section 204. *Status of Group Legal Services Corporations; Liability for Negligence*

Group legal services corporations authorized by this Act shall be exempt from all statutes regulating insurance companies except as

provided by this Act. Group legal services corporations shall be liable for damages resulting from the negligence of their staff attorneys. Nonprofit group legal services corporations shall be exempt from all state and local taxes.

COMMENT: One purpose of this section is to make the Act and those statutes explicitly referred to in it the only insurance law regulating the activities of group legal services corporations. While presumably the courts will borrow concepts and rules from the common law when asked to interpret the statute, there is no intention to require the incorporation of existing case law or to place reliance on it. Rather, the hope is that the courts will interpret the statute in light of the peculiar needs of the sponsors, insurers, and consumers of group legal services plans.

This section also provides that a group legal services corporation which sponsors a delivery plan shall be liable for damages resulting from the negligence of its staff attorneys. This is consistent with the trend toward requiring employers of professional workers to assume responsibility for the acts of their employees.[87] The benefits gained from holding the employer responsible are sufficiently great to outweigh the detriments that allegedly result.[88]

It is suggested that legislators also consider imposing liability on sponsors of insurance plans for the negligence of their participating attorneys. Making an insurance plan liable for participating attorney negligence appears to go beyond current law.[89] However, it seems that several of the policy considerations that justify imposing liability on employers of professionals[90] apply equally to financers of professional services. Indeed, the health services experience indicates that it is only by heavily pressuring insurers

87 *See* Darling v. Charleston Community Hosp., 33 Ill. 2d 326, 211 N.E.2d 253 (1965).

88 *Id.*

89 Applying traditional notions of agency law to the relationship between a participating attorney and the sponsor of an insurance plan, one is inclined to conclude that a participating attorney would generally be considered an independent contractor and that, as a result, the sponsor would not usually be held liable for the contractor's negligence. *Cf.* California Physicians Serv. v. Garrison, 28 Cal. 2d 790, 795, 804-08, 172 P.2d 4, 7-8, 13-15 (1946): RESTATEMENT (SECOND) OF AGENCY § 223a (1957).

90 Foremost of these is the interest in encouraging financers of professional services to take an active interest in the quality of the services their clients receive. Closely related are concern for the efficient delivery of the services, control over costs, and general consumer satisfaction.

that the state can force them to take an interest in the cost and quality of the services their funds are used to purchase.[91]

Since the statute sets negligence as the threshold of responsibility, the danger of undesirable interference with or unnecessarily close supervision over the activities of professionals seems minimal.[92] In any event, providing consumers of group legal services with the additional protection from incompetent attorneys that an organized, self-interested, and financially capable supervising entity can provide seems worth the risk involved.

Section 205. *Judicial Review of Administrator's Refusal to Certify Documents*

If, pursuant to §§ 201, 202, or 203, the administrator certifies that the articles of organization, bylaws, records, or other documents of an advent, preexisting, or foreign group legal services corporation fail to meet the requirements of law, the incorporators or officers of the aggrieved corporation shall have the right to judicial review of the administrator's determination in accordance with [the state Administrative Procedure Act]. A petition for review shall be filed within 30 days of notice of the administrator's certificate of noncompliance.

TITLE III: REGULATION OF GROUP LEGAL SERVICES PLANS

Subtitle A: Legal Services Cost Insurance Plans

Section 301. *Applicability and Scope*

No insurance plan shall be operated in this state unless the plan, its sponsor, and its insurer all meet the requirements of this subtitle.

Section 302. *Authorization to Sponsor Insurance Plans*

Any person who complies with the appropriate requirements of this Act is hereby authorized to sponsor an insurance plan, notwithstanding any statute or other rule of law of this state.

---

91 Political pressure has come from state commissioners of insurance. For instance, Commissioner Denenberg of Pennsylvania has sharply criticized Pennsylvania Blue Cross-Blue Shield and issued a set of guidelines designed to encourage Blue Cross-Blue Shield to take an active interest in the cost and quality of hospital services. *AMA Council Voices Concern About Denenberg's Guidelines*, AMERICAN MEDICAL NEWS, Nov. 5, 1973, at 23.

92 Development of an adequate reporting system coupled with periodic reviews of participating attorney performance should be sufficient measures to protect sponsors from incurring liability.

COMMENT: This provision responds to the position of some state insurance commissioners that legal services cost insurance cannot be filed without authorizing legislation.[93] While none of the group legal services cases considered by the United States Supreme Court involved the constitutionality of state action preventing the sponsoring of insurance plans,[94] the applicable cases appear to provide constitutional protection to persons interested in offering this kind of insurance coverage. The provision's constitutionality under state law presents a separate problem. Concern with the doctrine of separation of powers among the branches of state government may lead a state supreme court to hold the provision void as beyond the power of the legislature. The constitutional arguments made earlier[95] also apply here.

Section 303. *Conditions of Operation*

Prior to commencing operations, including offering for sale any contract of insurance or collecting any premiums, the sponsor of a proposed insurance plan shall submit to the administrator such evidence as the administrator may require to establish the sponsor's compliance with the following subsections of this section. Upon receipt of the evidence required under this section, the administrator shall issue a certificate of compliance or a certificate of noncompliance as the case may require. Review of the administrator's action may be had according to the provisions of § 330.

COMMENT: For ease of reference, comments to each subsection of this section are printed immediately following the text. This section enumerates the conditions which the sponsor of an insurance plan must meet before he may commence operations. The intention is to prevent any merchandising of the insurance before compliance with this section. Planning activities, including negotiations with interested groups, are permissible prior to compliance with this section.

(a) Contracts for legal services. All contracts for legal services between a sponsor of an insurance plan and participating attorneys shall contain provisions guaranteeing the integrity of the attorney-client relationship and the ability of the participating attorneys to

93 Segal, *supra* note 43, at 19; *cf.* Bartosic, *supra* note 26, at 460 n.164.

94 Cases cited note 46 *supra*.

95 *See* text at note 27 *supra*.

exercise independent professional judgment on behalf of their clients. All contracts shall require that a participating attorney provide legal services to any subscriber requesting him to do so, *provided* that such a request is neither frivolous nor in contravention of [the rule of court enacting the Code of Professional Responsibility or its analog]. All contracts shall set forth the amounts of payments ("fee schedules") to be made by the sponsor or his insurer to participating attorneys for legal services rendered pursuant to the benefits package in the insurance contract. These amounts shall at all times be subject to the previous written approval of the administrator according to the procedure in §§ 306-08.

COMMENT: The contract between the sponsor of an insurance plan and the plan's participating attorneys constitutes a basic legal determinant of plan performance. In this section the Act requires that the contract define the relationship between plan sponsors and participating attorneys so as to protect the interests of a plan's clients from undesirable pressures from either party. The Act also seeks to preclude the plan's sponsor from interfering in an inappropriate manner with professional activities of participating attorneys. Finally, it seeks to protect the legitimate economic interests of sponsors and clients by requiring the development of fee schedules.

Tensions exist between the specific requirements of this subsection. The history of litigation in this area shows that the interest of clients and attorneys in a plan are not necessarily the same.[96] It is intended that any conflict between or among the requirements of this section be resolved in a manner most beneficial to the client-consumers of group legal services.

Some language in this subsection is patterned after that used in the Code of Professional Responsibility. As in the case of the anticipated use of common law insurance concepts and rules discussed in the comment to § 204, courts may be expected to look to the Code, the old Canons of Professional Ethics, and the hundreds of years of common law rulemaking defining the proper activities of attorneys for guidance in interpreting this section's ethical provisions. However, the Code's unsuitability for group legal services plans prevents its unqualified adoption.[97] Many of

96 *See* cases cited note 46 *supra*.

97 *See, e.g.,* DR 2-103 (D) (5).

the Code's rules are aimed at problems characteristic of a traditional system for providing legal services to individual clients on a fee-for-service basis and may be quite irrelevant if not harmful to the novel needs of group legal services plans.[98] For instance, the Act requires sponsors of insurance plans to supervise participating attorneys. There seems to be no reason why such supervision must conflict with the exercise of a participating attorney's independent professional judgment. Suitable procedures can be developed by the courts and the administrator to avoid undesirable exertions of control over professional activities of participating attorneys. Current experiments with monitoring physician behavior by third parties concerned with the financing of physician services suggest that a successful compromise between the need for professional independence and the requirements of cost and quality control can be achieved.[99] It is important that the administrator adopt a creative approach to fashioning regulations under this section.

(b) Contracts for legal services cost insurance.

(1) Benefits packages. The coverage provided by an insurance plan's benefits package shall be reasonable in scope and extent and shall be designed to cover at least 80 percent of the cost of legal services provided to 90 percent of the plan's subscribers; *provided,* however, that the administrator may alter or waive this requirement if he finds that:

(A) the level of coverage required by this subdivision would be prohibitively expensive for the particular group for which the plan is designed;

(B) adequate safeguards are incorporated in the plan's contract for legal services to prevent participating attorneys from unjustifiably raising the prices they charge plan subscribers; and

(C) through continual monitoring, no inflationary price increases related to the availability of coverage under the plan occur.

COMMENT: The health services experience indicates that one problem with using insurance to finance professional services is

98 The Code itself admits the difficulty of its position concerning solicitation in light of the vastly different social circumstances which currently structure attorney behavior. *See* EC 2-6 to -8.

99 *See* Brian, *Government Control of Hospital Utilization,* 286 NEW ENG. J. MED. 1340 (1972). *But see Doctors' Views of Medi-Cal,* 287 NEW ENG. J. MED. 618-19 (1972) (critical replies to Brian's article).

that professionals tend to inflate their prices when insurance payments become common.[100] This phenomenon results when these professionals realize that the introduction of insurance coverage effectively increases the consumer's buying power. The consumer can purchase more expensive services, because the insurer assumes responsibility for a substantial portion of the bill.

Some professional services cost insurance plans provide such limited coverage that consumers fail to benefit from them or, alternatively, the restrictions on coverage force providers to recommend unnecessary and expensive services to bring their activities within the scope of the benefits package.[101] The provision in subdivision (1) of subsection (b) reduces the tendency of legal services cost insurance to stimulate price inflation and unnecessary utilization of expensive benefits. The requirement of reasonableness is inserted to permit the administrator and the courts to determine, on the basis of experience, whether certain benefits packages are so limited in their coverage that they are uneconomical to consumers or exert inflationary pressure on the price structure of the delivery system. Should the administrator determine that a benefits package has either of these characteristics, it is intended that the package be barred from sale. The minimum coverage provision is inserted to place a floor under the requirement of reasonableness. Since there is no data upon which to determine the appropriate level of minimal coverage, some states may choose to adopt a different minimum coverage. For the same reason, the administrator is granted power to waive or alter this requirement, provided his action is based upon certain findings.

(2) Choice of attorney. A subscriber shall be guaranteed the right to select any participating attorney to provide legal services pursuant to the subscriber's insurance contract.

COMMENT: Since a major advantage of insurance, in contrast to delivery, plans is that the former permit their subscribers to choose among a large number of attorneys,[102] it seems appropriate to

100 *See* Andersen, *supra* note 41; Newman, *supra* note 50; *cf. Prepaid Group Practice*, *supra* note 41, at 893-94, 899-900. *See generally* Faltermayer, *supra* note 60.

101 *See Prepaid Group Practice*, *supra* note 41, at 899-900.

102 *See* Bartosic, *supra* note 26, at 427-33 (discussion of 'closed" (delivery) and "open" (cost insurance) plans).

require that legal services cost insurance plans guarantee their subscribers the right to select any participating attorney. This provision should not be interpreted to prevent an insurance plan from terminating a contract for legal services with a participating attorney for cause, nor should such a termination be considered the basis for rescinding the contract between the plan and any subscribers.

(3) Protection of professional relationships. A subscriber shall be guaranteed that neither the sponsor nor insurer of an insurance plan shall interfere with the subscriber's ability to maintain proper professional relationships with his attorney.

COMMENT: This subdivision precludes interference created by administrative laxity or inappropriate exercise of the sponsor's limited supervisory power over the professional activities of its participating attorneys. The health services experience suggests that methods can be developed to insure the proper performance of professionals without interfering with proper professional relationships.[103]

(4) Premiums. Premiums shall be reasonable in relation to the insurance coverage provided by the benefits package of the insurance contract and shall be regulated by the administrator pursuant to §§ 306-08.

(5) Contract liability. The duty of a sponsor or insurer of an insurance plan to indemnify a subscriber against incurred legal expenses shall not depend on any contingency beyond the control of an individual subscriber including the financial ability of the sponsor or his insurer to meet his contractual obligation.

COMMENT: This provision is intended to prevent the sale of insurance contracts which, while not fraudulent or illusory, are contingent on circumstances beyond the control of an individual subscriber.[104] On the other hand, given the novel nature of legal services cost insurance, some flexibility must be permitted to encourage experimentation. Thus the provision bars a sponsor or insurer from conditioning its duty to indemnify, but does not bar a sponsor or insurer from providing that the agreement may

103 *See* comments to § 303(a) *supra*.
104 For example, limitation on benefits imposed if costs exceed estimates.

be terminated as to any class of subscribers in advance of the subscribers' incurring liability to pay legal fees.

(6) Termination of contract before expiration. A contract for insurance may be terminated prior to its date of expiration, provided:

(A) Premiums are prorated and the unearned balance returned to the affected subscribers;

(B) The termination applies to an entire natural class of subscribers; and

(C) Any other conditions the administrator may by regulation reasonably impose to protect the interests of subscribers are met.

COMMENT: As used in this section, the term "natural class" means a class of subscribers existing independently of any decision to terminate an insurance contract.

(c) Reserve funds. The sponsor of an insurance plan shall establish or cause to be established an initial reserve fund adequate to protect subscribers within such time as the administrator may by regulation reasonably require.

COMMENT: Reserve funds are a traditional part of insurance fiscal planning. This subsection grants the administrator discretion to determine the amount of money initially required and the time allowed to accumulate it. Most sponsors of insurance plans will probably secure their reserve funds by contracting with insurance companies or will themselves be insurance companies with adequate financial strength. However, a sponsor may wish to generate the required funds from premium income or other sources; and such experimental efforts would be permissible under this subsection if the administrator finds that the plan's subscribers would be adequately protected by such practices.

(d) Administrative and acquisition costs. Administrative and acquisition costs incurred by an insurance plan shall at all times be limited to such reasonable amounts as the administrator may approve in advance or retroactively. An initial budget for these costs shall be approved by the administrator prior to the commencement of operations of an insurance plan.

COMMENT: The health services experience indicates that the administrative and acquisition costs of insurance plans used to finance

the provision of professional services vary widely.[105] Thus the administrator is required to supervise and approve these expenditures. While advance approval is preferable, the subsection does permit retroactive approval to give the administrator the necessary flexibility to allow unforeseen or extraordinary expenses as well as initial costs which cannot be accurately estimated.

In determining whether such costs or the initial budget required by the section should be allowed, the administrator must judge whether the requested level of expenditure is required to properly administer the plan and develop a sufficient subscriber population. To further the Act's purpose of enabling persons of low and moderate income to gain access to quality legal services at the lowest possible cost, the administrator should prevent sponsors or insurers from lavishly expending premium funds.

Section 304. *Insurance Certificate*

An insurance certificate shall be issued by the sponsor or insurer of an insurance plan to each subscriber or group of subscribers. No insurance certificate shall be issued unless the administrator has approved the form of the certificate in writing and it contains in substance the following provisions:

(a) A description of the benefits package indicating in detail the legal services covered by the package;

(b) A statement of the duration of the insurance contract and of the terms and conditions upon which it may be extended, renewed, revised, or cancelled;

(c) A statement of the period of grace allowed for making any payment due from the insured under the contract, but this period shall not be less than 30 days.

