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DEVELOPING LIMITS ON COMPENSATION OF MUTUAL FUND ADVISERS

ALAN W. ROTTENBERG*

Introduction

The aggregate asset value of mutual funds in the United States has grown from less than $450 million in 1940 to over $50 billion,[1] yet these funds are still primarily regulated by the Investment Company Act of 1940.[2] In recent years, Congress has repeatedly been concerned with the effectiveness of this regulation and has considered new legislation to correct various flaws. This article will follow the developments in Congressional action toward regulation of the compensation of the money managers behind the funds. The article traces Congressional hearings that began during the Soaring Sixties with funds prospering and proliferating, continued during the steep market skid of the last year that saw substantially all of the funds drop in net asset value per share, and now are continuing into the Seventies. The loud cries that superlative performance justified tremendous compensation have been stilled somewhat by the market slide. The lobbyists have had ample time to have their say. Now only the conclusion of the Congressional deliberations remains. This article will outline the legislative developments during this period. While the author does not pretend to be prophetic, a careful reading of this article

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1 *Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess., pt. 1, at 125 (1967) [hereinafter cited as *1967 Senate Hearings*]; *Hearings on H.R. 11995, S. 2224, H.R. 13754, H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess., pt. 1, at 181, 186, 428 (1969) [hereinafter cited as *1969 House Hearings*]. Much of this growth (50 percent) has occurred in the past 5 years and it appears that the annual rate of growth is now nearly $10 billion. *Hearings on S. 34 and S. 296 Before the Senate Comm. on Banking and Currency*, 91st Cong., 1st Sess. 8 (1969) [hereinafter cited as *1969 Senate Hearings*]; *1969 House Hearings* pt. 2, at 568.

2 54 Stat. 789 (1940), *as amended*, 15 U.S.C. §§ 80 a-1 to 80a-52 (1964).

will enable the reader to better understand the ultimate Congressional resolution, whatever it may be.

I. The Need for Legislative Inquiry

During the 1940 Hearings on "Investment Trusts and Investment Companies," Merill Griswold, then chairman of the largest mutual fund and a principal witness for the mutual fund industry, stated his belief that mutual funds could never grow to a gigantic size.[3] Such representations by industry leaders as to inherent limitations on mutual fund growth, as well as the nature of the fund industry at that time, resulted in an act which with respect to the size of advisory fees contained only a "few elementary safeguards."[4] More recently, however, the newly elected chairman of the Investment Company Institute, John C. Boyle, expressed his optimism that the now more than $50 billion industry will triple to $150 billion within the next ten years.[5] Such a phenomenal growth in the amount of mutual fund assets without a change in compensation arrangements would result in further drastic increases in the size of advisory fees, since fees are commonly calculated as a percentage of a fund's average net assets.[6] Furthermore, reports by the Wharton School of Finance[7] and the Securities and Exchange Commission[8] concluded: (1) that the control relationship between the funds and their advisers precludes effective competition and meaningful arm's-length bargaining[9] and (2) that mutual fund managements have shared with the investor-consumers only to a minimal extent the substantial economies of size realized by the recent growth of the industry.[10]

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3 *Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 500 (1940) [hereinafter cited as *1940 Senate Hearings*].

4 *1940 Senate Hearings* 252. The safeguards can be found in section 15 of the Investment Company Act of 1940. 54 Stat. 789 at 812-13.

5 Wall Street Journal, Jan. 24, 1969, at 8, col. 2.

6 *1967 Senate Hearings* pt. 1, at 132.

7 Wharton School of Finance and Commerce, A Study of Mutual Funds, H.R. Rep. No. 2274, 87th Cong., 2d Sess. (1962) [hereinafter cited as Wharton Report].

8 Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966) [hereinafter cited as SEC Report].

9 *1967 Senate Hearings* pt. 1, at 126.

10 *Id.* at 131-32.

Sparked by the beginnings of the predicted spiral of continued growth at an ever-increasing rate, Congress has felt it necessary to investigate compensation arrangements which often allow for individuals to receive personal compensation of more than $450,000 per year for performing management functions for internally managed mutual funds — and considerably more for external adviser-managers.[11] Section 1(b)2 of the 1940 Investment Company Act, as amended, declares that the national public interest of investors is adversely affected:

> when investment companies are organized, operated, managed, or their portfolio securities selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof . . . rather than in the interest of all classes of such companies' security holders.[12]

Accordingly, Congress is examining the adequacy of the present legislative foundation for the regulation and development of the mutual fund industry in the light of both the needs of today and the probable needs of tomorrow.

This article deals with open-end investment companies or mutual funds, by far the dominant and most dynamic part of the investment company industry.[13] They are usually organized in corporate form, although the trust form is also common. Unlike the conventional corporation, however, the general pattern of the mutual fund industry is to contract out principal management functions to a separate company, an investment adviser, which is paid an advisory fee, almost always a percentage of the fund's net assets. This externalization of management was firmly imbedded in the industry by 1940 and was allowed by Congress in the Investment Act.[14] Despite this formal structure of a contract between two separate legal entities, often the investment adviser creates, staffs, and controls the mutual fund. Although the fund may grow to very substantial size, the fund often remains almost totally dependent on its adviser-underwriter. The selection of the fund's officers and directors (almost invariably interlocking with those

11 *Id.* at 133.
12 15 U.S.C. § 80a-1(b)(2) (1964).
13 SEC REPORT 42-45.
14 *1940 Senate Hearings* 251-52.

of the adviser to the extent permitted by the 1940 Act) and many basic policy decisions of the fund are subject to the control of its adviser.[15] To consider an alternative adviser is often unrealistic.

The result of this unique structure is a built-in conflict of interest between the adviser-directors and the shareholders of the mutual fund with respect to advisory fees.[16] And since the adviser, wearing one hat, sets his own fee without fear that the fund's board, on which he wears his other hat, will bargain effectively with him, much less actually shop around for other offers, competitive forces and arm's-length bargaining are in fact non-existent with respect to advisory fees.[17] The result is numerous complaints that fees are not responsive to the economies of size resulting from the growth of mutual funds.[18] This conflict of interest relationship between the investment adviser and the investment company has been characterized in academic circles as "anomalous"[19] and as "business incest."[20]

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15 WHARTON REPORT 33-36, 64-67, 452. However, Nathan Lobell vigorously disagrees with this conclusion: "They (the shareholders) can strip the fund of assets; for they do not merely sell, they redeem. Fund managers live under the shadow of this power and it haunts every major move they make . . . The distribution of voting power, the 'control' of proxy machinery, the 'scatteration' of holdings — all these paraphernalia dwindle in importance against the fact of the redemption privilege as indicating the 'real locus' of control. It is in the shareholders." Lobell, *A Critique of the Wharton School Report on Mutual Funds*, 49 VA. L. REV. 1, 54-55 (1963). *Contra*, Herman, *Lobell on the Wharton Study of Mutual Funds: A Rebuttal*, 49 VA. L. REV. 938, 950 (1963), who asserts not only that Lobell exaggerates the threat of redemption, but also that if dissatisfied shareholders do adopt the alternative of redemption, management control is even further enhanced.