COMMENT: This section is adapted from Massachusetts General Laws ch. 176A, § 8 (Supp. 1973).

Section 305. *Books and Records of Sponsors and Insurers*

Any person who acts as a sponsor or insurer of an insurance plan shall maintain his or its books and records as the administrator may by regulation reasonably require in order that the information in them shall be readily available to the administrator, provided that client confidentiality shall be preserved as required by § 311.

105 Weiss, *supra* note 56.

COMMENT: No problem with the confidentiality of client files should be created under this section. However, should the administrator find it necessary to perform an investigation, either under this section or § 311, which requires access to client information normally privileged, § 311 requires deletion from the records of as much identifying information as possible. Ultimately, protection of the public interest may require compromising confidentiality of client files. The problem is currently troubling state administrators charged with responsibility for their states' "Medicaid" programs,[106] and the experience accumulated in the health services field may help develop procedures for use with group legal services plans.[107]

Section 306. *Regulation of Premiums and Fees—In General*

The purpose of this section and §§ 307 and 308 is to regulate the premiums of insurance plans so they are not excessive, inadequate, or unfairly discriminatory. Nothing in these sections is intended to prohibit reasonable and fair competition or uniformity in premiums for insurance, the fees of participating attorneys, premium setting systems, or insurance rating plans or practices. Premiums for legal services cost insurance and fees of participating attorneys shall be subject to regulation exclusively under the provisions of this subtitle. No participating attorney may charge a subscriber a fee, directly or indirectly, for services rendered pursuant to the subscriber's insurance contract in excess of the amount approved in accordance with this Act.

COMMENT: This section sets forth the general principles governing the setting of premiums for legal services cost insurance and the fees of participating attorneys. This process is equivalent to insurance rate regulation, but it does involve some significant legal problems. First, there is the difficulty of determining the proper criteria to use to evaluate premium proposals. The statute provides guidance for the administrator in § 307. Second, the antitrust implications of premium setting and fee schedules must be considered.

This section is modeled after Massachusetts General Laws ch.

106 Brant, Access to Medical Records by CHAMP Coordinators, Oct. 15, 1973 (unpublished memorandum on file with *Harvard Journal on Legislation*).

107 This issue is considered further in the comments to § 311.

175A, § 2 (1972). Language in that statute limiting the applicability of the antitrust laws has been deleted. Premiums and fees are regulated to protect the public from high rates and insurer insolvency.[108] Regulating the fees participating attorneys may charge is an integral part of determining the cost of a benefits package and the reasonable premium permissible under § 303 (b)(4). Fee schedules and the contents of benefits packages will be examined and approved as part of the process of regulating premiums.

Recently, the United States Department of Justice has taken an interest in the minimum fee schedules promulgated by many bar associations, and a federal court has held that these fee schedules violate the antitrust laws.[109] Bar association fee schedules perform functions quite different from the fee schedules this Act requires. Under this Act fee schedules are required to control the upward cost of attorneys' services, not to establish minimum prices for services. Attorneys would be free to charge less than the fees established under the premium regulating procedure, so the complaints against minimum fee schedules are inapplicable here.

The Act's relationship to the McCarren-Ferguson Act[110] should be considered. That law exempts insurance from federal antitrust statutes to the extent it is regulated by the states.[111] This Act is meant to utilize that exemption; therefore it should not be construed to provide sponsors and insurers with an exemption from federal antitrust laws broader than that given by the McCarren-Ferguson Act.[112]

Section 307. *Regulation of Premiums*

(a) Filing of proposed premiums with administrator. Every sponsor of an insurance plan shall file with the administrator a schedule of the premiums it proposes to charge subscribers. Each such filing shall state the proposed effective date of the premium schedule,

---

108 These are the traditional concerns justifying insurance rate setting or regulation. *See* R. KEETON, *supra* note 68, § 8.3.

109 Goldfarb v. Virginia State Bar, 355 F. Supp. 491 (E.D. Va. 1973).

110 15 U.S.C. § 1011 (1970).

111 15 U.S.C. § 1012 (1970).

112 A general discussion of this problem in the context of traditional insurance plans may be found in R. KEETON, *supra* note 68, § 8.4(a); Gardner, *Insurance and the Anti-trust Laws: A Problem in Synthesis*, 61 HARV. L. REV. 256 (1948).

which shall be at least 60 days from the date of filing, and shall indicate in detail the nature of the benefits package provided. It shall also state the fees the sponsor will pay participating attorneys for legal services covered by the benefits package. The administrator may require a sponsor or his or its insurer to furnish the information used to determine the proposed premium schedule or otherwise to support the soundness of the proposed schedule. Any schedule may be supported by (1) the experience or judgment of the sponsor making the filing or his or its insurer, (2) the experience or judgment of other sponsors or insurers, or (3) any other relevant information. A filing and its supporting information shall be open to public inspection after the filing has become effective.

COMMENT: This provision is modeled after Massachusetts General Laws ch. 175A, § 6 (1972).

(b) Review by the administrator. The administrator shall evaluate all filings of proposed premium schedules on the basis of the following criteria:

(1) Premiums shall be reasonable and not be excessive, inadequate, or unfairly discriminatory.

(2) Due consideration shall be given to past and prospective loss experience within this state; to a reasonable allowance for profit; to dividends, savings, or premium deposits returned to subscribers; to past and prospective expenses applicable to operations within this state; and to all other relevant information.

(3) Within 30 days after a schedule of proposed premiums has been filed with the administrator, he shall notify the sponsor making the filing whether a public hearing to consider the schedule will be held. If the administrator decides not to hold a public hearing, he shall notify the sponsor of his approval or disapproval of the proposed premium schedule within 45 days after the filing. If the administrator decides to hold a public hearing, he shall notify the sponsor and shall approve or disapprove the proposed premium schedule within a reasonable time.

COMMENT: This provision is modeled after Massachusetts General Laws ch. 175A, § 5 (1972). Subdivision (2) states that information relevant to the determination of a reasonable premium does not include past or prospective expenses applicable to operations outside the state. A hearing requirement is included in the filing process by subdivision (3) in preference to the "file and use"

practice common in several states. Such a requirement offers the consumer better protection than reliance on retroactive action by the administrator.

(c) If at any time the administrator finds that a filing in effect pursuant to the requirements of subsection (a) of this section no longer conforms to the requirements of this Act, he shall hold an adjudicatory hearing. Not less than 10 days written notice shall be given to every sponsor and insurer operating under such a filing. The notice shall specify the matters to be considered at the hearing. If the administrator finds that the filing does not comply with this Act, he shall issue an order specifying why he finds the filing to be nonconforming and stating the date upon which the filing shall be deemed ineffective. Copies of this order shall be sent to every sponsor and insurer affected by it.

(d) Any person, other than a sponsor or insurer, who is aggrieved with respect to any effective filing may make a written application to the administrator specifying the grounds for the grievance. If the administrator finds that the application is made in good faith and that the applicant would be unjustly aggrieved if his grounds were established, he shall hold a hearing within 30 days after receipt of the application. Ten days prior written notice of the hearing date shall be sent to the applicant and every sponsor and insurer operating under the filing to be reviewed. If the administrator finds that the filing does not conform to this Act, he shall issue an order specifying why the filing is nonconforming and stating the date upon which the filing shall be deemed ineffective. Copies of this order shall be sent to the applicant and every sponsor and insurer affected by it. Any applicant proceeding under this subsection and aggrieved by any action of the administrator taken after a hearing pursuant to this subsection shall be entitled to judicial review thereof according to [the state Administrative Procedure Act].

COMMENT: This provision gives consumers of group legal services, as well as other interested persons, an opportunity to complain to the administrator concerning any aspect of an approved filing which may appear unjust, *e.g.*, unduly high premiums, unreasonably low fee schedules, or unsatisfactory benefits packages. Sponsors and insurers are not permitted to proceed under this subsection but are given a broader opportunity for review under § 330.

Section 308. *Insurance Company Groups*

Two or more sponsors or insurers who, by virtue of their business associations in the United States, represent themselves to be or are customarily known as an "insurance company group" or similar trade designation shall have the right to make the same filings and use the same premium schedules, subject to the provisions of § 307. This section shall not apply to two or more sponsors or insurers who are not under the same general management or control, or who act in concert in underwriting groups or pools.

COMMENT: This section is patterned after Massachusetts General Laws ch. 175A, § 5(e) (1972).

Section 309. *Investment of Funds*

The funds of an insurer shall be invested only in such securities as are permitted by [the statute regulating investment of capital by insurance companies], except that not more than 5 percent of its invested assets, exclusive of real estate occupied by itself for the transaction of business, may be invested in mutual funds, and it may deposit the whole or any portion of its funds in any savings bank or savings account in a trust company organized under the laws of the state or a national banking association. The administrator may require any insurer after the first full calendar year of doing business to maintain a contingency fund, over and above its reserves and liabilities, in such amount as the administrator may deem proper.

COMMENT: This provision is modeled after Massachusetts General Laws ch. 176B, § 10 (Supp. 1973).

Section 310. *Annual Statement*

Every sponsor and insurer shall, on or before the first day of March each year, file with the administrator a statement verified by at least two of its principal officers containing the following information: a financial statement showing its condition as of the last day of December of the preceding year; a statistical summary listing the numbers and types of claims paid and the average dollar amount of each type of claim; a list of the groups currently subscribing to the plan or plans sponsored; and such other information as the administrator by regulation may reasonably require. Such statements shall be in the form required by the administrator. A sponsor or insurer neglect-

ing to file its annual statement within the time specified shall forfeit $100 for each day such neglect continues. Upon notice by the administrator of its failure to file the required statement, its authority to acquire or seek new business shall cease and shall be renewed only after the statement is filed.

Section 311. *Inspection and Review of Sponsors and Insurers*

The administrator shall visit all sponsors and insurers of insurance plans at least once every three years, and at such other reasonable times as the administrator may deem prudent, to examine their affairs. The administrator shall have free access to all books, records, and papers of the sponsor or insurer and may summon and examine under oath its officers, agents, employees, and other persons concerning its affairs and condition.

To insure delivery of quality legal services by participating attorneys, the administrator shall have the power to examine the relevant books and records of participating attorneys including client files. If the need arises to examine client files, the administrator shall seek permission from those clients whose files are to be reviewed. If permission cannot be obtained, the administrator may instruct the participating attorney to delete as much personal identifying material as possible from the file without destroying the significance of its contents and may then proceed to examine it. No copies of such a record shall be made. The information gained from its examination shall not be disclosed to any other person, except as required by formal administrative or judicial proceedings. Any client of a participating attorney aggrieved by the administrator's intention to examine his file shall be entitled to contest the administrator's decision according to § 330. The administrator shall not examine the file of a client contesting his decision to do so until the client has exhausted, or has had the opportunity to exhaust, the procedures available to him under § 330.

COMMENT: This section provides the administrator with power to inspect the business affairs of sponsors and insurers and creates the primary mechanism for controlling the quality of legal services delivered by participating attorneys. This mechanism is necessary to insure the availability of quality legal services to persons of low and moderate income. The Act authorizes the administrator to perform inspections equivalent to those referred to in the health

services field as "medical audits."[113] The purpose of such inspections is to determine, with the help of outside experts, whether a subscriber received professional services of appropriate quality. Determining the acceptable level of quality will be a difficult task and one which must be left to the administrator within the broad limits of the Act. The intention is to insure that subscribers receive the same quality of legal representation that well-educated moderate income clients familiar with lawyers would expect to receive from their attorneys. There is no intention to require delivery of services of the quality provided by a state's large and expensive law firms. On the other hand, the Act avoids adopting as the standard of professional performance existing levels of private practice, since these levels are generally unsatisfactory.[114]

Section 312. *Authorization to Self-Insure*

Upon a showing satisfactory to the administrator that a sponsor possesses the financial and technical ability to underwrite the plan by itself, the administrator may grant the sponsor permission to sponsor and insure a legal services cost insurance plan. A sponsor who chooses to self-insure an insurance plan shall be subject to all provisions of this Act regulating the activities of either sponsors or insurers of insurance plans.

COMMENT: Presumably only insurance companies will be interested in both insuring and sponsoring an insurance plan, but a business, union, or other entity might wish to sponsor and self-insure a plan. The decision to permit such an arrangement is left to the administrator.

Subtitle B: Legal Services Delivery Plans

Section 313. *Applicability and Scope*

Section 314. *Authorization to Sponsor Delivery Plans*

The above sections mirror §§ 301 and 302 except that "insurance plans" becomes "delivery plans."

113 Lembcke, *Evolution of the Medical Audit*, 199 J.A.M.A. 543 (1967); Lembcke, *Medical Auditing by Scientific Methods*, 162 J.A.M.A. 646 (1956).

114 *See* ABA SPECIAL COMM. ON EVALUATION OF DISCIPLINARY ENFORCEMENT, *supra* note 37; J. CARLIN, LAWYERS ON THEIR OWN (1962); Q. JOHNSTONE & D. HOBSON, LAWYERS AND THEIR WORK (1967); Bartosic, *supra* note 26, at 419-20.

COMMENT: The United States Supreme Court has held that a group legal services plan very similar to the type authorized by § 314 is constitutionally protected from state prohibition.[115] It seems clear that state regulation of the type provided in this subtitle is permissible.

Section 315. *Conditions of Operation*

Prior to commencing operations, including the collection of any membership fees, the sponsor of a proposed delivery plan shall submit to the administrator such evidence as the administrator may require concerning the sponsor's compliance with the requirements set forth in the following subsections of this section. Upon receipt of the evidence required under this section, the administrator shall issue a certificate of compliance or a certificate of noncompliance as the case may require. Review of the administrator's action may be had according to the provisions of § 330.

COMMENT: Most of the provisions of this section are similar to those of § 303. The comments deal only with significantly different provisions.

(a) Contracts for professional employment. All contracts for professional employment between the sponsor of a delivery plan and staff attorneys shall contain provisions guaranteeing the observance of rules concerning proper professional relationships, including maintenance of the integrity of the attorney-client relationship and the ability of a staff attorney to exercise his independent professional judgment on behalf of his client.

COMMENT: The major difference between insurance and delivery plans is that the sponsor of a delivery plan employs attorneys to provide legal services to plan members. The existence of an employment relationship between the staff attorneys and the plan's sponsor creates different kinds of professional responsibility problems than are faced in an insurance plan. For instance, the sponsor of a delivery plan has a stronger interest in the activities of its staff attorneys than a sponsor of an insurance plan has in those of its participating attorneys. Such an interest is based partly on the legal rule that an employer may be liable for any tortious act committed by one of his employees.

115 UMW v. Illinois State Bar Ass'n, 389 U.S. 217 (1967).

In this instance, as in § 303, total incorporation of the Code of Professional Responsibility is undesirable. The development of appropriate rules to protect professional relationships is committed to the administrator and the courts. They are relied on to fashion rules to meet the novel needs of delivery plans.

(b) Membership contracts. All contracts between the sponsor of a delivery plan and the plan's members shall contain provisions designed to fulfill the following requirements:

(1) Benefits packages. The services provided by a delivery plan shall be reasonable in scope and extent. If the plan provides legal services to its members in addition to those covered by its benefits package on a fee-for-service basis, the benefits package shall be designed to cover at least 80 percent of the cost of legal services provided to 90 percent of the plan's members; *provided,* however, that the administrator may alter or waive this requirement if he finds that the conditions of §§ 303(b)(A)-(C) are met.

COMMENT: Unlike insurance, the introduction of delivery plans does not seem to carry the same danger of inflating the price of legal services. However, if a delivery plan does not offer comprehensive coverage, but does provide legal services beyond those available under the benefits package on a fee-for-service basis, the plan does have inflationary potential. Staff attorneys providing fee-for-service assistance may be able to coerce clients, increase their charges, and generate unnecessary business since consumers probably will be reluctant to forego continuing to use a lawyer once a delivery plan has made one available. Therefore, this subdivision provides that the benefits package of a noncomprehensive legal services delivery plan which provides additional legal services on a fee-for-service basis must meet the same standards as an insurance plan.

(2) Membership fees. Membership fees shall be reasonable in relation to the legal services provided by the plan and shall be set by the administrator pursuant to §§ 318 and 319.

(3) Protection of professional relationships. A member shall be guaranteed that the sponsor of a delivery plan shall not interfere with the member's ability to maintain proper professional relationships with his attorney.

(4) Contract liability. The duty of a sponsor of a delivery plan

to provide promised legal services to the plan's members shall not depend on any contingency beyond the control of an individual member, including the financial ability of the sponsor to meet his contractual obligations, unless the administrator permits exception for experimental reasons or to accommodate unusual circumstances for a limited period of time.

COMMENT: This provision precludes premising a delivery plan's duty to *provide* legal services on a contingency beyond the control of an individual member. Because of the different purposes of delivery and insurance plans, regulation of delivery plans need not protect consumers from legal expenses for which they may not receive reimbursement. However, the need to permit experimentation in the development of legal services delivery plans requires the introduction of some flexibility to protect the sponsor of a delivery plan from truly unforeseen or imponderable risks. The language suggests that exceptions to this provision should only be granted by the administrator in unusual cases and then only for experimental purposes for a specific period of time.

(5) Termination of contract before expiration. A membership contract may be terminated prior to its date of expiration provided:

(A) Premiums are prorated and the unearned balance returned to the affected members;

(B) The termination applies to an entire natural class of members; and

(C) Any other conditions the administrator may by regulation reasonably impose to protect the interests of members are met.

(c) Administrative and acquisition costs.

This part mirrors § 303(d) except that "insurance plan" becomes "delivery plan."

Section 316. *Membership Certificate*

Section 317. *Books and Records of Sponsors*

Section 318. *Regulation of Membership Fees — In General*

These sections mirror §§ 304, 305 and 306 except that: (a) "insurance certificate" becomes "membership certificate," (b) "sponsor or insurer" becomes "sponsor," (c) "insurance plan" becomes

"delivery plan," (d) "insurance contract" becomes "membership contract," (e) "insured" and "subscriber" become "member," (f) "§ 311" becomes "§ 321," (g) "§§ 307 and 308" becomes "§ 319," and (h) "premiums for insurance, the fees for participating attorneys, premium setting systems, or insurance rating plans or practices" becomes "membership fees for delivery plans or membership fee setting systems."

Section 319. *Regulation of Membership Fees*

(a) Filing of proposed fee with administrator. Every sponsor of a delivery plan shall file with the administrator a statement of the fee it plans to charge members. Each filing shall state the proposed effective date of the membership fee, which shall be at least 60 days from the date of filing, and shall indicate in detail the nature of the benefits package provided. The administrator may require the sponsor to furnish any information used by it to determine the proposed membership fee or otherwise to support the reasonableness of the proposed membership fee. A statement filed under this subsection shall be open to public inspection after the filing has become effective.

(b) Review by the administrator. The administrator shall evaluate all statements of proposed membership fees on the basis of the following criteria:

(1) Membership fees shall be reasonable and not be excessive, inadequate, or unfairly discriminatory.

(2) Membership fees shall be adequate to generate income to permit the sponsor to employ sufficient personnel, both professional and nonprofessional, and defray other expenses necessary to providing the legal services described in the benefits package. In the case of a delivery plan sponsored for profit, fees shall be adequate to provide a profit which shall not exceed 10 percent of gross income.

Part (3) of § 319(b) mirrors part (3) of § 307(b) except that "schedule of proposed premiums" becomes "statement of proposed fees."

Subsections (c) and (d) of § 319 mirror subsections (c) and (d) of § 307 except that "a filing" becomes "a statement," and "sponsor and insurer" becomes "sponsor," and "ten days" becomes "twenty days."

COMMENT: Three alternatives are available to the legislature

regarding limitations on profit under (b)(2). First, if no limitation is desired, the provision in subdivision (b)(2) limiting return should be deleted. Second, profits can be limited to a certain percentage of capital invested in the business. Should this option be preferred, a suitable change in the language of subdivision (b)(2) would be required. Third, return can be limited to a percentage of gross income. This is the option chosen for the Act.

From a consumer perspective, some limitation on return seems desirable, but an argument can be made that price and profit regulation is not a wise way to control business activity and protect consumers. From this perspective, the lack of effective alternatives makes no control the best of several evils. If one rejects not controlling profits, the problem of what base to use to measure permissible return remains.

An alternative to no regulation is to limit rate of return to a percentage of capital invested. This measure provides a basis for determining whether profits are unreasonable compared to profits in other industries. However, using capital invested as the base creates an incentive to invest funds in unnecessary structures, equipment, and library facilities. This would be a waste of money in an organization in which the primary product is professional service.

Using gross income as the measure would stimulate sponsors to increase the size of their plans, reach more people, and provide more services. In a system with price control, using gross income as a base could create problems of unwarranted expansion and shoddy performance. This would not be true if there were also quality control, as there is in this Act. Without some method of overseeing prices, using gross income would encourage inflation.

Section 320. *Annual Statement*

Section 321. *Inspection and Review of Sponsors*

These sections mirror §§ 310 and 311 except that (a) "sponsor or insurer" becomes "sponsor," (b) "claims paid and the average dollar amount of each type of claim" becomes "legal services rendered," (c) "subscribing to the plan or plans sponsored" becomes "members of the plan," and (d) "participating attorneys" becomes "staff attorneys."

Subtitle C: Other Group Legal Services Plans

Section 322. *Authorization to Sponsor a Nonidentified Group Legal Services Plan*

Any person who complies with the appropriate requirements of this Act is hereby authorized to sponsor a nonidentified plan, notwithstanding any statute or other rule of law of this state.

COMMENT: A large number of group legal services plans share some of the characteristics of insurance and delivery plans but vary substantially from them. For instance, automobile clubs provide a form of group legal services which resembles legal services cost insurance, but its narrow purpose and limited coverage distinguish it from true legal services cost insurance. While it seems clear that not all group legal services plans are patterned after the insurance or the delivery model, this fact does not imply that these different types should not be regulated. Many of the same concerns which justify regulating insurance and delivery plans also support regulating plans offered by automobile clubs and trade unions.[116]

Section 323. *Regulation and Exemptions*

When the administrator declares a plan to be a nonidentified plan, the order shall also set forth the provisions of this title to which the plan shall be subject; *provided* that every nonidentified plan shall be subject to the provisions of this subtitle and the relevant provisions of the following sections: 303(a), 303(b)(1), 303(b)(3)-(6), 303(d), 304 or 315, 305 or 317, 306, 307, 310 or 320, 311 or 321, and all sections in subtitle D; *provided further* that the administrator may exempt a nonidentified plan from any of these enumerated provisions if the sponsor of the plan establishes that the burdens on the plan's sponsor or clients (including termination of the plan) would be inconsistent with the purposes of this Act.

COMMENT: This section creates the regulatory structure for nonidentified plans. It permits the administrator to exempt nonidentified plans from some or all requirements upon a showing of severe hardship. The administrator is not required to permit the exemption, but rather is granted discretion to do so. Exercise of the

116 For example, cost and quality control, consumer unfamiliarity with lawyers and the use of legal services, and problems of third-party interference with the attorney-client relationship.

administrator's judgment is permitted to accommodate the possibility that some plans may be so poorly organized that their continued existence would be contrary to the policy of the Act. In such a case, the plan should be required to meet the appropriate standards and ordered to discontinue operations upon failure to do so.

Subtitle D: Miscellaneous Provisions

Section 324. *Grievance Procedures Required*

Every sponsor of a plan shall create a procedure for settling disputes between or among the sponsor, insurer, participating or staff attorneys, and the subscribers or members. Such a procedure shall include a provision permitting, but not requiring, recourse to arbitration by the administrator or by an independent panel of attorneys and nonattorneys who are consumers of group legal services. It shall also include such other provisions as the administrator by regulation may reasonably require.

Disputes involving claims for money damages in excess of $1,000 shall be resolved by resort to court procedures and the traditional principles of law and equity. Claims of $1,000 or less shall be resolved by resort to arbitration, unless a party elects to exercise his right to a judicial determination of the controversy. A party who elects a judicial forum and fails to prevail shall be liable for all court costs, including reasonable attorneys' fees.

The procedures created pursuant to this section and reviewable according to § 401 shall be the sole mechanism for resolving disputes related to the operation of a group legal services plan.

COMMENT: This section requires the creation of an internal grievance procedure with recourse to arbitration. It preempts external grievance processes to promote efficiency and prevent minor grievances from becoming court suits. Persons aggrieved by the outcome of this procedure may take their cases before the Review Committee on Group Legal Services established by § 401. Access to the courts is then available according to the provisions of the state Administrative Procedure Act.

Section 325. *Authorization to Sponsor More than One Type of Plan*

Any person who meets the appropriate requirements of this Act may sponsor one or more of any type of group legal services plan.

Section 326. ***Status of Noncorporate Sponsors of Group Legal Services Plans***

A noncorporate sponsor of a group legal services plan shall enjoy the same rights and privileges and be subject to the same duties and liabilities as a corporate sponsor created by title II of this Act.

Section 327. *Determination of Status*

Any person who proposes to sponsor a plan or who, when this Act becomes effective, is sponsoring a plan and believes that the plan is neither an insurance nor a delivery plan may file a petition for determination of status with the administrator. Commencement of operations of a proposed plan shall be delayed until the administrator issues an order determining the applicability of the regulatory provisions of this title to the proposed plan.

COMMENT: It is unfeasible to attempt to classify each type of plan and provide for its regulation in a separate subtitle. While § 328 requires the administrator to determine the status of all plans, this section gives a sponsor the option of anticipating the administrator's action and petitioning for a determination of status as a nonidentified plan.

Section 328. *Procedure for Determination of Status*

Within 30 days after filing of the statement required by § 101, the administrator shall, on the basis of a petition for determination of status filed with him or such other evidence as he may acquire by a hearing or in an informal manner, determine whether a plan is an insurance, delivery, or nonidentified plan. If the administrator determines that the plan is an insurance or a delivery plan, he shall issue an order declaring the status of the plan and specifying the reasons for his conclusion. If he determines that the plan is neither an insurance nor a delivery plan, he shall determine it to be a nonidentified plan and issue an order declaring his determination and the reasons for it.

Section 329. *Alteration of a Determination of Status*

A determination of status made by the administrator may be altered by the administrator at any time subject to the procedures required by [the state Administrative Procedure Act]. A sponsor of a plan who wishes to seek an adjustment in the status of his plan may petition the administrator for such an adjustment, stating reasons justifying

granting the request. The administrator shall consider such a petition in the same manner he considers an original petition for determination of status and issue an order granting or denying the sponsor's request and specifying the reasons for his action. A sponsor of a plan may not seek an adjustment in the status of his plan within six months of the last determination of the status of his plan.

Section 330. *Review of Administrator's Action*

(a) Any party aggrieved by any action of the administrator taken without a hearing may, within 30 days after notice of such action, petition the administrator in writing for a hearing. The administrator shall grant a hearing within 30 days after receiving the petition and shall give at least 10 days written notice of the time and place of the hearing. Within 30 days after the hearing the administrator shall affirm, reverse, or modify his previous action, specifying in writing the reasons for his decision. Pending such a hearing and decision, the administrator may suspend or postpone the effective date of his previous action.

In the case of a petition for hearing by a client of a participating or staff attorney, the basis for a grievance cognizable under this section is limited to the administrator's intention to examine the client's file contrary to the client's wishes.

(b) All hearings conducted pursuant to the provisions of this section shall be adjudicatory hearings in accordance with [the state Administrative Procedure Act] unless the petitioner waives this procedure in writing.

(c) Any party who or which was a party to the proceeding and is aggrieved by final action of the administrator, taken after the hearing provided for in subsection (a), shall be entitled to judicial review thereof. Such review shall be conducted in accordance with [the state Administrative Procedure Act]. The reviewing court shall be bound by the findings of fact made by the administrator if based upon substantial evidence in the record considered as a whole.

TITLE IV: MISCELLANEOUS PROVISIONS

Section 401. *Resolution of Disputes*

Disputes arising between or among sponsors or insurers of group legal services plans, participating or staff attorneys, and plan subscribers or members shall be resolved according to the provisions of this section and § 324.

(a) Establishment of review committee. A Review Committee on Group Legal Services, hereinafter called the committee, is hereby established within the [Department of Insurance, the Department of Justice, or other appropriate department]. The committee shall be five individuals appointed by the governor for three year terms. Two shall be attorneys, and three shall not be attorneys. Two of the non-lawyers shall be members of or subscribers to a group legal services plan. Committee appointments shall be staggered, and in years when two appointments are made to fill expired terms, one shall be of a lawyer and the other of a member of or a subscriber to a plan. Appointments to create the committee shall be for one, two, and three year terms in order to fulfill the objectives of this section. None of the members of the committee shall be an employee of or have a fiduciary relationship to any sponsor or insurer of a group legal services plan, or any person or entity providing legal services to a plan. Members of the committee shall be paid at the rate of fifty dollars a day for services rendered and be reimbursed for necessary expenses incurred in the course of their official duties. The committee shall have the power, subject to the appropriation of funds for such purposes, to employ sufficient staff to enable it to fulfill its duties. The administrator shall serve as an ex-officio, nonvoting member of the committee. The committee shall have the power to promulgate rules of procedure to govern the conduct of its affairs.

(b) Submission of disputes. Within 60 days after a dispute has been reviewed and acted upon according to the procedures required by this Act, a petition for review may be filed with the committee. The committee shall promptly hold an adjudicatory hearing on the petition subject to the provisions of [the state Administrative Procedure Act] and shall render a written decision.

(c) Judicial review of committee action. Any party aggrieved by final action of the committee shall be entitled to judicial review thereof according to the provisions of [the state Administrative Procedure Act]. The reviewing court shall be bound by the findings of fact made by the committee if supported by substantial evidence in the record considered as a whole.

COMMENT: This section creates an administrative procedure for resolving grievances. The committee created under the section may be established within any part of the state's governmental structure. Considerations similar to those governing selection of an administrator should be weighed in deciding the committee's appropriate location within the state government.

The committee's structure is modeled after the Massachusetts Health Facilities Appeals Board.[117] The Act creates a committee with representation for consumers of group legal services and for the legal profession. This will insure that the committee is familiar with the professional issues involved in regulating plans. It may be that additional restrictions on committee membership should be imposed (*e.g.*, income requirements to assure the representation of poor and working class people and geographical requirements), but the governor is probably best able to make this judgment.

Section 402. *General Powers and Duties of Administrator*

(a) The administrator shall adopt regulations to interpret and implement the provisions, purposes, and policies of the Act. The regulations may

(1) contain classifications, differentiations, and interpretations of this Act, and such other provisions as he may deem necessary, and

(2) prescribe the form and content of notices, disclosures, writings, agreements, and other documents required by this Act or the regulations of the administrator.