16 Manuel F. Cohen, former chairman of the SEC, notes that this conflict, between the adviser-director's duty to the fund shareholders to keep advisory fees as low as possible and his own self-interest in maximizing fees, has an additional facet where the investment adviser is publicly owned and the interlocking directors owe inconsistent duties to the different shareholders. *1967 Senate Hearings* pt. 1, at 130-31.

17 SEC REPORT 126-27; *1967 Senate Hearings* pt. 1, at 10. Indeed, Abraham Pomerantz, testifying before the Senate Committee, notes that the managing group often wears not two, but four hats: (1) directors and principal officers of the fund; (2) underwriter of the fund; (3) investment adviser of the fund; (4) broker for the fund. *Id.* pt. 2, at 706.

18 WHARTON REPORT 493-94.

19 Modesitt, *The Mutual Fund — A Corporate Anomaly*, 14 U.C.L.A. L. REV. 1252 (1967).

20 Note, *The Mutual Fund and its Management Company: An Analysis of Business Incest*, 71 YALE L.J. 137 (1961). Abraham Pomerantz similarly states: "(O)f all conflicts on this (American corporate) scene, nothing — but nothing — approaches the open-end mutual fund for incestuous relationships . . . (W)here there is conflict between self-interest and fiduciary duty, you and I know who comes out on top." *Conference on Mutual Funds*, 115 U. PENN. L. REV. 669, 739 (1967).

Industry spokesmen, however, vigorously assert that management fees are negotiated in the context of a highly competitive business.[21] Although competition may have been lacking during the prior growth period of mutual funds, the SEC Report, it is suggested, fails to take into account the developments and trends of the most recent few years which have triggered competitive forces and a resulting decline in advisory fees.[22] Robert Loeffler, Vice-President of Investors Diversified Services, Inc., stated in his testimony during House Hearings:

> What we compete for essentially is the investor dollar of the customer, the ultimate customer. In doing so, the price of our product is an aspect of that product . . . We compete with 100 other sponsors of mutual funds who compete for the customer favor, the ultimate consumer, for his dollar, and the cost of our service, which is clearly disclosed on the prospectus, is an aspect of the service that we are selling.[23]

Loeffler's arguments ignore that the fact mutual fund shareholders have already invested and thus are locked in at least to some extent. Another fallacy of his argument is that mutual fund shares have to be sold. They are not bought.[24] The investor, the ultimate consumer, does not distinguish among the funds, but instead he essentially relies upon the salesman.[25] The result is competition not for the investor-consumer's dollar through reducing management fees but competition for the salesman's favor by offering him more and more remuneration.[26]

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21 *E.g., 1967 Senate Hearings* pt. 1, at 188-92 (testimony of Francis S. Williams); *Id.* pt. 1, at 262 (testimony of Prof. Jesse Markham); *Conference on Mutual Funds, supra* note 20, at 734-35 (remarks of Joseph E. Welch).

22 *Conference on Mutual Funds, supra* note 20, at 736-37 (remarks of Robert M. Loeffler).

23 *Hearings on H.R. 9510, H.R. 9511 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 90th Cong., 1st Sess., pt. 2, at 480 (1967) [hereinafter cited as *1967 House Hearings*].

24 *1967 Senate Hearings* pt. 2, at 726-27 (testimony of Prof. Edward Herman).

25 *Id.* pt. 2, at 677-78 (testimony of Prof. Irwin Friend). This also accounts for the finding by the Wharton Report that purchases of mutual fund shares are not related to performance. WHARTON REPORT 20.

26 SENATE COMM. ON BANKING AND CURRENCY, INVESTMENT COMPANY AMENDMENTS ACT OF 1968, S. REP. No. 1351, 90th Cong., 2d Sess. 7 (1968) [hereinafter referred to and cited as 1968 SENATE COMMITTEE REPORT]; *1967 Senate Hearings* pt. 1, at 354 (testimony of Prof. Paul A. Samuelson); *1967 House Hearings* pt. 2, at 712 (testimony of Manuel F. Cohen). Moreover, even if the investor were more informed, competition in its usual form is not feasible where the skill and experience of the supplier is a major factor in the selection process. *1967 Senate Hearings* pt. 1, at 110.

II. Excessive Advisory Fees?

There are three principal and interrelated sources of income and other benefits that accrue to investment advisers and affiliated persons maintaining effective control over mutual funds: (1) advisory and management fees; (2) payments for distributing and selling the fund's shares; and (3) brokerage commissions for the purchase and sale of the fund's portfolio securities. Advisory fees, the subject of this article, are the most important source of income for almost all investment company advisers.[27]

By the end of 1966, the annual amount of advisory fees paid by externally managed funds had reached about $140 million.[28] The SEC's position is that "by any objective standard . . . the advisory fees paid by a number of the funds are excessive, and that this is due, in the main, to the mechanical application of a formula related only to the assets of the fund — regardless of the extent to which the growth of these assets is caused by aggressive sales efforts without any proportional increase in the costs of advising the fund."[29]

The SEC Report confirmed the findings of the Wharton Report

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27 Wharton Report 28. "Give-ups" provide another source of compensation for the mutual fund manager. Because of rigid minimum commission rate structure adopted by all national securities exchanges, there is no volume discount available to mutual funds to attract their business. However, mutual fund managers have taken advantage of competition among brokers for institutional business by using, among other devices, the "give-up." Under this arrangement a broker-dealer executing a fund's order will agree to give up a portion of his minimum commission, perhaps as high as 75 percent, to be distributed to other brokers selected by the manager. In this way, the manager can divert commissions generated by his fund's transactions to uses totally unrelated to the transactions. These uses may include payment to an affiliate (of the fund manager) which provides advisory services and may be credited against the fund's advisory fee. In this way a certain amount of the commission can be recaptured for the fund's shareholders. In a few instances, however, the fund manager has kept all give-ups it has directed to its brokerage affiliate for itself without lowering the advisory fees charged to the fund whose portfolio transactions are the source of such give-ups. Because of the adverse effects of give-ups on the New York Stock Exchange and its member firms (give-ups divert commissions to non-members of the NYSE), the Exchange has proposed abolishing give-ups and allowing a form of volume discount. 33 Fed. Reg. 2393 (1968); *1969 House Hearings* pt. 1, at 218-27. The abolition of give-ups became effective December 5, 1968. For the effects of the abolition on the mutual fund industry see *Id.* pt. 1, at 233-36, 426-27. For the effect upon non-NYSE broker-dealers, see *Id.* pt. 2, at 528, 531-34.

28 *1967 Senate Hearings* pt. 1, at 10.

29 *1967 House Hearings* pt. 1, at 37-38; *1967 Senate Hearings* pt. 1, at 134.

that substantial economies of size exist in the investment company industry, reflecting the fact that management of a small security portfolio requires much the same general economic and market forecasting and much the same security analysis as does management of a large portfolio.[30] Indeed, increases in fund size need not even result in an increase in the number of different securities in its portfolio. Most investment advisers, however, are not sharing these economies of size with the funds and their shareholders.