(b) In addition to all other duties created by this Act, the administrator shall

(1) receive and act on complaints;

(2) commence actions on his own initiative to obtain compliance with this Act;

(3) establish consumer education programs concerning group legal services plans;

(4) make and publish studies appropriate to effectuate the provisions, purposes, and policies of this Act;

(5) hold public or private hearings deemed necessary or proper to effectuate the purposes and policies of this Act;

(6) subpoena witnesses, compel their attendance, administer oaths and affirmations, adduce evidence, and require the production of such relevant matter as is deemed necessary or proper to effectuate the provisions, purposes, and policies of this Act;

(7) adopt as a regulation a description of the organization of his office, stating the general course and method of its operations and the methods available to the public to obtain information and make submissions and requests;

---

117 MASS. GEN. LAWS ANN. ch. 6, § 166 (Supp. 1973).

(8) adopt rules of practice setting forth the nature and requirements of all formal and informal procedures, including a description of all forms and instructions used by the administrator or his office;

(9) maintain necessary offices within this state;

(10) subject to appropriation of sufficient funds, appoint attorneys, hearings examiners, clerks, and other employees and agents who, in the administrator's judgment, are reasonably necessary to perform the functions necessary to enforce this Act; and

(11) fix the compensation of attorneys and authorize them to appear for and represent the administrator in court.

(c) Upon the failure of any person without lawful excuse to give testimony or obey a subpoena or order issued by the administrator pursuant to any provision of this Act and upon reasonable notice to all persons affected thereby, the administrator may apply to the appropriate court for an order compelling compliance.

Section 403. *Investigatory Powers*

(a) Subject to §§ 311 and 321, the administrator shall conduct whatever investigations are necessary to perform his duties under this Act and, in addition to all other powers conferred by this Act, may, in the course of an investigation,

(1) obtain access, for purposes of examination, to books, records, and other documents relevant to the investigation;

(2) compel disclosure of the identity and location of persons having knowledge of relevant facts;

(3) compel the disclosure of any other matter reasonably calculated to lead to the discovery of relevant evidence; and

(4) recover the reasonable cost of making any investigation which results in an action in which the administrator prevails.

(b) If the records of a person being investigated are located outside this state, the person shall at his option either make them available at a convenient location within this state or pay the expenses reasonably and necessarily incurred by the administrator to examine them at the place where they are maintained. The administrator may designate representatives, including comparable officials of the state in which the records are located, to inspect them on his behalf.

(c) Notwithstanding subsection (b), the administrator may by regulation require that sponsors and insurers of group legal services plans maintain certain records within this state and issue notice of their location.

Section 404. *Limitation of Rule Against Corporate Practice of Law*

No action or activity permitted by this Act shall be restricted by application of the common law rule prohibiting the corporate practice of law.

COMMENT: This section should be broadly construed to preclude the application of the common law rule to any activity explicitly or implicitly authorized by this Act.

Section 405. *Conduct of Attorneys*

The conduct of participating and staff attorneys shall be subject to [the rule of court embodying the Code of Professional Responsibility or its analog] of [name of the state supreme court] as amended from time to time, *provided* that the conduct of a participating or staff attorney permitted by this Act shall not be condemned by inconsistent requirements of [the rule of court].

COMMENT: The Code of Professional Responsibility as it exists in most states contains provisions contrary to those suggested for this Act.[118] Therefore this section provides that as a general matter the Code shall continue to govern the activities of attorneys associated with group legal services plans, but those attorneys shall be exempt from the provisions which restrict the operation of the plans or otherwise conflict with the Act.

Section 406. *Conduct of Sponsors and Insurers*

All sponsors and insurers of plans shall be subject to the provisions of [the state's unfair and deceptive trade practices act or, if such a statute exists, the law regulating unfair insurance practices].

COMMENT: This provision subjects sponsors and insurers of plans to the prohibitions of the state's unfair and deceptive trade practices act. In those states in which a law regulating unfair and deceptive insurance practices exists, reference should be made also to the provisions of that statute.[119] In the absence of appropriate legislation, this section should be expanded to perform the task of enumerating and prohibiting undesirable practices. Models for such an expanded provision may be found in several existing stat-

118 *See, e.g.*, DR 2-103(D) (5); DR 2-104(A) (2); DR 5-107(C) (3).
119 *E.g.*, MASS. GEN. LAWS ANN. ch. 176D (Supp. 1973).

utes regulating health services cost insurers and the sponsors of prepaid medical group practices.[120]

Section 407. *Partial Invalidity*

If any provision of this Act or any application of it to any person or circumstance is held invalid, such invalidity shall not affect the validity of other provisions or applications of the Act which can be given effect without the invalid provision or application.

Section 408. *Effective Date*

This Act shall take effect on ________________. Enforcement of the regulatory requirements in title III shall be delayed for six months after enactment.

120 *E.g.*, CAL. GOV'T CODE § 12531 (West Supp. 1973).

NOTE

LIMITED FEDERAL CONSTITUTIONAL CONVENTIONS: IMPLICATIONS OF THE STATE EXPERIENCE

Introduction

Article V of the United States Constitution offers two distinct procedures for constitutional amendment: initiation by two-thirds of each House of Congress and ratification by three-fourths of the states, or a convention called on petition of two-thirds of the states and ratification of its proposals by three-fourths of the states.[1] No constitutional amendment has ever successfully traveled the convention route. Indeed, there has not been a federal constitutional convention since 1787.[2] The convention clause is hardly a "dead letter," however, for there have been numerous efforts to call an article V convention.[3] As recently as 1967, unrest attributable to the Supreme Court's "one man-one vote" decisions of the early 1960's[4] had affected state legislatures to the extent that arguably 32 states — only two short of the required 34 — had petitioned Congress for a constitutional convention.[5]

---

1 The Congress, whenever two thirds of both Houses shall deem it necessary, shall propose Amendments to this Constitution, or, on the Application of the Legislatures of two thirds of the several states, shall call a Convention for proposing Amendments, which, in either Case, shall be valid to all Intents and Purposes, as Part of this Constitution, when ratified by the Legislatures of three fourths of the several States, or by Conventions in three fourths thereof, as the one or the other Mode of Ratification may be proposed by the Congress ....

U.S. CONST. art. V.

2 There have been federally called state conventions, however. *See* text at notes 73-85 *infra.*

3 *See* Prager & Milmoe, *Table of State Applications for an Article V Convention,* in ABA Special Constitutional Convention Study Committee, Report of American Bar Association Constitutional Convention Study Committee app. B [hereinafter cited as ABA Report]. The table records over 300 convention applications from state legislatures.

4 Lucas v. Forty-Fourth General Assembly, 377 U.S. 713 (1964); Reynolds v. Sims, 377 U.S. 533 (1964); Baker v. Carr, 369 U.S. 186 (1962). *Lucas,* invalidating an apportionment plan which had been approved and instituting one defeated in a statewide popular referendum, generated particular discontent.

5 *See* Graham, *Efforts to Amend the Constitution on Districts Gain,* N.Y. Times, Mar. 18, 1967, at 1, col. 6. For a general background on the effort and its rationale, see Dirksen, *The Supreme Court and the People,* 66 MICH. L. REV. 837 (1968).

One consequence of this activity was the introduction into Congress of legislation to establish procedures for the calling and holding of a national constitutional convention. The bill, authored by Senator Sam Ervin (D.-N.C.), passed the Senate 84 to 0 in 1971, but died in the House.[6] It was reintroduced in the 93d Congress, and the Senate passed it again in July 1973.[7] The Ervin Bill stimulated renewed interest in constitutional conventions. The American Bar Association soon became involved; in July 1971 it created a Special Constitutional Convention Study Committee to "evaluate the ramifications of the constitutional convention method of initiating amendments."[8]

The Special Committee had much to study, for the vagueness of the Article V convention clause has given constitutional scholars ample opportunity to debate the form, powers, and procedures of a federal convention. In the vacuum created by lack of firm federal precedent, convoluted exegesis and painstaking dissection of the "legislative history" of article V (*i.e., The Federalist,* and the various Notes on the convention of 1787[9]) have flourished.[10] Madison's objection to the convention mechanism, voiced in 1787, has proven to be prophetic: "difficulties might arise as to the form, the quorum, etc., which in Constitutional regulations ought to be as much as possible avoided."[11]

Of the many disputes which have arisen in the contemplation of a national convention, none has been so hotly debated as whether or not such a convention can be "limited." Can the petitioning states, or Congress, or both, legitimately restrict the matters to be considered by an article V convention? The question

---

6 117 CONG. REC. 36,803-06 (1971). *See also* S. REP. No. 336, 92d Cong., 1st Sess. (1971); 117 CONG. REC. 35,764, 35,988, 36,442, 36,753, 46,642 (1971); *Hearings on S. 2307 Before the Subcomm. on Separation of Powers of the Senate Comm. on the Judiciary,* 90th Cong., 1st Sess. (1967).

7 The bill was reintroduced in the Senate as S. 1272, 119 CONG. REC. S5017-19 (daily ed. Mar. 19, 1973); favorably reported by the Judiciary Committee, *id.* at S12,462 (daily ed. June 29, 1973); and passed by the Senate, *id.* at S12,728 (daily ed. July 9, 1973).

8 ABA Report, *supra* note 3, at 2.

9 The Notes are collected in THE RECORDS OF THE FEDERAL CONVENTION OF 1787 (M. Farrand ed. 1911) [hereinafter cited as FARRAND].

10 *See, e.g.,* ABA Report, *supra* note 3, at 13-16; Kauper, *The Alternative Amendment Process: Some Observations,* 66 MICH. L. REV. 903 (1968).

11 2 FARRAND, *supra* note 9, at 630.

clearly is fundamental, for it goes to the very basis of the convention's powers and its relationship to the other organs of government.

On one side in the dispute stand those who would proclaim a convention "the personification of the sovereign people assembled for the discharge of the solemn duty of framing their fundamental law."[12] "The character and extent of a constitution that may be framed by that body is freed from any limitations other than those contained in the Constitution of the United States."[13] In the view of these opponents of limited conventions, a convention ought to be free to consider and propose whatever amendments it desires.

On the other side stand those who would permit the states, Congress, or both to limit the convention, either by forbidding it to discuss specified matters (thereby leaving the convention free to deal with all other subjects at its discretion), or listing those topics which the convention may take up and precluding the consideration of all others. Delegates to a convention, in this view, "are but agents of the people, and are restricted to the exercise of the powers conferred upon them by the law which authorizes their selection and assemblage."[14]

That the issue is at once divisive and critical is demonstrated by the peculiar fact that the Special Constitutional Convention Study Committee unanimously agreed that a national convention could be properly limited "to the subject matter on which the legislatures of two-thirds of the states request a convention,"[15] whereupon the Council of the ABA's Section on Individual Rights and Responsibilities (SIRR) "voted, without dissent, to reject and oppose the basic recommendations"[16] of the Special

---

12 Walker, *Myth and Reality in State Constitutional Development*, in MAJOR PROBLEMS IN STATE CONSTITUTIONAL REVISION 15 (W. Graves ed. 1960) (denominated a "myth").

13 Livermore v. Waite, 102 Cal. 113, 117, 36 P. 424, 426 (1894) (dicta).

14 Quinlan v. Houston & T.C. Ry., 89 Tex. 356, 376, 34 S.W. 738, 744 (1896).

15 ABA Report, *supra* note 3, at 11.

16 Letter from Professor Jefferson B. Fordham to the Honorable Judge C. Clyde Atkins, Aug. 17, 1973. The Special Committee's Report was approved unanimously by the ABA House of Delegates at the latter's convention during the summer of 1973, an event attributable more to the absence of its enemies than the depth of its support. In rejecting the Special Committee's Report, the SIRR was disowning its

Committee. At least one member of the SIRR — who is also on its Committee on National Constitutional Conventions — has commented that the "fundamental weakness" of the Special Committee's report was "its infirmly supported position that the legislatures applying for the call of a convention could limit convention jurisdiction to one or more specific subjects."[17] Though there never has been an article V convention, this Note suggests that the controversy surrounding limitation of such a body may be resolved, or at least focused, through examination of the state experience with limited conventions.

Conventions have been the preferred instrument for thoroughgoing revision of state constitutions since the Delaware, New Hampshire, and Massachusetts gatherings of the late 1770's. To date there have been approximately 225 state constitutional conventions:[18] New Hampshire has convened the most (15 — until 1964 the New Hampshire constitution could be amended in no other way), while 11 states have convened only one. Four-fifths of the states provide for such conventions in their constitutions, and in the remainder conventions have been held, often with judicial approval.[19] If, as has been claimed, the constitutional convention is one of the original and significant American contributions to democratic political theory,[20] it is the state experience which gives substance to that assertion. It is in the crucible of state legislatures, courts, and ballot boxes that the theoretical bases of the institution have been hammered out, and its relation to the more ordinary governmental bodies established.

---

own child, inasmuch as the Special Committee was set up at the behest of SIRR's Council in 1971. *See* ABA Report, *supra* note 3, at 1.

17 Letter from Professor Jefferson B. Fordham to the Honorable Judge C. Clyde Atkins, Aug. 17, 1973.

18 Sturm, *State Constitutions and Constitutional Revision, 1970-1971*, in COUNCIL OF STATE GOVERNMENTS, THE BOOK OF THE STATES, 1972-73, at 10 (1972).

19 *See* A. STURM, THIRTY YEARS OF STATE CONSTITUTION-MAKING; 1938-68, app. C, 132-37 (tabular presentation of each state's provisions for constitutional conventions); Sturm, *State Constitutions and Constitutional Revision, 1970-1971*, in COUNCIL OF STATE GOVERNMENTS, THE BOOK OF THE STATES, 1972-73, at 24 [this table is hereinafter cited as *Procedures for Calling Constitutional Conventions*]; Note, *State Constitutional Conventions: Limitations on Their Powers*, 55 IOWA L. REV. 244, 247 (1969) [hereinafter cited as Iowa Note].

20 R. HOAR, CONSTITUTIONAL CONVENTIONS: THEIR NATURE, POWERS AND LIMITATIONS 1-3 (1917) [hereinafter cited as HOAR]; J. WHEELER, THE CONSTITUTIONAL CONVENTION: A MANUAL ON ITS PLANNING, ORGANIZATION AND OPERATION xi (1961).

This Note argues that the theoretical framework developed to support the prevailing view that state conventions may be limited is persuasive, that the similarities and differences between the state and federal levels make the case for limited article V conventions still more persuasive, and that the state experience sheds light on potential problems of limited article V conventions. The Note concludes that a limited federal convention is appropriate and that denying the states the opportunity to call a limited convention would be inappropriate under article V.

I. Limitability: The State Experience

"The customary manner of calling constitutional conventions in the United States is by resolution of the legislature followed by a submission of the question to the electorate,"[21] though there have been exceptions.[22] The customary scenario proceeds somewhat as follows: the legislature passes a resolution initiating the convention; this is submitted to the electorate for approval; after approval the legislature passes an enabling act to provide for a budget, temporary officers, and the election of delegates; the delegates are elected; the convention meets; and the final product is submitted to the electorate for approval. The details of the process vary by state — in particular, 12 states have constitutional provisions which require that the question of calling a convention be submitted to the electorate periodically, thus bypassing the legislature at the initial stage of the procedure — but the basic structure is surprisingly uniform throughout the nation.[23]

---

21 Annot., *Power of State Legislature to Limit the Powers of a State Constitutional Convention*, 158 A.L.R. 512 (1945).

22 Most of these occurred before the present century. Examples include the first state conventions of the late 18th century, which were "revolutionary" in origin as well as outlook; the congressionally instigated conventions preliminary to statehood, discussed in part II(A) *infra*; and the Reconstruction conventions held after the Civil War. Modern exceptions include conventions in those states in which the state constitution provides that the convention question shall be submitted to the people periodically, and those conventions called by popular initiative in states allowing such procedures. *See Procedures for Calling Constitutional Conventions, supra* note 19.

23 *See Procedures for Calling Constitutional Conventions, supra* note 19. This is not to suggest that the details of the process of amending a constitution through a constitutional convention always are handled smoothly or without legal questions. *See generally, e.g.*, Dodd, *State Constitutional Conventions and State Legislative*

As noted above,[24] conventions historically have been used primarily for major revisions of state constitutions. Indeed, in the absence of explicit provisions in its enabling act or in the legislative resolution submitting the convention question to the electorate, a convention is presumed to be *un*limited and to possess plenary powers to propose revision and amendments as it sees fit.[25]

Little mention is made of limited conventions in the 39 state constitutions which explicitly provide for constitutional conventions. At least one state constitution (Alaska's) forbids limited conventions;[26] and the Alabama constitution of 1901, framed by a convention which itself exceeded limitations placed upon it, affirms the unlimited authority of future conventions.[27] Tennessee's constitution, on the other hand, explicitly grants the legislature and electorate the right to convene limited conventions.[28] And several early state constitutions appear to have envisioned limited conventions.[29]

In a number of the states whose constitutions require that the question of calling a convention be submitted periodically to the electorate (*e.g.*, Michigan, Missouri, and New York), the convention article lays out convention procedures in a manner that suggests limitations are precluded. New York's constitution specifies the form in which the question is to be presented for a popular vote: "Shall there be a convention to revise the constitution and amend the same?"[30] This might eliminate the possibility of a limited convention, at least under the analysis below; but a limited convention has been upheld in Virginia under a virtually identical provision.[31] In any event, many states over the past two

Power, 2 VAND. L. REV. 27 (1948); Iowa Note, *supra* note 19, at 247-52, 254-59; Note, *Constitutional Revision by a Restricted Convention*, 35 MINN. L. REV. 282, 287-88, 292-93 (1951) [hereinafter cited as Minnesota Note]; Annot., 158 A.L.R. 512 (1945). For a discussion of potential issues in the article V amendment process, see ABA Report, *supra* note 3, at 33-42. The scope of this Note is restricted to limitability, enforcement of limitations, and legislative refusal to call a convention.

24 See text preceding note 18 *supra*.

25 W. DODD, THE REVISION AND AMENDMENT OF STATE CONSTITUTIONS 76-77 (1910) [hereinafter cited as DODD].

26 ALASKA CONST. art. 13, § 4.

27 ALA. CONST. art. 18, § 286.

28 TENN. CONST. amend. 1.

29 ABA Report, *supra* note 3, at 18-20.

30 N.Y. CONST. art. 19, § 2.

31 Staples v. Gilmer, 183 Va. 613, 625, 33 S.E.2d 49, 52, 158 A.L.R. 495 (1945) (per

centuries have successfully convened limited conventions,[32] although efforts to limit a convention have occasionally failed.[33]

A. *Forms of Limitation*

A convention may be limited in a number of ways. Explicit limiting directives may, in the first instance, be either procedural (*i.e.*, dealing with such matters as recordkeeping, printing of convention records, etc.) or substantive (going to the subject matter which a convention may discuss and on which it may propose amendments). Procedural limitations have usually been invalidated.[34] A convention "has full control of all its proceedings."[35] Indeed, some have said that a convention may properly ignore efforts at outside control of its internal procedures.[36] This Note deals almost exclusively with substantive limitations; but the distinction should be kept in mind, for at least two cases often cited in support of unlimited constitutional conventions in fact hold only that such matters as choice of printer, date of submission of the convention product, etc. are beyond legislative control.[37]

---

curiam). *See* J. WHEELER, SALIENT ISSUES OF CONSTITUTIONAL REVISION 52 (1961); A. STURM, *supra* note 19, at 67.

32 Approximately 35, or nearly 15 percent, of all state constitutional conventions have been substantively limited. And the proportion of limited conventions has been higher since World War II. For details on many of the pre-1940 conventions, see HOAR, *supra* note 20, at 105-28; J. JAMESON, A TREATISE ON CONSTITUTIONAL CONVENTIONS; THEIR HISTORY, POWERS AND MODES OF PROCEEDING §§ 382-82(c) (4th ed. 1887) [hereinafter cited as JAMESON]. On the post-1940 conventions, see A. STURM, *supra* note 19, at 56-60, 113.

33 Examples of limited conventions which overrode limitations are those in Georgia (1789), Minnesota (1857), Pennsylvania (1872), Alabama (1901), Virginia (1901), and Michigan (1908). *See* HOAR, *supra* note 20, at 111-15.

34 *See, e.g.*, Iowa Note, *supra* note 19, at 259-60; Minnesota Note, *supra* note 23, at 290; Annot., 158 A.L.R. 512, 522-23 (1945). The ABA Special Committee concluded that an article V convention should not be subject to procedural limitation. ABA Report, *supra* note 3, at 22-23.

35 Goodrich v. Moore, 2 Minn. 61, 66 (1858).

36 The leading cases, although their holdings do not directly support the point, are Carton v. Secretary of State, 151 Mich. 337, 340, 115 N.W. 429, 430 (1908), and Goodrich v. Moore, 2 Minn. 61, 66 (1858). *See* HOAR, *supra* note 20, at 117-18, 173, 177; JAMESON, *supra* note 32, §§ 453-56; Dodd, *supra* note 23, at 31.

37 Carton v. Secretary of State, 151 Mich. 337, 115 N.W. 429 (1908); Goodrich v. Moore, 2 Minn. 61 (1858). The Delaware and Hawaii Constitutions explicitly grant this power to conventions. DEL. CONST. art. XVI, § 2; HAWAII CONST. art. XV, § 2. There may be some difficulty in drawing the line between such "housekeeping" matters as the legislature may regulate in its enabling act and the internal procedure of the convention, which only the convention may regulate. The former are

Substantive limitations take many forms. A convention may be prohibited from amending one or more portions of the state constitution, but otherwise left free to alter as it wishes.[38] Alternatively, a convention resolution or enabling act may specify certain subjects to be considered and prohibit discussion of any others — as has every limited convention since 1945, except New Jersey's in 1947. New Jersey's experience since World War II illustrates the difference: its 1947 convention was permitted to make changes in any area except the apportionment of the state legislature, while its 1966 convention was prohibited from considering any issue except legislative apportionment.[39]

Variations abound. A convention may be required to consider some matters and left free to deal with others as it wishes.[40] Perhaps the most complex and bizarre set of limitations was imposed upon the North Carolina convention of 1835. It was required to author amendments on four topics, permitted to treat 16 more, and prohibited from acting upon anything else.[41] Most recent limited conventions have been restricted to proposing amendments on one or a few subjects. There are no theoretical differences between the various forms of limited conventions, however, and accordingly this Note will make no distinctions among them.

B. *Sources of Limitation*

It is an axiom of modern democratic theory that the legitimacy and authority of a government depend upon the consent of the governed. In America "the people, in their collective and national capacity, established the present constitution . . . acting as sover-

---

apparently such details as are required to start up and house the convention; the latter concerns the convention's course and rules after it has come into being.

38 Examples include North Carolina's convention of 1875, Law of Mar. 19, 1875, ch. CCXXII § 4, [1875] N.C. Laws 305; and Louisiana's conventions of 1898, Act. No. 52, § 3(a)(b), [1896] La. Acts 85; 1913, Act No. 1, §§ 1(3)(a)-(c), [1913] La. Acts 2d Extra Sess. 3; and 1921, Act. No. 180, § 1(4), [1920] La. Acts 292.

39 Law of Feb. 17, 1947, ch. 8, § 2, [1947] N.J. Laws 24; Law of May 10, 1965, ch. 43, § 2, [1965] N.J. Laws 101.

40 One example is Alabama's convention of 1875, which was required to provide for a public school system. Law No. 24, § 9, [1875] Ala. Laws 112. Another is Connecticut's court-ordered convention of 1965, required to consider only legislative apportionment. *See* Butterworth v. Dempsey, 237 F. Supp. 302 (D. Conn. 1965) (per curiam). It was not restricted in any other way and ultimately rewrote the entire state constitution.

41 JAMESON, *supra* note 32, § 382(a).

eigns of the whole country."[42] It follows, from the very definition of sovereignty, that changes in the fundamental law (the constitution) can be made only by the electorate or those to whom the electorate has delegated its powers to amend. The legitimacy of a constitutional convention, therefore, rests on the delegation by the electorate of authority to propose amendments.[43] Delegates to a convention "derived their power and authority from the people in their sovereign capacity."[44] Nearly unanimous agreement on the foregoing propositions has not led to agreement on which, if any, of the numerous potential sources of limitations — constitutional, executive, judicial, legislative, and popular — comport with those propositions.

At the state level, the Constitution and laws of the United States clearly limit state constitutional conventions through the supremacy clause.[45] Arguably, those provisions of a constitution governing the amendment process itself are binding upon any constitutional convention called pursuant to that process.[46] The role of the executive is less clear.[47]

---

42 Chisholm v. Georgia, 2 U.S. (2 Dall.) 440, 462 (1793) (Jay, C.J.). The position has received consistent support from the Supreme Court, political philosophers such as Jameson and Woodrow Wilson, and popular interpretation of the democratic state. It has also been criticized as a philosophical, rather than legal, conclusion. *See* L. ORFIELD, THE AMENDING OF THE FEDERAL CONSTITUTION 141-48, 141 n.26 (1942). For an excellent analysis of the evolution of popular support for the idea in early America, see G. WOOD, THE CREATION OF THE AMERICAN REPUBLIC, 1776-1787, ch. 9 (1969).

43 "A convention has delegated, and not inherent, rights." *Ex parte* Birmingham & Atl. Ry., 145 Ala. 514, 521, 42 So. 118, 125 (1905). *See also, e.g.*, Chenault v. Carter, 332 S.W.2d 623 (Ky. 1960); State v. American Sugar Ref. Co., 137 La. 407, 68 So. 742 (1915); Opinion of the Justices, 60 Mass. (6 Cush.) 573, 574-75 (1833); Erwin v. Nolan, 280 Mo. 401, 217 S.W. 837 (1920); Frantz v. Autry, 18 Okla. 561, 91 P. 193 (1907); *In re* Opinion to the Governor, 55 R.I. 56, 178 A. 433 (1935); State *ex rel.* M'Cready v. Hunt, 20 S.C.L. 1, 222-23 (1834); Quinlan v. Houston & T.C. Ry., 89 Tex. 356, 34 S.W. 738 (1896); Staples v. Gilmer, 183 Va. 613, 33 S.E.2d 49, 158 A.L.R. (1945); Loomis v. Jackson, 6 W. Va. 613 (1873).

44 Frantz v. Autry, 18 Okla. 561, 589, 91 P. 193, 202 (1907).

45 *See* DODD, *supra* note 25, at 92. But the ability of Congress to explicitly limit a state constitutional convention, even as a condition for admission to the Union, is much less clear. *See* Iowa Note, *supra* note 19, at 262-63; part II(A) *infra.*

46 *See, e.g.*, provisions cited notes 26-28, 30 *supra. See generally* Dodd, *supra* note 23; Annot., *Power of State Legislature to Limit the Powers of a State Constitutional Convention*, 158 A.L.R. 512 (1945).

47 At the state level, *see* Iowa Note, *supra* note 19, at 268. At the federal level, *see* ABA Report, *supra* note 3, at 28-33. *But see* Black, *Amending the Constitution: A Letter to a Congressman*, 82 YALE L.J. 189, 206-10 (1972).

The judiciary obviously is not an independent source of limitations on constitu-

The debate on limitability has focused upon the roles of the legislature and the electorate. At least three distinct positions have emerged: that the legislature alone may limit a convention; that the electorate (directly *or* by ratification of a legislative resolution) may impose limitations; and that the convention is sovereign and inherently "illimitable."

C. *The Debate over Limitability: Legislature and Electorate*

In the first major treatise on the subject, Jameson concluded that constitutional conventions ought to be subject to such limitation as state legislatures saw fit to impose (except for internal convention procedures).[48] Jameson's position elicited some support,[49] and a great deal of vitriolic opposition.[50]

Much of what is reputed to be opposition to limited conventions as a whole has been expressed as opposition to legislatively limited conventions, as if legislative limitations were the only kind possible. For example, one case asserted that

> the legislature is prohibited from any control over the method of revising the Constitution. The convention is an independent and sovereign body whose sole power and duty are to prepare and submit to the people a revision of the Constitution . . . . It is elected by the people, answerable to the people, and its work must be submitted to the people through their electors for approval or disapproval.[51]

One judge "had no difficulty" in concluding that "a constitutional convention lawfully convened does not derive its powers from the legislature, but from the people . . . that the powers of the consti-

---

tional conventions. However, the ability and willingness of courts to enforce limitations is necessary if limitability is to have meaning in the event of a convention which purports to exceed limitations imposed by the people. *See* part III *infra.*

48 JAMESON, *supra* note 32. Jameson's reasoning was influenced by the controversies surrounding the Illinois Conventions of 1862 and 1869. His work was largely a polemic in support of the legislature's position during those troubled gatherings.

49 A particularly glowing reference may be found in *Ex parte* Birmingham & Atl. Ry., 145 Ala. 514, 519, 42 So. 118, 119 (1905).

50 *See, e.g.,* Sproule v. Fredericks, 69 Miss. 898, 11 So. 472 (1892); Frantz v. Autry, 18 Okla. 561, 91 P. 193 (1907). Both HOAR, *supra* note 20, at 58-79, 105-20, and DODD, *supra* note 25, at 72-93, make major assaults on Jamesosn's thesis. After being abandoned for most of the 20th century, it has apparently been revived, at least implicitly, in the Ervin Bill. *See* part III(C) *infra.*

51 Carton v. Secretary of State, 151 Mich. 337, 340-41, 115 N.W. 429, 430 (1908) (Grant, C. J.).

tutional convention are in the nature of sovereign powers . . . that the legislature can neither limit or [*sic*] restrict them in the exercise of these powers . . . ."[52] "In the area of constitutional drafting," concludes one commentator, "the convention must be completely free of legislative restrictions since its authority derives from the sovereignty of the people."[53]

This opposition to limited conventions, rooted in the metaphysics of sovereignty, does have some support. A number of state courts have favored the position, though generally in dicta handed down over 60 years ago.[54] The Federal Convention of 1787 and early state and colonial conventions are frequently cited to support the point that a convention may not be limited,[55] but such citation reflects failure to distinguish between "revolutionary" conventions (extra-constitutional in nature and resulting from the manifestation of power sufficient to change the form of government) and "constitutional" conventions (called under the aegis of an existing legislature and constitution).[56]

---

52 Loomis v. Jackson, 6 W. Va. 613, 708 (1873) (obiter dicta).

53 Iowa Note, *supra* note 19, at 266.

54 *See, e.g.*, Livermore v. Waite, 102 Cal. 113, 36 P. 424 (1894) (dictum); Koehler v. Hill, 60 Iowa 543, 14 N.W. 738 (1883); Miller v. Johnson, 92 Ky. 589, 18 S.W. 522 (1892); Anderson v. Baker, 23 Md. 531 (1865); Carton v. Secretary of State, 151 Mich. 337, 115 N.W. 429 (1908); Sproule v. Fredericks, 69 Miss. 898, 11 So. 472 (1892); Lawson v. Jeffries, 47 Miss. 686 (1873); Frantz v. Autry, 18 Okla. 561, 91 P. 193 (1907); Taylor v. Commonwealth, 101 Va. 829, 44 S.E. 754 (1903); Loomis v. Jackson, 6 W. Va. 613 (1873). The only recent case to so hold is Board of Supervisors of Elections v. Attorney General, 246 Md. 417, 229 A.2d 388 (1967). The issue in that case was whether the legislature was bound by an act, approved by the electorate, which mandated a constitutional convention within two years; and the court held that the legislature was so bound: "[H]aving submitted the question to the people in proper legal fashion, it bound itself to the mandate expressed by them." 246 Md. at 445, 229 A.2d at 403 (quoting the unpublished decision below). The court thus, in effect, enforced a "limitation" because it was approved by the people, which weakens the case as authority for the position that conventions are sovereign. The opinion was phrased, as are all, in the language of the people's sovereignty and their sole right to delegate that sovereignty.