The industry's choice of statistics in attempting to show that management fees are reasonable and that profits are modest is revealing. By placing management fees "in the proper perspective of their cost to the [individual] investor"[31] and by presenting advisers' profits in relation to the total assets of the mutual funds,[32] the industry spokesmen are utilizing the so-called "shell theory"[33] to obscure the effect of the current rate structure.[34]

The SEC and Wharton Studies concluded not only that advisory rates paid by externally-managed mutual funds are inflexible and unrelated to costs, but also that in other areas of investment management, where the forces of competition are able to operate, advisory fees are more responsive to economies of size.[35] Three

30 SEC REPORT 94-95; WHARTON REPORT 503. Prof. Richard Jennings agrees that economies of scale clearly operate in this area, but he refuses to go so far as does Judge Moore in Brown v. Bullock, 294 F.2d 415 (2d Cir. 1961) stating that "(I)t costs no more in research effort to buy 100 shares of stock than 10 shares." *1967 House Hearings* pt. 2, at 634.

31 *1967 Senate Hearings* pt. 1, at 192.

32 *1967 House Hearings* pt. 1, at 240-241.

33 In an externally managed mutual fund, a fee is negotiated between the mutual funds directors and the external investment advisers. One theory would hold that the fund's directors owe a fiduciary duty to the fund's shareholders to minimize the advisory fee — to deal at arm's length with the advisers. However, "within the mutual fund industry, the view is widely held that the mutual fund corporation is merely a shell, and that the advisory contract is actually negotiated between the investment adviser and the fund shareholders when the fund shares are purchased. . . . It is contended, therefore, that the fairness of the advisers' fee is not a question for the directors." *1967 House Hearings* pt. 2, at 635 (testimony of Prof. Richard Jennings); *see also 1967 Senate Hearings* pt. 2, at 1197-98 (noting the inconsistency between the shell theory and the existence of effective independent fund directors).

34 Prof. Henry Wallich notes the differences between the data presented by the SEC and by the industry spokesmen: "The difference here is partly one of presentation of statistics, partly of proper choice of comparisons, partly even of semantics. In my view, the Commission's way of summarizing the complex facts is substantially right in terms of what it is proper to compare and what data to use." *1967 House Hearings* pt. 2, at 582.

35 "(A)dvisory fee rates charged open-end companies by investment advisers are

examples are available. First, fees charged by banks for investment management services to pension and profit-sharing plans for a $100 million portfolio are only 0.06 percent of total asset value. While there are some differences in services or costs which may justify a lower rate, neither of these factors nor any possible differences in performance can adequately explain the disparity between 0.06 percent and the rates levied on open-end investment companies, which are eight times the typical fee for pension and profit-sharing plans.[36] The industry response to these figures is that a comparison with the fees charged by banks to pension and profit-sharing plans is prejudicial because banks may handle these as "loss leaders"[37] or because, unlike the investment adviser, a bank has many other potential sources of income.[38]

Second, the studies found that advisory fee rates charged to externally managed investment companies operated for banks as well as advisory rates charged to nonfund clients are substantially lower than the rates paid by mutual funds for comparable asset levels. Indeed, the very same investment adviser may charge a nonfund client a significantly lower and more flexible rate than a fund client with a larger portfolio, despite the fact that advisers who manage both fund and nonfund clients tend to have "sharply higher" operating costs per dollar of assets managed than advisers managing only mutual fund assets.[39]

Third, a comparison between the management costs of externally managed and internally managed mutual funds appears to confirm the SEC's conclusion that differences in functions or services cannot wholly account for the relatively high fees charged

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both significantly higher and significantly less responsive to changes in the volume of assets supervised than is the case with other client assets managed by these advisers or with open-end company assets managed internally by boards of directors or trustees." WHARTON REPORT 491; *see* SEC REPORT 102-21.

36 SEC REPORT 115; *1967 Senate Hearings* pt. 1, at 16.

37 Note, *Management Compensation: The SEC Mutual Funds Report*, 3 COLUM. J. OF LAW & SOC. PROB. 66, 78 (1967).

38 *1967 House Hearings* pt. 2, at 780 (statement of Bache & Co., Inc.).

39 SEC REPORT 118-21; WHARTON REPORT 28, 492-95. Lobell considers such findings irrelevant since such alternatives as private management are not open to the small mutual fund investor with $5,000 or $10,000. Lobell, *A Critique of the Wharton School Report on Mutual Funds*, *supra* note 15, at 37-40. But Lobell does not come to grips with the question why the fund is paying a higher advisory fee than other individual or aggregate clients despite the relatively low costs involved. *See* Herman, *supra* note 15, at 954.

by investment advisers to externally managed funds. Both the Wharton Report and the SEC Report found that the expense and management cost ratios of internally managed funds are substantially lower than those of the externally managed mutual funds although both types of funds perform the same functions.[40] Indeed, in a memorandum at the conclusion of the Senate hearings the SEC states:

> It strikes us as highly significant that large *internally-managed* mutual funds such as MIT and members of the Broad Street group of funds have advisory expenses which, as a percentage of their assets, is *less than one half* the expense ratio of almost all externally-managed funds.[41]

The SEC concludes that the disparity between the expense ratios is primarily due to differences in charges for management services.[42]

Industry's response to this internally-externally managed comparison is twofold. First, the industry denies that the expense ratios of internally managed funds, other than MIT which is a "historical anomaly," (of over two billion dollars in assets),[43] are significantly lower than the expense ratios of comparable externally managed funds.[44] Second, the industry presents its study of executive compensation in advisory organizations of externally managed investment companies which shows that the salaries, plus company contributions to retirement or profit-sharing plans, of top executives of mutual fund advisory organizations are on average considerably less than executive compensation in other industries.[45] Neither of these responses, however, seems entitled

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40 SEC REPORT 102-11; WHARTON REPORT 491. Neither can these differences be explained by better quality of service, *i.e.*, performance. *Id.* at 494.

41 *1967 Senate Hearings* pt. 2, at 1194.

42 SEC REPORT 110.

43 *1969 House Hearings* pt. 2, at 878.

44 *See 1967 House Hearings* pt. 1, at 274 (letter of Robert L. Augenblick); *1967 Senate Hearings* pt. 1, at 219, 283-85 (testimony and letter of Francis S. Williams). In 1969, MIT converted to external management along with Massachusetts Investors Growth Stock Fund. Together these two funds, which have interlocking directorships, possessed in 1968 net assets of over $3.6 billion. The largest internally managed fund today is National Investors with assets of only $772 million. The management expense ratio for National Investors was 0.17 percent in 1968, well below the median 0.59 for externally managed funds. *1969 House Hearings* pt. 2, at 878, 880.

45 *1967 Senate Hearings* pt. 1, at 327-28.

to much weight. Not one of the industry spokesmen ever explains why MIT is able to offer the investor comparable services at a much lower cost, even while paying an average of almost $450,000 to each of its five trustees for the year 1966.[46] Furthermore, while salaries of the executives of externally managed funds may well be relatively modest, these salaries give only a partial indication of the benefits these managers-advisers actually receive from the fund. For example, in 1964 The Dreyfus Corporation (owned by only eleven stockholders) paid only $198,000 as direct compensation to officers and realized a net pre-tax profit of $2,520,000. In 1965, its owners sold 88.1 percent of the stock of the advisory corporation to the public realizing, at capital gains rates, over $41 million.[47] Thus the industry argument, based solely on salary, is incomplete.

That advisory fee rates charged externally managed mutual funds have not been significantly reduced despite phenomenal growth in the size of assets managed, and that both internally managed mutual funds and nonfund clients of comparable size pay significantly less for advisory services compels the conclusion that excessive advisory fees are paid by mutual funds to external advisers. One additional fact not mentioned either in the Wharton and SEC Reports or in the Senate Hearings but raised briefly in the House Hearings is important to note. Some external advisers, while charging the fund a typical advisory rate, contract with other advisory organizations to provide research and investment advice at significantly lower and more flexible rates.[48] That subadvisers can provide substantially equivalent services at a far lower rate supports the conclusion that effective competition or regulation would reduce advisory fees.

Even if advisory fees charged to externally managed mutual funds are above a competitive level, the industry spokesmen nevertheless defend the present rates by citing both the profitable per-

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46 *Id.* pt. 1, at 133.

47 *Id.* pt. 2, at 1196-97.

48 *1967 House Hearings* pt. 1, at 136-39. For example, American Investors Management Corp. charges its fund an advisory fee of 0.50 percent, but then engages Standard & Poor's Corp. as a subadviser for a rate of 0.25 percent first $1,000,000, 0.20 percent next $3,000,000, 0.166 percent next $2,000,000, 0.125 percent next $2,000,000, 0.10 percent excess. *Id.* at 137.

formance of the funds[49] and their own entrepreneurial risks. In contrast, the SEC Report denies that there is a need to assess the merits of the services of the industry beyond the generalization that investment company management has been diligent and competent. The Report chooses instead to focus upon the costs of management.[50] The SEC goes too far when it labels the industry's argument based on performance as "totally irrelevant" to the reasonableness of advisory compensation.[51] Performance as well as cost is relevant when determining reasonableness.[52] Nevertheless, it is difficult to accept a high level of performance as a justification for the present level of fees in view of the Wharton Report's finding that there exists no relationship, either a *positive* or *negative*, between management fee rates and performance.[53] Moreover, some have questioned the relationship between the investment advisers' services and the admirable performance of the mutual funds. Often referred to as the "dart throwing method" or the "random selection method" of selecting an investment portfolio, this theory concludes that the value of investment advice on average is very low or zero.[54] Although more difficult to practice than to accept in theory, this proposition at least points out that one should not quickly dismiss important questions as to the fairness of advisory fees solely because of profitable performance.

With respect to entrepreneurial risk, which the SEC Report similarly mentions only briefly,[55] the promoter-adviser contributes initiative and capital, often assuming substantial organizational

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49 The claim of superior performance is questionable in today's market. For an analysis of the performance of various types of mutual funds for 1969, see *1969 House Hearings* pt. 2, at 921.

50 SEC REPORT 1-2. See Werner, *Protecting the Mutual Fund Investor: The SEC Reports on the SEC*, 68 COLUM. L. REV. 1, 32-34 (1968), for the assertion that this is a major weakness in the SEC Report.

51 *1967 Senate Hearings* pt. 1, at 23.

52 See pp. 341-343 *infra*.

53 WHARTON REPORT 345. If fees are tied to performance, it seems logical that proportionate penalty provisions should be applied when performance is below average. *See* 1968 SENATE COMMITTEE REPORT 44.

54 *1967 Senate Hearings* pt. 2, at 1062 (testimony of Prof. Henry Wallich); *id.* pt. 1, at 369-70 (testimony of Prof. Paul Samuelson). For an interesting and amusing test of the dart throwing method performed by Senator McIntyre see *id.* pt. 2, at 803-06.

55 SEC REPORT 77.

and operating expenses, in return for a minimal fee during the growth period of the fund,[56] and it seems fair, therefore, that some portion of the fee be attributed to promoter profits in determining the reasonableness of the fee of a successful fund. Nevertheless, at some point in time and growth, the entrepreneurial reward will have been reaped. Neither entrepreneurial reward nor profitable performance, standing alone, sufficiently justify the present level of advisory fees being paid by some of the larger mutual funds.

III. The Present Regulatory Requirement

The structure of the investment company industry has evolved within a comprehensive federal statutory context. The Securities Act of 1933[57] is essentially a disclosure statute concerned with the initial distribution of securities. Since most mutual funds constantly make public offerings of their own shares, they are constantly required to deliver a prospectus to each purchaser containing, among other things, a brief description of the basis for determining the remuneration of its investment adviser. The Securities Exchange Act of 1934[58] is concerned primarily with post-distribution trading. Among the provisions of the Exchange Act which bear most directly on the investment company industry are those establishing administrative mechanisms to protect the public from dishonest or irresponsible brokers and dealers. The Investment Advisers Act of 1940[59] requires registration with the SEC of persons who receive compensation for rendering advice or for issuing analyses or reports concerning securities.

The above statutes are concerned primarily with disclosure and the prevention of fraud. The Investment Company Act of 1940 is a more comprehensive regulatory statute.[60] The House Report on the Act stated that "[t]he record is clear that publicity alone is insufficient to eliminate malpractices in investment com-

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56 *See* Modesitt, *supra* note 19, at 1259; Note, *Management Compensation: The SEC Mutual Funds Report, supra* note 37, at 67-69. For this reason, if compulsory internalization of management were to be adopted as some have proposed, some provision must be made for rewarding this entrepreneurial risk.

57 Securities Act of 1933, 15 U.S.C. §§ 77a-aa (1964).

58 Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-jj (1964).

59 Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 *et seq.* (1964).

60 L. Loss, Securities Regulation 144 (2d ed. 1961).

panies."[61] There are several reasons why pure disclosure, standing alone, is ineffective in the area of advisory fees: (1) the annual impact of advisory fees on individual fund shareholders is small; (2) appraisal of the fairness of charges for an entire package of services is far more complex than an appraisal of the reasonableness of individual executive compensation; (3) while disclosure may be effective in preventing a rise in the advisory rates, disclosure will not easily effect a reduction from an industry-wide rate level, and (4) no real choice is available to the investor.[62]

The general policy of the Act is to prevent exploitation of the funds' assets by unscrupulous management and advisers.[63] It contains numerous specific regulatory controls. For instance, in an attempt to prevent management control of the funds, section 10(a) requires that at least 40 percent of the board of directors consist of persons who are neither officers nor employees of the investment company and who are unaffiliated with its investment adviser.[64] Section 13 of the Act requires authorization by a vote of the majority of a fund's shareholders before changing the status and policies of a company as set forth in its registration statement. Section 16(a) requires at least two-thirds of the directors of an investment company to have been elected by the shareholders. Sections 32(a) and (b) require shareholder ratification of the selection of accountants. Section 15 requires initial approval of management contracts by a fund's shareholders. Section 32 requires that financial statements be certified by independent accountants.