55 Thus Note, *The Legal Effect Under American Decisions of an Alleged Irregularity in the Adoption of a Constitution or Constitutional Amendment*, 10 St. Louis L. Rev. 279, 295 (1925) [hereinafter cited as St. Louis Note], cites Kamper v. Hawkins, 1 Va. Cas. 20 (1793), in which several opinions stress the revolutionary nature of colonial conventions.

56 *See* Erwin v. Nolan, 280 Mo. 401, 217 S.W. 837 (1920); State *ex rel.* Kvaalen v. Graybill, 496 P.2d 1127 (Mont. 1972); Staples v. Gilmer, 183 Va. 613, 33 S.E.2d 49, 158 A.L.R. 495 (1945); Hoar, *supra* note 20, at 15-16, 34-39; Jameson, *supra* note 32, at 10-11; Hendricks, *Some Legal Aspects of Constitutional Conventions*, 2 Texas L. Rev. 195, 195-96 (1924); Braxton, *Powers of Conventions*, 7 Va. L. Reg. 79 (1901); Iowa Note, *supra* note 19, at 245-46; Minnesota Note, *supra* note 23, at 285-86.

Limited conventions also have been opposed on more practical grounds. Professor Graves has advanced the theory that the limited convention is a tool of various interest groups seeking to block substantive reform:

> To those who do not want general revision and who do not really believe in the democratic process anyway, it provides a made-to-order means of avoiding the opening up of the whole array of constitutional problems for general discussion. . . . More than that, it makes readily available a tool by which powerful special interest groups may, with a high degree of certainty, protect whatever type of sacred cow in which they happen to be interested.[57]

Some who favor limited conventions suggest that those ostensibly opposed only to limited conventions in fact look with disfavor upon the convention mechanism generally. These opponents argue against limited conventions, the theory claims, because they know many people fear that an unlimited convention might become a "runaway" and tamper with basic constitutional guarantees.[58] If a limited convention can be blocked, these strategists count on public sentiment against unlimited conventions to complete the plan and assure that no convention will be called.[59]

Many proponents of limited conventions, in contrast to advocates of Jameson's position of legislative supremacy over conventions and in contrast to opponents of all limited conventions, maintain that

> where the legislature, in the performance of its representative function, asks the electors if they desire a convention to

57 Graves, *Current Trends in State Constitutional Revision*, 40 NEB. L. REV. 560, 570 (1961). *See also* Bebout, *Recent Constitution Writing*, 35 TEXAS L. REV. 1071, 1074-75 (1957).

58 With reference to "runaways," see Sorenson, *The Quiet Campaign to Rewrite the Constitution*, SATURDAY REVIEW, July 15, 1967, at 17; 113 CONG. REC. 10,102-03, 10,108-09, 10,112 (1967) (remarks of Senators Tydings, Proxmire, Javits, and Dirksen); N.Y. Times, Mar. 18, 1967, at 1, col. 6.

59 For obvious reasons the position is not espoused publicly. The closest thing to public admission of the goal is probably in Black, *Amending the Constitution; A Letter to a Congressman*, 82 YALE L.J. 189 (1972), where opposition to a limited convention and opposition to article V conventions in general is intermingled. *See* Note, *Proposed Legislation on the Convention Method of Amending the United States Constitution*, 85 HARV. L. REV. 1612, 1628-29 & n.88 (1972) [hereinafter cited as Harvard Note].

> amend or revise a certain part of the Constitution but not the whole Constitution, an affirmative vote of the people on such a question would have the binding effect of the people themselves limiting the scope of the convention to the very portion of the Constitution suggested to them by the legislature. The wishes of the people are supreme.[60]

In distinguishing themselves from both Jameson and the opponents of all limited conventions, these advocates of conventions limited by the sovereign electorate draw

> a clear distinction between the lack of power of the legislature to control the convention, and the power of the people to control it. This distinction is the real answer to the question whether the convention is bound by the convention act. If the convention act be the creature of the people, the convention *is* bound.[61]

That the convention act can be "the creature of the people" is explained as follows:

> If, at the time the question of calling the convention is submitted to them, the people are informed of the scope of the convention and the manner in which it is to conduct its deliberations . . . then a convention called in this manner will be limited as therein set forth and the convention will then be bound to confine itself within the stated limits of the act of the assembly. The reason for this is that it is the people, under such circumstances, who prescribe the conditions in the legislative act by approving the call for the convention in accordance with the provisions of such act. The legislature merely proposes the conditions. It is the vote of the people for the convention that ratifies them and makes them binding upon the delegates.[62]

Perhaps the point most in contention between opponents and proponents of limited conventions is the weight to be accorded electoral approval of a limited convention resolution proffered by the legislature. Opponents claim that the choice given the electorate when told to accept a limited convention as proposed by the legislature (in the initiating resolution) or have no convention at

60 Staples v. Gilmer, 183 Va. 613, 627, 33 S.E.2d 49, 158 A.L.R. 495 (1945).
61 HOAR, *supra* note 20, at 120-21.
62 *In re* Opinion to the Governor, 55 R.I. 56, 99, 178 A. 433, 452 (1935).

all is an illusory one. It is said that true popular control in such a situation does not exist, since real power remains in the hands of the legislature — a claim which raises all of the arguments advanced with great force against Jameson's position of legislative supremacy.[63] Only the people can change the fundamental law — the constitution — of which the legislature is a creation, not a master. Proponents counter with "the fact that there would be no convention unless the people voted affirmatively, that an affirmative vote would result in holding exactly the sort of convention in every detail provided in the act, and that the people are presumed to know the terms of the act under which they vote."[64]

The favored solution to this problem is a two-step popular vote on the convention question: first, on the convention in general; and second, on the proposed limitations.[65] Under such a system, the people can convene an unlimited convention if they so choose. In its absence, the only popular check is said to be the clumsy and ineffectual mechanism of electing legislators who will offer the electorate the kind of convention it desires.[66] In any case the legislature should be prohibited from making further changes after the electorate has approved a given set of proposed limitations.[67]

At least from the perspective of classic democratic theory, there is no question but that, as between those who would permit limited conventions approved by the electorate and opponents of all limited conventions, the former have the better of the argument. If, as all agree, the power of constitutional amendment rests ultimately with the sovereign people, then no authority can exist which may rightfully limit the people's discretion in delegat-

---

63 *See* DODD, *supra* note 25, at 74-76; Gooch, *The Recent Limited Constitutional Convention in Virginia*, 31 VA. L. REV. 708, 717 (1945); Iowa Note, *supra* note 19, at 264; Minnesota Note, *supra* note 23, at 286-87.

64 HOAR, *supra* note 20, at 71. In some state legislatures (*i.e.*, Georgia, Maine, and Mississippi), no popular referendum is required and the legislature can convene a convention on its own motion. Presumably in such states limited conventions would not be appropriate under the theoretical model developed here. Other states permit popular calling of a convention by initiative, without need for legislative action (in Florida, this is the only way to call a convention). In those, the problem is moot. *See Procedures for Calling Constitutional Conventions*, *supra* note 19.

65 *See* Iowa Note, *supra* note 19, at 264 & n.170.

66 *See* Wells v. Bain, 75 Pa. St. 39, 47 (1874); Staples v. Gilmer, 183 Va. 613, 33 S.E.2d 49, 158 A.L.R. 495 (1945).

67 HOAR, *supra* note 20, at 98-99.

ing that power. Such an authority would be above the people, and if sovereignty means anything it is that no power may restrict the sovereign without his consent. Against this doctrinally compelled conclusion, the opponents of limited conventions can raise only the practical objection, discussed above, that electoral power over legislative restrictions is illusory.[68]

The outcome in practice is clear. The position upholding limited conventions when the electorate has approved the limitations has gained nearly universal acceptance in state courts and legislatures. With one arguable exception,[69] no state court in over 60 years has reached any conclusion other than that "a convention is not bound by legislative restrictions which apply to the work of such organ, but that the mandate of the people, either in calling the convention or in approving the convention act, is controlling."[70]

The one arguable question in this area is how late in the convention process the legislature can impose limitations which may be validated by electoral approval. At least two state courts have upheld legislative limitations imposed after electoral approval of the initiating resolution, on the theory that by the act of electing convention delegates the electorate implicitly ratifies any limita-

---

68 Whatever its validity at the state level, this objection is of no import whatsoever to an article V convention. *See* text at note 101 *infra*.

69 Board of Supervisors of Elections v. Attorney General, 246 Md. 417, 229 A.2d 388 (1967) (discussed in note 54 *supra*).

70 A. STURM, METHODS OF STATE CONSTITUTIONAL REFORM 102 (1954). *See generally* Opinion of the Justices, ___ Del. ___, 264 A.2d 342 (1970); Bradford v. Shine, 13 Fla. 393 (1871) (dictum); Chenault v. Carter, 332 S.W.2d 623 (Ky. 1960); Gaines v. O'Connell, 305 Ky. 397, 204 S.W.2d 425 (1947); Hayne v. Assessor, 143 La. 697, 79 So. 280 (1918); Foley v. Democratic Parish Comm., 138 La. 220, 70 So. 104 (1915); State v. American Sugar Ref. Co., 137 La. 407, 68 So. 742 (1915); Louisiana Ry. & Nav. Co. v. Madere, 124 La. 635, 50 So. 609 (1909); Loring v. Young, 239 Mass. 349, 132 N.E. 65 (1921); Opinion of the Justices, 60 Mass. (6 Cush.) 573 (1833); Erwin v. Nolan, 280 Mo. 401, 217 S.W. 837 (1920); State *ex rel.* Kvaalen v. Graybill, 496 P.2d 1127 (Mont. 1972); Wood's Appeal, 75 Pa. 59 (1874); Wells v. Bain, 75 Pa. 39 (1874); *In re* Opinion to the Governor, 55 R.I. 56, 178 A. 433 (1935); State *ex rel.* M'Cready v. Hunt, 20 S.C.L. 1 (1834); Illustration Design Group, Inc. v. McCanless, 224 Tenn. 284, 454 S.W.2d 115 (1970); Cummings v. Beeler, 189 Tenn. 151, 223 S.W.2d 913 (1949); Quinlan v. Houston & T.C. Ry., 89 Tex. 356, 34 S.W. 738 (1896); Staples v. Gilmer, 183 Va. 613, 33 S.E.2d 49, 158 A.L.R. 495 (1945); Nespereira c. Alcalde del Distrito Central, Sent. No. 72, 12 Mayo 1931, 29 GAC. OF. (22 Mayo 1931) 9285 (Cuban Supreme Court decision discussed in Ireland, *Constitutional Amendments — Power of Conventions*, 6 TULANE L. REV. 75 (1931)). *See also* HOAR, *supra* note 20, at 21, 120-21.

tions contained in the convention enabling act providing for the elections.[71] The better rule is that only those limitations contained in the initiating resolution — and thus explicitly before the people when they authorize the convention — are binding.[72]

II. The Theory of a Limited Federal Convention

A. *Reasons to Examine the State Experience*

Looking to the state experience in considering the permissible nature of an article V constitutional convention is justified because there is no directly relevant federal experience, while there is a rich state experience upon which to draw.

The federal experience, after the convention of 1787, consists wholly of federally called state conventions. Commencing with the act providing for the admission of Ohio,[73] Congress has often provided for the calling of a convention and the drafting of a state constitution as part of the process of admission to statehood. Since the act admitting Louisiana,[74] Congress has been in the habit of mandating certain provisions and prohibiting others in state constitutions-to-be. Thus the Louisiana act required that the state's constitution, among other things, guarantee trial by jury and "contain the fundamental principles of civil and religious liberty."[75] The act providing for the admission of Utah[76] included substantive limitations in at least four areas, one of which requires that in the state constitution "polygamous or plural marriages are forever prohibited."[77] Virtually all of the admitting acts after 1811, up to and including Hawaii's in 1959, contain such limitations, as well as detailed instructions on how the convention is to be called, the election and apportionment of delegates, etc.[78]

---

71 *Ex parte* Birmingham & Atl. Ry., 145 Ala. 514, 42 So. 118 (1905); Wells v. Bain, 75 Pa. 39 (1874); Annot., 158 A.L.R. 512, 518-20 (1945).

72 *See, e.g.*, Carton v. Secretary of State, 151 Mich. 337, 115 N.W. 429 (1908). *See also* Hoar, *supra* note 20, at 98-99.

73 Act of Apr. 30, 1802, ch. 40, 1 Stat. 173.

74 Act of Feb. 20, 1811, ch. 21, 2 Stat. 641.

75 *Id.* § 3, 2 Stat. 642.

76 Act of July 16, 1894, ch. 138, 28 Stat. 107.

77 *Id.* § 3, 2 Stat. 108.

78 *See, e.g.*, the admitting and/or enabling acts for Missouri, Act of Mar. 6, 1820, ch. 22, 3 Stat. 545; Indiana, Act of Apr. 19, 1816, ch. 57, 3 Stat. 289; Mississippi,

Two factors undercut the utility of these conventions as precedents for an article V convention. First, "The instances of successful restraint of territorial conventions by Congress are not in point, for Congress is an outside sovereign, not at all comparable to the legislature of the territory itself."[79] Congress power to govern and admit the Territories[80] is not subject to the problems which attend the attempted exercise of power by one body over another when both are at least arguably of equal stature and authority.

Second, Congress (paradoxically) has very little real discretion over the *kinds* of restrictions which it can validly impose on prospective state constitutions. In 1845 the Supreme Court held that once Congress had admitted a state, it was forbidden to inquire into whether a condition of religious liberty which was part of the state's enabling act had been violated.[81] Later the Court went further yet and held that Congress could impose no restrictions upon the admission of a state which had not been imposed upon other states of the Union.[82] Congressional commands in areas of federal authority (*e.g.*, public lands) were to be obeyed, but those on subjects which (after statehood) would be within the sole province of the state to decide (*e.g.*, the location of the state capital) were held void and of no effect.[83] The question still arises occasionally,[84] but there are clearly grave difficulties in using congressional control of territorial conventions as a precedent for article V conventions, if only because of the unique complexity of the former.[85]

Act of Mar. 1, 1817, ch. 23, 3 Stat. 348; Illinois, Act of Apr. 18, 1818, ch. 67, 3 Stat. 428; Alabama, Act of Mar. 2, 1819, ch. 47, 3 Stat. 489; Texas, J. Res. of Mar. 1, 1845, No. 8, 5 Stat. 797; Wisconsin, Act of Mar. 3, 1847, ch. 53, 9 Stat. 178; Nevada, Act of Mar. 21, 1864, ch. 36, 13 Stat. 30; Colorado, Act of Mar. 3, 1875, ch. 139, 18 Stat. 474; Nebraska, Act of Apr. 19, 1864, ch. 59, 13 Stat. 47; North Dakota, South Dakota, Montana, & Washington, Act of Feb. 22, 1889, ch. 180, 25 Stat. 676; and Arizona & New Mexico, Act of June 20, 1910, ch. 310, 36 Stat. 557.

79 HOAR, *supra* note 20, at 111.

80 U.S. CONST. art. IV, § 3.

81 Permoli v. First Municipality, 44 U.S. (3 How.) 589 (1845). The condition is quoted in text at note 75 *supra*.

82 Coyle v. Smith, 221 U.S. 559 (1911).

83 *Id.*

84 *See, e.g.*, Island Airlines, Inc. v. CAB, 363 F.2d 120 (9th Cir. 1966).