In the area of advisory fees, however, the 1940 Act neither prohibits the externalization of management nor expressly limits the amount of compensation paid to the investment adviser.[65] The

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61 H.R. REP. No. 2639, 76th Cong., 3d Sess. 10 (1940).

62 SEC REPORT 127-128.

63 Investment Companies Act of 1940, 15 U.S.C. § 80a-1(b)(2) (1964).

64 See also Investment Company Act of 1940, 15 U.S.C. §§ 80a-10(b)(2), 10(d), § 2(a)(3) (definition of "affiliated person") (1964).

65 SEC REPORT 70; *see* testimony of David Schenker, chief counsel to the Investment Trust Study, *1940 Senate Hearings* 252: "What have we done with respect to management contracts? There is not a single provision in section 15 which even remotely assumes to fix what they should be paid as compensation. . . . We feel that is a question for the stockholders to decide. If they want to pay a man a million dollars to manage the fund and if they know they are paying him a million dollars and if they have the right to approve the payment of a million dollars, the bill says that is perfectly all right."

SEC suggests that, logically, Congress might well have included fund management contracts within the restrictions of Section 17(a), which flatly prohibits substantially all purchases and sales of securities or property between an investment company and its affiliates without a Commission finding of fairness, since both present similar conflicts of interest problems.[66] The Act, however, did not.

Instead, section 36 authorizes the Commission to seek court orders enjoining officers, directors, investment advisers, and principal underwriters of registered investment companies who are "guilty . . . of gross misconduct or gross abuse of trust" from serving in such capacities permanently or for such time as the court deems appropriate. The scope of a director's or an investment adviser's fiduciary duty under section 36 is unclear. Some courts have construed the section broadly as a reservoir of fiduciary obligations imposed upon affiliated persons to prevent them from operating the fund for their own self-interest and personal advantage;[67] and under this view, charging the fund excessive advisory

66 *1967 Senate Hearings* pt. 2, at 1193. Indeed, former SEC chairman Cohen asserts: "I must emphasize again the administrative anomaly that exists at the present time. I refer to section 17 of the Investment Company Act. Under that provision, if a director or manager wants to sell 10 shares of General Motors stock to the fund, he is prohibited from doing so, because of his conflict of interest. He has to file an application with the Commission . . . [which] make[s] findings that the price is fair, reasonable, there is no overreaching . . . But here [in the area of advisory fees] we have a situation of built-in conflict of interest . . . and the Congress thought that certain elementary safeguards built into the statute, now contained in section 15, would take care of it." *1967 House Hearings* pt. 1, at 133.

67 Brown v. Bullock, 194 F. Supp. 207, 238-40 (S.D.N.Y. 1961), *aff'd en banc*, 294 F.2d 415 (2d Cir. 1961) (an action by a shareholder); *accord*, Aldred Inv. Trust v. SEC, 151 F.2d 254 (1st Cir. 1945), *cert. denied*, 326 U.S. 795 (1946); *see* SEC REPORT 142; Eisenberg and Lehr, *An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under the Investment Company Act of 1940*, 20 RUT. L. REV. 181, 183, 225, 264-67 (1966) who believe that section 36, in conjunction with sections 10 and 15, provides the Commission [and fund shareholders, *see* IV *infra*] with an important instrument for challenging unfair advisory contracts as a breach of fiduciary duties. *But see* SEC v. Insurance Securities Inc., 254 F.2d 642 (9th Cir. 1958), *cert. denied*, 358 U.S. 823 (1958); SEC v. Midwest Technical Dev. Corp., CCH Fed. Sec. L. Rep. § 91252 (D. Minn. July 5, 1963); Jaretzki, *Duties and Responsibilities of Directors of Mutual Funds*, 29 LAW & CONTEMP. PROB. 777 (1964), who equates the duties and responsibilities of mutual fund directors with those of directors of ordinary business corporations and who rejects the existence of a fiduciary duty owing by the adviser to the fund; Lobell, *Rights and Responsibilities in the Mutual Fund*, 70 YALE L.J. 1258, 1263-72, 1282-83, 1294 (1961) who emphasizes that the director must not substitute himself for the shareholder, who purchased with full disclosure shares of that particular fund to secure the services of that

fees clearly is covered by section 36.[68] Although the SEC supports such a construction, it has been unwilling to utilize section 36 in its present form in the area of excessive advisory fees:

> Pending consideration by the Commission and Congress of more appropriate means for achieving more adequate controls over investment company management compensation, the Commission has been reluctant to stigmatize advisers with charges of "gross abuse of trust" solely because they have adhered to the traditional pattern of fee rates in the industry.[69]

Thus the SEC has placed the problem squarely in the lap of Congress.

Section 15 of the Investment Company Act provides for shareholder ratification and unaffiliated director approval of advisory contracts as regulatory substitutes for competitive forces. Section 15(a) declares it unlawful for anyone to act as an investment adviser unless pursuant to a written contract in which the adviser's compensation thereunder is precisely described. The holders of the majority of the fund's outstanding securities must approve the contract annually. Termination will automatically occur upon assignment by the adviser, or it may be effectuated by either the board of directors or a majority of the outstanding securities.

Shareholder ratification, however, seems to be peculiarly ineffective as a safeguard in the area of advisory fees[70] because, in

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fund's particular management company; *see also*, Eisenberg and Phillips, *Mutual Fund Litigation—New Frontiers for the Investment Company Act*, 62 COLUM. L. REV. 73 (1962); Greene, *Fiduciary Standards of Conduct Under the Investment Company Act of 1940*, 28 GEO. WASH. L. REV. 266 (1959); Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds*, 115 U. PENN. L. REV. 1058 (1967); Note, *Rights and Obligation in the Mutual Fund: A Source of Law*, 20 VAND. L. REV. 1120 (1967).

68 Amendments currently pending to section 36 strain this interpretation. See pp. 350-351 *infra*.

69 SEC REPORT 143; *accord*, Wymeersch, *Some Aspects of Management Fees of Mutual Funds*, 17 BUFF. L. REV. 747, 787 (1968). *But see* Werner, *supra* note 50, 1, 29-30 (1968) who concludes both that the SEC's demands for more specific controls over advisory compensation are inappropriate in light of the flexibility required to deal with complex financial practices, and that the SEC itself has reduced the 1940 Act to a few elementary safeguards by not using the powers it has in this area. "[T]he SEC, by its conduct and its interpretation of the Act, has converted into a dead letter what should have been the core of the act." *Id.* at 42. For a discussion of shareholder actions under both the Investment Company Act and state law challenging the present level of advisory fees see pt. IV *infra*.

70 SEC REPORT 128-30; WHARTON REPORT 53-57.

practice, shareholder ratification can be had for the asking.[71] Management has full control of proxy machinery. Dissatisfied shareholders can redeem more easily and less expensively than fight. Shareholders have no other choice than approve or be faced with the specter of no management at all.[72]

Section 15 clearly contemplates that unaffiliated directors of a mutual fund would also play an important role in preventing overreaching by management in the area of advisory contracts. Nevertheless, the Wharton Report suggested that unaffiliated directors in reality are of "restricted value,"[73] and the SEC Report called this a "wholly unrealistic alternative" to competition.[74] The ineffectiveness of unaffiliated directors in the area of advisory fees usually is attributed to three principal factors: (1) the dependence of unaffiliated directors upon the affiliated directors;[75] (2) the lack of time attributed to and lack of compensation received for their directorial duties, as well as the lack of information they are given by the affiliated directors;[76] and (3) their inability freely to terminate, or even to threaten to terminate, the advisory contract and to contract with other parties for the same services.[77]

Investment advisers, but for effective regulatory controls or a

71 *1967 Senate Hearings* pt. 1, at 112; *Conference on Mutual Funds, supra* note 20, at 740. In Saxe v. Brady, 40 Del. Ch. 474, 184 A.2d 602 (1962), 99.1 percent of the shareholders' votes cast were in favor of their adviser. *See generally* Lobell, *A Critique of the Wharton School Report on Mutual Funds, supra* note 15, referring to a Study on Knowledge and Attitudes Towards Mutual Funds wherein 93 percent of the persons interviewed said they were "satisfied" with their mutual fund investment.

72 *1967 Senate Hearings* pt. 1, at 19-20; *1967 House Hearings* pt. 1, at 41-42; WHARTON REPORT 34, 64. The shareholder vote is similar to an election in the Soviet Union — there is only one candidate for office.

73 WHARTON REPORT 34.

74 SEC REPORT 131. Manuel Cohen testified at the 1967 Senate Hearings that in his 25-odd years in associating with the mutual funds he never once heard of the unaffiliated directors ousting, or even trying to oust, management. *1967 Senate Hearings* pt. 1, at 81. Indeed, the SEC concluded at the end of the 1967 Senate Hearings that, on balance, approval of the advisory contract by the unaffiliated directors has the net effect of further *insulating* the adviser by creating the appearance of an independent "watch-dog" over the affiliated directors. *Id.* pt. 2, at 1200.

75 "Because if you really want to have a watchdog watch a man, you don't have the man select the watchdog." Testimony of Abraham Pomerantz, *1967 Senate Hearings* pt. 2, at 691.

76 SEC REPORT 130; Jaretzki, *supra* note 67, at 792-94.

77 SEC REPORT 131; *1967 House Hearings* pt. 1, at 41.

new judicial activism in this area, are in the enviable position of being able to decide for themselves whether and to what extent to share with the fund shareholders the substantial economies of size flowing from the dramatic growth of the mutual fund industry.

IV. Judicial Reluctance

Although collectively shareholders have been unable to achieve a reduction in advisory fees by threatening to terminate the management contract,[78] some fund shareholders, agreeing with the SEC that management compensation is too high, have resorted to the courts. More than fifty lawsuits have been brought alleging, principally, that the largest mutual funds have been paying grossly excessive advisory fees.[79] Most of these actions have been derivative in nature,[80] and have been based on state corporate and fiduciary concepts as well as on the Investment Company Act.[81] Thus far, however, this shareholder attack on the existing level of advisory fees has been relatively ineffective.[82] Three cases which have been fully litigated, two of which involved a flat 0.50 percent fee, have all held that the fees were not excessive.[83] Consequently, plaintiffs are under a great deal of pressure to accept any offers of settlement. Typically these settlements incorporate only moderate scale-downs on fee schedules.

The landmark case is *Saxe v. Brady*,[84] in which a shareholder of

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78 *See* pp. 323-324 *supra.*

79 SEC Report 132.

80 The courts have held that mutual fund shareholders may institute derivative suits. Saminsky v. Abbott, 40 Del. Ch. 528, 185 A.2d 765 (1961), *settlement approved,* 41 Del. Ch. 320, 194 A.2d 549 (1963), *aff'd sub nom.,* Kleinman v. Saminsky, 41 Del. Ch. 572, 200 A.2d 572, *cert. denied,* 379 U.S. 900 (1964); Taussig v. Wellington Fund, Inc., 187 F. Supp. 179 (D. Del. 1960), *aff'd,* 313 F.2d 472 (3d Cir. 1963), *cert. denied,* 374 U.S. 806 (1963).

81 *See, e.g.,* Rome v. Archer, 41 Del. Ch. 404, 197 A.2d 49 (1964); Acampora v. Birkland, 220 F. Supp. 527 (D. Colo. 1963); Saminsky v. Abbott, 40 Del. Ch. 528, 185 A.2d 765 (1961), *settlement approved,* 41 Del. Ch. 320, 194 A.2d 549 (1963), *aff'd sub nom.,* Kleinman v. Saminsky, 41 Del. Ch. 572, 200 A.2d 572, *cert. denied,* 379 U.S. 900 (1964).

82 *See* SEC Report 132-43.

83 Acampora v. Birkland, 220 F. Supp. 527 (D. Colo. 1963) (0.50 percent rate); Saxe v. Brady, 40 Del. Ch. 474, 184 A.2d 602 (1962) (0.50 percent rate); Meiselman v. Eberstadt, 39 Del. Ch. 563, 170 A.2d 720 (1961) (0.50 percent up to $75 million, 0.375 percent for $75 to $125 million, 0.25 percent for excess).

84 Saxe v. Brady, 40 Del. Ch. 474, 184 A.2d 602 (1962).

Fundamental Investors, Inc. brought a derivative action in the Delaware court against the fund's directors and adviser charging that the fees paid to the investment adviser at an annual rate of 0.50 percent of average daily net assets were "unreasonable, excessive, and an illegal waste and spoliation of the fund's assets."[85] The court, *per* Chancellor Seitz, stated the test applicable to shareholder ratification cases:

> When the stockholders ratify a transaction, the interested parties are relieved of the burden of proving the fairness of the transaction. The burden then falls on the objecting stockholders to convince the court that no person of ordinary, sound business judgment would be expected to entertain the view that the consideration was a fair exchange for the value which was given . . . If it can be said that ordinary businessmen might differ on the sufficiency of the terms, then the court must validate the transaction."[86]

The *Saxe* court held, therefore, that shareholder ratification not only shifts the burden of proof from defendants to plaintiffs, but also changes the applicable standard from fairness to waste. This was clearly confirmed the following year when the court in *Acampora v. Birkland*[87] restated the *Saxe* test of excessiveness in terms of "shocking" or "unconscionable" fees.[88]

The practical significance of this "waste" or "unconscionable" test is only to add to the stability of the current rates by erecting a very substantial barrier to a victory by plaintiffs. Where waste of corporate assets is alleged, the court:

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85 *Id.* at 476, 184 A.2d at 604.