85 *See generally* Plowman v. Thornton, 52 Ala. 559 (1875); Bradford v. Shine, 13 Fla. 393 (1871); Frantz v. Autry, 18 Okla. 561, 91 P. 193 (1907); Quinlan v. Houston

The states have held many constitutional conventions without congressional stimulus, while we still await the first article V convention. More important, the gross structures of the state and federal governments are remarkably similar. All provide for three branches of government: an executive, a bicameral legislature (except Nebraska), and an independent judiciary. Above all branches is set a written constitution.

As Justice Brandeis declared, "It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."[86] Justice Brandeis was defending a state statute from attack, but the metaphor is a sword as well as a shield. For, as he observed elsewhere in his opinion, "advances have been due to experimentation. . . . There must be power in the States and the Nation to remould, through experimentation, our . . . institutions to meet changing social and economic needs."[87]

The import of Brandeis' words is clear; the federal government can learn from the states, even as the states can profit from its example. Such "cross-fertilization" is a fruit of the federal system. That it has taken place on a large scale throughout our history is testimony to the structural similarities between the governments, which are extensive enough to allow entire institutions to be lifted from one level and used on another. Emancipation, women's suffrage, prohibition, minimum wage and workmen's compensation laws, public housing, the enfranchisement of 18-year-olds, and the direct election of Senators were all state "experiments" subsequently adopted at the national level, many by incorporation into the Constitution itself. Reflection of the state convention experience of two centuries, modified as required by the differences between state and federal situations, in the theoretical underpinnings and practical development of an article V

& T.C. Ry., 89 Tex. 356, 34 S.W. 738 (1896); Wickersham, *New States and Constitutions*, 21 YALE L.J. 1, 9-15 (1911); Iowa Note, *supra* note 19, at 262-63. The cases, except *Frantz v. Autry*, deal with Reconstruction conventions called and restricted by congressional acts or Presidential proclamations.

86 New State Ice Co. v. Liebman, 285 U.S. 262, 311 (1932).

87 *Id.* at 310-11.

convention would be no more than continuation of a long line of precedent.

B. *Comparison of State and Federal Convention Processes*

State and article V conventions can be compared on structural and functional bases. The parallels and contrasts between them in these respects illuminate the extent to which the theoretical foundation of limited state conventions can be utilized in analyzing the propriety of a limited federal convention. The model below demonstrates striking structural similarities (and one important difference) between the convention process at the state and federal levels.[88]

STAGE	STATE MECHANISM	FEDERAL MECHANISM
Initiation	Legislature	Informal[89]
Authorization	Popular vote	⅔ of states
Calling[90]	Legislature (& electorate)	Congress (& states or electorate)

88 It is important to note that the state procedure used in the model is not the only, nor the universal, method for conducting state constitutional conventions. It *is* the usual way to do so. Differences, notably at the initiation stage, do exist. *See* notes 22 and 64 *supra*. Clearly, the function or purpose of a state convention may be altered if the legislature is to be intentionally circumvented or ignored at the initiation stage.

At the ratification stage, Delaware alone provides for legislative proclamation of constitutional convention products without popular ratification. DEL. CONST. art. XVI, § 1. Occasionally other states will forego a popular vote for special reasons, as did Virginia in 1945. Ch. 1, § 1(B) [1944/45] Va. Acts Ex. Sess. 4.

It might be argued that an article V convention is more closely analogous to a state convention called by popular initiative than to a legislatively initiated convention, but the latter form dominates the state experience, so in this Note the term "state convention" generally means a legislatively initiated convention unless otherwise specified explicitly or by context. If the legislature does not fully control legislatively initiated conventions, it clearly should not fully control popularly initiated conventions, and if the legislature may be limited by popular vote on a legislatively submitted proposition, it clearly may be limited by direct popular initiative. Thus, the distinction between popular (or state) and legislative (or congressional) initiation of conventions does not diminish the value of comparing legislatively initiated state conventions with state initiated article V conventions.

89 The usual mechanism here has been a "groundswell" led by a prominent national leader or body, *e.g.*, the efforts of Senator Dirksen (R.-Ill.) in the mid-sixties to secure a convention to override the Supreme Court's "one man-one vote" decisions. *See* N.Y. Times, Mar. 18, 1967, at 1, col. 6. The Council of State Governments was active in the early 1960's in attempting to secure a convention to consider three amendments which it proposed. *See* ABA Report, *supra* note 3, at 5 & n.7.

90 The Calling consists of the legislative act funding the convention, setting up

Proposal of amendments	Convention	Convention
Ratification	Popular vote	3/4 of states

The model discloses a number of obvious structural parallels (the stages into which the process is easily divided, legislative role in the calling, the convention itself) and contrasts (the method of initiation, participation by the electorate versus participation by the state governments) between the state and federal procedures. Functionally, both share the same ultimate end — the change of fundamental law.

More subtly, perhaps, the states play the same roles at the same stages of a federal constitutional convention as are played by the electorate in state conventions. In each case, the group in question is responsible for both the authorization and ratification stages. Viewing the convention as the sovereign's means of directly altering the fundamental law, the provision for dual review is especially reasonable. Touching base twice with the source of amending authority emphasizes the convention's accountability and ensures that its work will meet with the approval of the body from which it receives all of its powers.

Extending the structural analogy would seem to imply that the states, seen from the perspective provided by the convention process, are sovereign in the United States, as is the electorate in the states.[91] Yet it is modern constitutional dogma that the question of state sovereignty was resolved in the negative by the Civil War, if not before. Invoking dogma, however, cannot settle the matter. First, the convention clause is not a 20th century product, but dates from 1787, when "the states were in a position of at least nominal sovereignty, and were considering whether to unite."[92] Second, a number of commentators, reasoning that the power to change the fundamental law is the essence of sovereignty, have in fact defined the sovereign in America as the equivalent

---

delegate selection procedures, naming temporary officers, etc. The stage also includes the election of delegates — hence the parenthetical additions.

91 Recall that the clear thrust of state experience is that only popularly approved limitations are binding. *See* part I(C) *supra*, especially text at notes 69-72 *supra*.

92 Black, *The Proposed Amendment of Article V: A Threatened Disaster*, 72 YALE L.J. 957, 964 (1963).

of the amending body. Insofar as the convention clause may be said to give the (*united*) states power both necessary and sufficient to amend the Constitution, some have proclaimed the states united as sovereign in the United States.[93] That view was disputed by Orfield, who would have included the Congress as well, as it must call a convention even when the states have petitioned for one, and it may choose the mode of ratification. Orfield does not, however, dispute the assertion that the "amending body" is the legal sovereign.[94]

In short, the sovereign is whoever has the last word. The Convention of 1787, after a great deal of discussion, decided that the states, and not Congress, would have the last word with respect to amendments. Indeed, "early discussions and proposals centered on the question of excluding Congress from a significant role in the amendment process."[95] The chief advocate of this position was Mason, a strong anti-Federalist who sought and achieved provision for independent state initiation of the amendment process because of his belief that it was needed as a check on potential congressional abuses.[96]

> What finally emerged from the convention was what may be described as the compromise set forth in article V, whereby a power of initiative was to reside in both Congress and the states pursuant to the two alternative methods, with the final authority of ratification under both methods in the states. . . . It is evident from the discussion at the time that the alternative method recognizing state initiative was considered an important safety valve to guard against abuses of federal

---

93 *See, e.g.*, 1 J. AUSTIN, JURISPRUDENCE 268 (4th ed. 1879); J. HURD, THE THEORY OF OUR NATIONAL EXISTENCE 139-40, 374 (1881).

94 L. ORFIELD, AMENDING THE FEDERAL CONSTITUTION 153-67 (1942).

95 Kauper, *The Alternative Amendment Process; Some Observations*, 66 MICH. L. REV. 903, 905 (1968). The Virginia Plan contained provision for the amendment of the prospective Constitution without congressional consent. 1 FARRAND, *supra* note 9, at 22.

96 *See* 1 FARRAND, *supra* note 9, at 202-03 (Mason's speech of June 11, 1787); 2 *id.* at 629 n.8 (Mason's marginal notes on article V); 2 *id.* at 629-30 (final debate on the convention clause). On Mason's anti-Federalism, see MITCHELL, A BIOGRAPHY OF THE CONSTITUTION OF THE UNITED STATES 37-38 (1964). It is noteworthy that all three of the delegates who refused to sign the Constitution in 1787 were among those who had striven mightily for the convention clause as it ultimately was adopted. *Id.* at 118-19.

> power which would not be corrected if the power to initiate amendments was vested solely in Congress.[97]

If the basis of the convention clause was fear of congressional tyranny and a desire to assure that the states could override it, then it should come as no surprise that article V casts the states in the role of final authority. The convention clause was not a unique provision, for the Constitution originally gave the states ultimate authority with respect to both selection of Senators and election of the President, as well as amendment of the organic law.[98]

C. *Limitability at the Federal Level*

Once it is seen that the states are meant to be the final authority in article V convention matters just as the electorate is the final authority in state conventions,[99] the further parallel is suggested that just as the electorate may delegate less than all of its authority and thereby limit state conventions,[100] so may the states delegate less than all of their authority in order to limit an article V convention. No reason appears why delegation should be possible on the state but not on the federal level. Indeed, the opposite is the case, for there are two factors providing stronger support for such delegation, and hence for limited constitutional conventions, on the federal than on the state level.

First, the purely structural difference between the federal and state convention initiation procedures (the initiation of a federal convention is informal, while initiation of a state convention is most often a task for the legislature) removes a principal objection to limited state conventions — that the sovereignty of the electorate in authorizing a limited convention is a legal fiction because the electorate becomes a mere pawn of the state legislature by being reduced to accepting the convention limits defined by the

---

97 Kauper, *supra* note 95, at 905.

98 Much authority in the federal system is still exercised by the states. *See generally* Wechsler, *The Political Safeguards of Federalism: The Role of the States in the Composition and Selection of the National Government*, 54 COLUM. L. REV. 543 (1954).

99 *See* part II(B) *supra*.

100 *See* part I(C) *supra*, especially text at notes 69-72 *supra*.

legislature or doing without a convention.[101] An article V convention could not be criticized on such grounds. Each state petitions individually for a convention. There is no ratification of the act of another body, so the states have full and untrammeled authority to specify those limitations they individually desire and to establish those upon which they can agree. The price paid for this high degree of control is the chaos of the informal initiation process. We have never had an article V convention, perhaps largely because it is so difficult to get two-thirds of the states to agree at any one time on any one set of limitations. Provided that the states alone can establish limitations, and that Congress must honor those limitations, adding none of its own, the power to limit an article V convention would in fact be lodged in the amending authority, and the objection that the procedures for limiting a state convention do not square with the theory would be of no force at the federal level.

A second factor lending stronger support to limitability at the federal than at the state level arises from the significant functional difference underlying the structural dissimilarity between the methods of initiation of state and article V conventions. Functionally, a state convention may be a vestigial organ, a means of effecting thoroughgoing revision of the fundamental law, or a device for achieving rapid adoption of amendments.[102] But, with rare exceptions, it cannot be a device for overruling or sidestepping the legislature, because the legislature is normally the initiator of the convention proceedings.[103] By contrast, the clear purpose of the article V convention mechanism is to provide "an alternative to the proposal of amendments by Congress in order to ensure that the states [can] correct congressional abuses of power or propose amendments which Congress refuse[s] to propose."[104]

101 *See* part I(C) *supra.*

102 As far as thoroughgoing revision is concerned, see Keith, *Recent Constitutional Conventions in the Older States,* in MAJOR PROBLEMS IN STATE CONSTITUTIONAL REVISION 38 (W. Graves ed. 1960). With reference to rapid adoption, see Graves, *State Constitutional Law: A Twenty-Five Year Summary,* 8 WM. & MARY L. REV. 1, 8-9 (1966).

103 It should be remembered that alternative means of initiation exist. *See Procedures for Calling Constitutional Conventions, supra* note 19; note 88 *supra.*

104 Harvard Note, *supra* note 59, at 1618 (citing Kauper, *supra* note 95, at 904-05 & n.2). *See* 1 FARRAND, *supra* note 9, at 202-03; 2 *id.* at 629-31.

This difference in function can only strengthen the argument for the power of the states to limit a federal convention convened at their behest. If a federal convention is to be a device for circumventing Congress, it would be uncontrollable in the absence of state controls. The role of the convention as the states' special tool is inconsistent with the position that the states cannot in some way define its work and agenda. To deny the states the power to limit a federal convention is to argue that the framers intended that the states be compelled to risk the entire structure of government whenever they sought to make a minor constitutional adjustment over the objections of Congress.[105]

The foregoing analysis suggests that the justification for limited state conventions applies with at least equal, and perhaps greater, force to federal conventions, both because a principal objection to limited state conventions does not apply to article V conventions, and because the different function of an article V convention provides a justification for limitability not found at the state level. To oppose a limited article V convention denies the right of the final authorities on the amendment of the Constitution — the states — to delegate less than all of their power to suggest amendments.[106]

III. Potential Problems of Limited Article V Conventions

Clearly the state experience is useful insofar as it provides theoretical insights into the possibility of a limited convention at the federal level. Beyond that narrow purpose, state precedents may prove helpful in considering the various problems which might confront a limited article V convention. In particular, the

---

105 *See* ABA Report, *supra* note 3, at 18-19; Harvard Note, *supra* note 59, at 1629 & n.92.

106 The attempt to deny such a power of partial delegation has been made. A number of the state decisions cited above, indicating that nothing can restrain a convention save the United States Constitution, would seem to imply that no mandate of the sovereign people can block the convention, which is itself sovereign. *See, e.g.*, Livermore v. Waite, 102 Cal. 113, 35 P. 424 (1894). But that view has not prevailed at the state level, *see* part I(C) *supra*; and the argument is particularly inadequate at the federal level, where all of the powers held by the government are nothing more than the partial delegation of the people's and states' own sovereignty. U.S. Const. art. X.

questions of enforcing valid limitations and coping with a congressional refusal to call an article V convention after petition by two-thirds of the states may be answered by an examination of how the states have confronted similar problems. In the same vein, the Ervin Bill's provisions concerning judicial review and congressional supervision of convention procedures may be profitably reexamined in the light of state experience.

A. *Enforcement of Limitations*

One can imagine a number of ways in which attempts by a convention to exceed valid limitations might be thwarted. Most obviously, the electorate (at the state level) or the states (at the federal level) can refuse to ratify the work of such a convention. However, that solution may be unsatisfactory for at least two reasons. Desired amendments might be lost if the convention's work were submitted as a whole with no opportunity for the ratifying body to choose from the lot those amendments it wished to adopt. Alternatively, the "runaway" amendment(s) might be ratified, thereby nullifying valid limitations properly imposed. While in theory the latter possibility ought not be repugnant — on the grounds that approval by the amending authority is in reality the only basis for judging an amendment, and that such approval, if forthcoming, can atone for all manner of past procedural irregularities — it would be a clear departure from anticipated procedures, upon which many will have relied, and a blow to the integrity of the amendment process.