86 *Id.* at 486, 184 A.2d at 610.

87 220 F. Supp. 527, 528 (D. Colo. 1963).

88 Acampora v. Birkland, 220 F. Supp. 527, 548 (D. Colo. 1963). Looking back, Eisenberg and Lehr call *Saxe* the "turning point in fund shareholder litigation." Eisenberg and Lehr, *supra* note 67, at 207. It should be noted that although *Saxe* did not involve allegations under the Investment Company Act, the *Saxe* test and reasoning has been explicitly held to apply to excessive fee actions involving allegations under the Investment Company Act. Rome v. Archer, 41 Del. Ch. 404, 410, 197 A.2d 49, 55 (1964); *see* Acampora v. Birkland, 220 F. Supp. 527 (D. Colo. 1963); Saminsky v. Abbott, 41 Del. Ch. 320, 194 A.2d 549 (1963) (settlement approved), *aff'd sub nom.*, Kleinman v. Saminsky, 41 Del. Ch. 572, 200 A.2d 573, *cert. denied*, 379 U.S. 900 (1964).

The *Saxe* court applied the rule for shareholder ratification in excessive compensation cases as formulated in Rogers v. Hill, 60 F.2d 109 (2d Cir. 1932), *rev'd*, 289 U.S. 582 (1933). For analyses of executive compensation case law and differences among

> is limited solely to discovering whether what the corporation has received is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid. If it can be said that ordinary businessmen might differ on the sufficiency of the terms, then the court must validate the transaction.[89]

But, as Chancellor Seitz himself points out, in view of the fact that a flat 0.50 percent rate is not uncommon but has prevailed throughout the entire mutual fund industry, a court is unlikely to find that this rate is not "commercially realistic" and that *all* the funds of comparable size are wasting their assets.[90] Moreover, how likely is it that a court will find that the fund has received services "so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid" when the court in *Acampora* recognizes that "it is impossible to evaluate the service rendered" by management and where millions of shares of various funds have thus been sold?[91] The application of a business judgment rule to advisory fees comes close to precluding a finding that the fees are unconscionable and constitute waste.[92]

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state courts see Wymeersch, *supra* note 69, at 764-71; Eisenberg and Lehr, *supra* note 67, at 216-24, 238-47. For an interesting but brief review of the standards applied by the courts to shareholder suits alleging excessive compensation prepared for the Investment Company Institute see *1967 Senate Hearings* pt. 1, at 323-27.

89 40 Del. Ch. at 486, 184 A.2d at 610.

90 40 Del. Ch. at 489, 184 A.2d at 611-12.

91 220 F. Supp. at 549. The difficulty of evaluating the services rendered rests in part on the fact that the charge for a professional's services is based on many factors in addition to time spent, Meiselman v. Eberstadt, 39 Del. Ch. 563, 565, 170 A.2d 720, 722 (1961), and in part on the fact that mutual fund advisers are entitled to entrepreneurial profits over and above management compensation. *Cf.* Saxe v. Brady, 40 Del. Ch. at 489, 495, 184 A.2d at 612, 615-16; Krieger v. Anderson, 40 Del. Ch. 363, 182 A.2d 907 (1962). Jaretzki notes not only that there is wide latitude for difference of opinion as to the relative competency of management, but also that directors are not required to insist upon the cheapest fee just as one does not insist on having the cheapest lawyer, physician, or other professional. Jaretzki, *supra* note 67, at 786.

92 "Although not an impossible burden, it [*Saxe v. Brady* test] is manifestly a heavy one. Most importantly, it will almost invariably be the applicable standard since overwhelming shareholder ratification of contracts with investment advisers may be had for the asking." Statement of Prof. Ernest L. Folk III, *1967 Senate Hearings* pt. 2, at 1002. Prof. Folk points out that the "business judgment test," originally meant to be applied in duty of care questions to immunize directors acting without any conflict of interests from liability, has recently been applied beyond its original contours to uphold transactions in which conflicts of interest

While the above decisions explain why plaintiffs alleging payments of excessive management fees appear unlikely to win on the merits and why courts have uniformly allowed plaintiffs to accept moderate settlements despite objections by some shareholders,[93] certain of these decisions have also generated pressure on the defendants to settle. In *Saminsky v. Abbott*,[94] Chancellor Seitz rejected the defendants' argument that the redemption privilege should be the remedy for dissatisfied shareholders and held that excessive advisory fees could be challenged in court under the doctrine of *Rogers v. Hill*.[95] Furthermore, Chancellor Seitz stated in *Saxe v. Brady*:

> It is also inherent in the "percentage-of assets" approach that at some point the relationship between admittedly reasonable expenses and net profits can become so disproportionate as to be shocking by any pertinent standard. . .
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> * * * * * *
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> Based on the 1959 and 1960 figures the profits are reaching the point where they are outstripping any reasonable relationship to expenses and effort *even in a legal sense*.[96]

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inhered. *Id.* pt. 2, at 1003; *see* Warshaw v. Calhoun, 221 A.2d 487 (Del. Sup. Ct. 1966); Case v. New York Central R.R., 15 N.Y.2d 150, 256 N.Y.S.2d 607 (1965); *cf.* Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (Del. Sup. Ct. 1964).

93 *E.g.*, Elster v. Dreyfus, CCH FED. SEC. L. REP. § 91,914 (N.Y. Sup. Ct. Mar. 3, 1967); Glicken v. Bradford, 35 F.R.D. 144 (S.D.N.Y. 1964); Rome v. Archer, 41 Del. Ch. 404, 197 A.2d 49 (1964); Saminsky v. Abbott, 41 Del. Ch. 320, 194 A.2d 549 (1963), *aff'd sub nom.*, Kleiman v. Saminski, 41 Del. Ch. 572, 200 A.2d 572, *cert. denied*, 379 U.S. 900 (1964). *But cf.* Norman v. McKee, 290 F. Supp. 29 (N.D. Cal. 1968), wherein the court refused to approve the proposed settlement as fair and reasonable because the proposed settlement would not confer significant benefits on present investors or on investors at the time of the alleged wrongdoings, and because it did not confer any significant benefit not already obtained by the Commission in an administrative proceeding. *See* 34 SEC ANN. REP. 121 (1968).

Shareholder approval is a "double edged" sword: first, in view of the effect given ratification by *Saxe* and *Acampora* the courts view almost any settlement as being more favorable than the likely adverse judgement on the merits; and second, "[W]here shareholders subsequently ratified all the actions under attack, such ratification was viewed as indication of the reasonableness of the settlement." SEC Report 140-41, 154; *see also* Eisenberg and Lehr, *supra* note 67, at 207 and n.88.

94 Saminsky v. Abbott, 40 Del. Ch. 528, 538, 185 A.2d 765, 771-72 (1961), *settlement approved*, 41 Del. Ch. 320, 194 A.2d 549 (1963), *aff'd sub nom.*, Kleinman v. Saminsky, 41 Del. Ch. 572, 200 A.2d 572, *cert. denied*, 379 U.S. 900 (1964).