Jameson proposed enforcement of limitations on state conventions by requiring delegates, prior to the opening of the convention, to take an oath to comply with the restrictions and limitations in the enabling act. Exceeding the limitations would violate the oath, subjecting violators to criminal penalties.[107] As Jameson himself admitted, however, conventions have on occasion refused to take, or taken and then ignored, such oaths, with no consequence but the elimination of the limitations the oath was to secure. The Ervin Bill would adopt this approach at the federal level, requiring an oath of prospective delegates that they will

107 JAMESON, *supra* note 32, § 381.

limit their considerations to the subjects specified in the convention call.[108]

The courts are probably more effective for enforcing (and testing) convention limitations than is dependence on the executive to bring criminal charges for violation of an oath. Courts have taken jurisdiction over controversies concerning the propriety of the practices and procedures employed in amending constitutions at both the state[109] and federal[110] levels. State courts, however, have been loath to interfere with the work of constitutional conventions. Conventions are seen as the voice of the electorate (*i.e.*, the sovereign), and thus less amenable to judicial scrutiny than other amendment procedures.[111] Consequently, courts have held that, even if a convention has exceeded proper limitations, general acceptance of its work "obtained either by acquiescence in a revision promulgated by a convention without submission, or by a formal vote of approval at the time of submission"[112] will legitimate the changes, shielding them from attack.[113] "The change made by the people in their political institutions, by the adoption of the proposed Constitution . . . forbids an inquiry into the merits of this case. The question is no longer judicial. . . ."[114] Acquiescence has, at the extreme, been used to preclude judicial review of state constitutions which, in defiance of the general law and their own enabling acts, were promulgated by conventions without being submitted to the electorate for ratification.[115]

The foregoing doctrine is by no means universally adhered to. Many jurisdictions refuse to recognize it, treating the work of a convention like that of any other amending process. Courts have

---

108 S. 1272, 93d Cong., 1st Sess. § 8(a) (1973).

109 *See* Iowa Note, *supra* note 19, at 266-68; Minnesota Note, *supra* note 23, at 294-97; St. Louis Note, *supra* note 55.

110 *See* ABA Report, *supra* note 3, at 24 n.44; Harvard Note, *supra* note 59, at 1636.

111 *See* sources cited note 109 *supra*.

112 Minnesota Note, *supra* note 23, at 295.

113 Wood's Appeal, 75 Pa. St. 59 (1874); Miller v. Johnson, 92 Ky. 589, 18 S.W. 522 (1892); Taylor v. Commonwealth, 101 Va. 829, 44 S.E. 754 (1903) (dictum).

114 Wood's Appeal, 75 Pa. St. 59, 68-69 (1874).

115 *See* Miller v. Johnson, 92 Ky. 589, 18 S.W. 522 (1892); Taylor v. Commonwealth, 101 Va. 829, 44 S.E. 754 (1903).

struck down ordinances passed by conventions with authority only to propose constitutional change and have even declared null and void sections of state constitutions passed by limited conventions without authority to consider the subject of the invalidated article.[116]

In any event, review is never certain. Courts may refuse to interfere with a convention before its work is completed and can be reviewed as a product rather than a mere proposal (the "ripeness" problem). Alternatively, ratification increases the pressures on a court to accept amendments, now imprinted with the seal of sovereign approval. Often courts wash their hands of the entire affair, branding it a political question.[117] Limitations seemingly are best enforced either immediately after the convention adjourns[118] or just after electoral approval, but before the challenged provisions have become part of the fabric of government.[119] Thus state precedent regarding constitutional conventions and both state and federal precedent regarding other modes of amendment suggest that courts might be willing, at least in some circumstances, to halt "runaway" amendments.

---

116 *See, e.g.*, Hayne v. Assessor, 143 La. 697, 79 So. 280 (1918); Foley v. Democratic Parish Comm., 138 La. 220, 70 So. 104 (1915); State v. American Sugar Ref. Co., 137 La. 407, 68 So. 742 (1915); Louisiana Ry. & Nav. Co. v. Madere, 124 La. 635, 50 So. 609 (1909). *See also Ex parte* Birmingham & Atl. Ry., 145 Ala. 514, 42 So. 118 (1905) (invalidated ordinances); HOAR, *supra* note 20, at 160 (also invalidated ordinances).

117 *See generally* DODD, *supra* note 25, at 93-103; HOAR, *supra* note 20, at 149-64; White, *Amendment and Revision of State Constitutions*, 100 U. PA. L. REV. 1132, 1149 (1952); Iowa Note, *supra* note 19, at 266-68; St. Louis Note, *supra* note 55, at 280-84. As to the political question issue at the federal level, see Harvard Note, *supra* note 59, at 1634-41.

118 Possible methods of obtaining review include refusal of government officers to take some action with respect to the amendments (*e.g.*, refuse to submit them to a ratification vote in order to force backers of the amendments to bring a writ of mandamus or declaratory judgment action) and a suit by private parties to enjoin submission (perhaps parties with a special interest at stake to confer standing). *See* Harvard Note, *supra* note 59, at 1641-44; Minnesota Note, *supra* note 23, at 296-97. Review might not be available prior to ratification because the possibility that the proposals would not be ratified means that no case or controversy exists. *See* Harvard Note, *supra* note 59, at 1641 n.150.

119 How long is too long to wait? The answer probably depends upon the degree to which substantial expectations have arisen due to the changes and the degree to which actions have been taken based upon such expectations. *See, e.g.*, Annot., 158 A.L.R. 512, 513 (1945).

B. *Refusal to Call a Convention*

A perhaps more likely problem is that Congress would refuse to call a convention, even after petition by two-thirds of the states. The problem is relatively rare at the state level, because the legislature generally initiates the convention process, making the passage of enabling legislation a foregone conclusion.[120] A federal convention, however, would be called not in furtherance of congressional desires but rather to circumvent congressional refusal to approve a desired amendment or amendments.[121]

The language of article V is mandatory; if two-thirds of the states petition for a convention, the Congress "shall" convene one. Virtually all authorities, including Senator Ervin,[122] recognize the mandatory nature of Congress duty under the convention clause. Hamilton (himself a foe of state initiation of amendments) wrote in *The Federalist* that "[t]he words of this article are preemptory. The Congress 'shall call a convention.' Nothing in this particular is left to the discretion of that body. And of consequence, all the declamation about their disinclination to a change, vanishes in air."[123]

Nevertheless, the problem is a real one. At the federal level, efforts to block a convention might well be made in Congress. The absence of procedures in the Constitution by which to determine when and how to implement the article V convention machinery suggests a role for Congress in convention implementation.[124] At least one Senator refused to see himself as bound to vote to call a convention despite identical petitions from 34 states, asserting that Congress should not accept a petition to overrule the Supreme Court's apportionment decisions from a malapportioned state

---

120 In those states in which the convention process may be initiated by the electorate, legislative approval could not be taken for granted. Indeed, the problem was foreseen in some such states, in which the constitutions contain detailed provisions for calling the convention into existence. *See* Iowa Note, *supra* note 19, at 252.

121 *See, e.g.*, Dirksen, *supra* note 5. The effort to convene a federal convention to consider the apportionment problem was begun only after Congress refused to pass the "Dirksen Amendment."

122 *See* Ervin, *Proposed Legislation to Implement the Convention Method of Amending the Constitution*, 66 MICH. L. REV. 875, 885-86 (1968).

123 THE FEDERALIST, No. 85, at 403 (Hallowell, Masters, Smith & Co. ed. 1852) (A. Hamilton).

124 *See* part III(C) *infra*.

legislature[125] and further that "Congress clearly has the authority to rule out petitions on the ground that circumstances which led to their submission have materially changed."[126] At the state level, legislatures have occasionally refused to pass enabling legislation, even in the face of a popular mandate for a convention.[127] And a number of state courts have refused, notwithstanding constitutional language similar to article V, to issue writs of mandamus to state legislatures which balked at calling conventions authorized by the electorate.[128] In *Wells v. Bain* the court did not see the people's authorization as compelling: "It was not even a mandate, further than the moral force contained in an expressed desire of the people."[129]

The early authorities evidently viewed the legislative prerogatives in this politically charged area as unchallengeable,[130] but Jameson (rather uncharacteristically) affirmed the rights of a convention to provide for its own financial support and meeting place should the legislature refuse either out of pique or politics.[131] Recent cases have indicated that the legislature, in calling a convention after the electorate's affirmative vote on the convention resolution, is performing a mere ministerial act, and that failure to call the convention is grounds for a writ of mandamus.[132] The same reasoning would appear to apply to congressional refusal to call an article V convention.[133]

---

125 113 CONG. REC. 10,101 (1967) (remarks of Senator Tydings).

126 *Id.* at 10,102.

127 Examples include New Hampshire in 1860 and 1864; New York for eight years after popular approval in 1886; Iowa in 1920; California in 1934, 1945, and 1946; and Maryland in 1950.

128 *See, e.g.*, Fergus v. Marks, 321 Ill. 510, 512, 152 N.E. 557, 560 (1926). *See also* HOAR, *supra* note 20, at 118-19.

129 Wells v. Bain, 75 Pa. 39, 50 (1874).

130 *See generally* DODD, *supra* note 25, at 53-57; HOAR, *supra* note 20, at 116-18; Iowa Note, *supra* note 19, at 252-53.

131 HOAR, *supra* note 20, at 117-18, 177-78; JAMESON, *supra* note 32, §§ 453-56.

132 Chenault v. Carter, 332 S.W.2d 623, 626 (Ky. 1960); Board of Supervisors of Elections v. Attorney General, 246 Md. 417, 445, 229 A.2d 388, 403 (1967).

133 The problem is complicated by the unique historical interrelationships among the three branches of the federal government. This may well mean that the courts would only declare Congress constitutional duty and refuse directly to order Congress to act. *See* Powell v. McCormack, 395 U.S. 486 (1969); Harvard Note, *supra* note 59, at 1641-44. *But see* Bonfield, *The Dirksen Amendment and the Article V Convention Process*, 66 MICH. L. REV. 949, 978-85 (no mandamus to compel Congress to call a convention — the article predates *Powell*).

C. *The Ervin Bill, the Role of an Article V Convention, and the State Experience*

The Ervin Bill grants Congress sole authority to judge state petitions and to specify the limitations (through perusal of the state petitions) binding upon the convention.[134] Given the absence of implementing provisions in article V, a role for Congress here is probably both necessary and desirable.[135] However, making Congress the *sole* arbiter, as the Ervin Bill does by barring judicial review,[136] would be neither. Congress might avoid blunt refusal to call a convention under the guise of finding the state petitions inadequate or dictate its own limits under the guise of interpreting state-created limits.

More seriously, the Ervin Bill permits Congress to refuse to submit amendments to the states for ratification if, in its judgment, they exceed in scope the limits placed on the convention which authored them.[137] Though congressional supervision of the convention process before the convention can be justified, such a role after the convention has completed its work is unwarranted. Congress may play a part in interpreting state petitions, but there is no reason why the states themselves or the courts cannot police the convention itself. Congressional participation at this stage opens the door to congressional abuses in the guise of enforcing previously established limitations.

Judicial resolution of the question of congressional power over article V conventions ordinarily would be expected, but the Ervin Bill purports to prohibit judicial review.[138] If it becomes law, constructive use of state precedent may be precluded in determining what power Congress has to determine the judicial role in article V conventions. However, one doubts that judicial review may be excluded. It may be particularly noteworthy that the issue is not merely one of general congressional power to regulate the jurisdiction of the federal courts, but also a question of the extent of

134 S. 1272, 93d Cong., 1st Sess. § 6 (1973). *See* Harvard Note, *supra* note 59, at 1630-32.

135 *See generally* ABA Report, *supra* note 3, at 20-22; Harvard Note, *supra* note 59, at 1615-18.

136 S. 1272, 93d Cong., 1st Sess. §§ 3(b), 5(c), 10(b), 13(c) (1973).

137 *Id.* § 11(b)(1).

138 *Id.* §§ 3(b), 5(c), 10(b), 13(c) (1973).

congressional discretion under a constitutional provision explicitly mandating particular congressional action.[139]

The very purpose of the article V convention clause was to provide a means for circumventing Congress. Therefore it seems desirable to restrict the opportunities for congressional meddling, and hence to minimize congressional discretion, as much as possible. Conceding the necessity for a congressional role in determining whether the conditions invoking its duty to call a convention have been satisfied, in defining the limitations contained in the state petitions, and in calling a convention, still the courts must be able to review the congressional determinations if the purpose of the convention clause is to be effectuated.

The need for a congressional role in enforcing convention limitations, as by power to refuse to submit convention proposals for ratification, is much less clear and the need for judicial review of such determinations thus the more clear. Indeed, both the inherent conflict of interest between Congress and an article V convention[140] and analogy to the state experience with legislative limitations imposed after electoral authorization[141] suggest that only the states may limit an article V convention and that the contemplated congressional role in enforcing limitations is singularly inappropriate, perhaps even unconstitutional.[142] While a few state courts have upheld such legislative limitations on the theory that in voting for convention delegates the people implicitly con-

139 The issue is beyond the scope of this Note. On judicial review, *see generally* ABA Report, *supra* note 3, at 23-27; Harvard Note, *supra* note 59, at 1634-48.

140 *See* text at note 104 *supra*. Conflict between Congress and the convention could be more apparent than real in some circumstances. It may fairly be assumed that no serious attempt to call an article V convention would be made unless attempts to have Congress initiate amendments had already failed. But a two-thirds vote of both Houses is required to propose amendments, while presumably only a majority vote would be required in the exercise of its functions in the article V convention process. Thus, if a simple majority of those voting, but less than two-thirds of the entire Congress, favored an amendment on the subject in question, Congress might not be inclined to impede the convention process. However, minimizing the role of Congress as suggested herein is still appropriate because this situation likely would not always exist and the alternatives — enforcement as discussed in part III(A) *supra* and judicial review of congressional action — are equally appropriate even when this situation does exist.

141 *See* text at notes 71-72 *supra*.

142 *See* Harvard Note, note 59 *supra*, at 1630-33. *But see* ABA Report, note 3 *supra*, at 8, 21, 67-69.

done the legislature's actions,[143] the position is not only an unsound minority one, but also clearly inapplicable to a federal convention.[144]

The provision of the Ervin Bill substituting the judgment of Congress for that of the federal courts as final arbiter of convention disputes should be deleted.[145] The provision making Congress an enforcer of convention limitations might well be deleted.[146] If the Ervin Bill is passed without such changes, judicial decisions restricting the scope of congressional discretion in this matter would accord best with both the theory of the article V convention and the state experience.

Conclusion

The theoretical foundations of constitutional conventions at the state level clearly permit limited constitutional conventions, and this conclusion is supported by both experience and judicial opinion. Federal article V conventions and state conventions operate on much the same principles and with similar procedures. Moreover, what differences there are make the argument for limited constitutional conventions more compelling at the federal level. Thus, article V should be interpreted to allow limited constitutional conventions. The limitations to be imposed would be those, and only those, found in the petitions of at least 34 states.

If limited article V conventions do occur, the state experience in enforcing limitations on limited conventions and dealing with legislative refusal to call electorally mandated conventions may

---

143 *See* note 71 *supra*.

144 The presumption that in voting for delegates the people implicitly ratify the enabling act is derived from the earlier presumption that the people, in approving the legislature's convention resolution, have approved all the limitations contained therein. *See* text at notes 63-70 *supra*. A federal convention would have no legislative resolution and hence no need for the first presumption. There would thus be no basis for the questionable reasoning involved in asserting that electing delegates necessarily implies embracing the entire convention act, especially when to do so would impose new and previously unrequested restrictions.

145 S. 1272, 93d Cong., 1st Sess. §§ 3(b), 5(c), 10(b), 13(c) (1973). *See* Harvard Note, *supra* note 59, at 1632-33. *See generally* the excellent discussion of this problem in ABA Report, *supra* note 3, at 23-28; and the suggested new section of S. 1272, *id.* at 75-76.

146 S. 1272, 93d Cong., 1st Sess. § 11(b)(1) (1973).

be useful in predicting and dealing with problems at the federal level. Those provisions of the Ervin Bill dealing with congressional power over article V conventions seem inconsistent with the rationale underlying article V conventions and should be modified before the bill becomes law.

*Henry D. Levine**

---

*Member of the Class of 1975 at Harvard Law School. The author expresses his appreciation to Mr. John Feerick of the ABA Special Constitutional Convention Study Committee for his support and guidance of the basic research for this Note, undertaken while the author was a research assistant to the Special Committee.