95 Saminsky v. Abbott, 40 Del. Ch. 528, 538, 185 A.2d 765, 771-72 (1961), *settlement approved*, 41 Del. Ch. 320, 194 A.2d 549 (1963), *aff'd sub nom.*, Kleinman v. Saminsky, 41 Del. Ch. 572, 200 A.2d 572, *cert. denied*, 379 U.S. 900 (1964); Rogers v. Hill, 60 F.2d 109 (2d Cir. 1932), *rev'd*, 289 U.S. 582 (1933).

96 40 Del. Ch. at 496, 498, 184 A.2d 615-16 (emphasis added).

Similarly, the court stated in *Acampora v. Birkland* that the amount of advisory fees seemed high, although not legally excessive:

> Certainly the one-half of one per cent approach leaves a great deal to be desired . . . Such a guaranteed fee fails to take into account success or failure of the advisory effort. Still another bad feature is that its probable increase is disproportionate to the value of the services rendered.[97]

Thus, litigation has imposed some pressure upon management to offer moderate settlements rather than to risk a capricious court finding that their fee had crossed the shadowy line separating lawful fees from excessive fees (especially where the moderate scale-down in fees will be more than offset by the rapid growth of the fund's assets), while at the same time litigation has generated great pressure on plaintiffs to accept, and on courts to approve, these settlements in view of the likelihood of an adverse judgment under the waste standard.[98]

The SEC, both in its Report and at the 1967 Senate and House Hearings, points out the irony apparent from an examination of what has happened to fund shareholders in the courts:

> Thus, the Congressional requirement of approval by the shareholders and a majority of the unaffiliated directors, which was intended to act as a *protection for the shareholders*, has not only failed to work in the way in which it was intended but has actually insulated the fees from judicial scrutiny and *deprived the shareholders of judicial protections which they would otherwise have enjoyed.*[99]

The interaction of the 1940 Act's requirement of disclosure and ratification along with the effect given to ratification by most state courts has shielded the fees from judicial inquiry into their reasonableness, and has prevented judicial intervention unless the fees

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97 220 F. Supp. at 548-49.

98 SEC REPORT 138-39. As Judge Friendly points out, plaintiff's counsel in a derivative action will be under considerable pressure to accept a settlement. "[B]ecause a bird in the hand is considerably more valuable than one in the bush, and there is also the law of diminishing returns." *1967 House Hearings* pt. 2, at 614-15; *see* SEC REPORT 139-171.

99 *1967 House Hearings* pt. 1, at 43; *see* SEC REPORT 141-43; *1967 Senate Hearings* pt. 1, at 21.

can be found to be "wasteful," "unconscionable," or "shocking." Chancellor Seitz suggests that such a "shield" is not altogether unwelcome from the point of view of the courts, who otherwise would be obligated to make complex judgments in determining whether the fees are "reasonable" or "excessive."[100]

Although judicial examination of advisory fees has not to date acted as an effective substitute for competition or for arm's-length bargaining induced by statutory regulation, some commentators suggest the possibility of an end run around the firmly entrenched *Saxe* test of waste. One alternative which, it is suggested, would leave the fairness standard intact despite shareholder ratification and director approval is to view the fund-adviser relationship as one between a trust and a fiduciary or as one between corporations with interlocking directorships.[101] However, this proposed analogy to conflict of loyalty cases seems to disregard the advent of state statutes specifically validating transactions involving conflicts of interests if shareholders ratify after full disclosure or if a majority of the disinterested directors approve the transaction "in good faith" or if the transaction is found to be fair to the corporation as of the time it is made.[102] Since the transaction is substantially immunized if any *one* of these conditions is met, this analogy to the law applied in conflicts of loyalty cases is not likely to be fruitful.[103]

In marked contrast, a second alternative has been optimistically proposed as a way to avoid the effect given to ratification by state law. This alternative suggests the use of section 36 of the Investment Company Act to create federal substantive standards incor-

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100 Saxe v. Brady, 40 Del. Ch. at 486, 184 A.2d at 610.

101 Wymeersch, *supra* note 69, at 756-64, 771-77, 785-87.

102 *E.g.*, DEL. GEN. CORP. LAW § 144(a) (1967).

103 A similar proposal contends that the directors of a fund have divested both the fund and its shareholders of a valuable corporate opportunity by contracting with an affiliated adviser rather than internalizing management. *E.g.*, Complaint at 18, 20-21, Gardner v. Morgan, Civil No. 32834 (E.D. Pa., Feb. 11, 1963) (Wellington Fund, Inc.); *see* Amended Complaint at 17-18, Archer v. Morgan, Civil No. 1311 (Del. Ch., Jan. 7, 1963).

"The doctrine of [diversion of] corporate opportunity is a significant aspect of the general rule requiring the undivided loyalty of fiduciaries to their corporation." Note, *Mutual Funds and the Investment Advisory Contract*, 50 VA. L. REV. 141, 167 (1964) which questions the application of this doctrine to mutual fund advisory fund contracts. *Id.* at 168; *cf.* note 110 *infra*.

porating, supporting, and supplementing the duties of directors as specified by state law and by sections 10 and 15 of the Act.[104] This alternative runs afoul of precedents such as *Rome v. Archer* which stated that "the same considerations found relevant in *Saxe* would probably also be relevant in litigation considering the Investment Company Act of 1940.[105] However, Eisenberg and Lehr argue that it is "well settled that violations of a federal statute cannot be ratified . . . Under this approach, a court — upon finding of a section 36 violation — would disregard as irrelevant the act of ratification."[106] Thus, Eisenberg and Lehr seek to draw into the 1940 Act the fiduciary standards of state common law but not the effect given to ratification by the state courts. However, they concede that the content of this body of law "remains to be formulated."[107]

A third approach is in the process of being tested. The complaint in *Kauffman v. The Dreyfus Fund, Inc.* alleges, *inter alia,* that a multitude of the externally managed mutual funds have entered into an unlawful combination and conspiracy to unreasonably restrain trade in violation of the antitrust laws by (1) adopting grossly excessive fees unrelated to services performed by advisers or to the performance of the funds' portfolios, (2) maintaining and stabilizing prices for services performed by investment advisers by adherence to schedules of inordinate fees, (3) refraining from competing for the business of externally managed funds or the business of investment advisers, (4) refraining from encouraging the funds to purvey internal advisory or management services, and (5) otherwise fixing prices in and monopolizing the management market.[108]

Despite the possibility of one of the above judicial alternatives being adopted, there is no sign that the courts are shifting away from the waste doctrine, which has precluded effective judicial examination of the present level of advisory fees. Absent Congres-

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104 Eisenberg and Lehr, *supra* note 67, at 183, 264-67; *see* Werner, *supra* note 50, at 21-23, 37-42.

105 Rome v. Archer, 41 Del. Ch. 404, 410, 197 A.2d 49, 55 (1964); *see* note 88 *supra*.

106 Eisenberg and Lehr, *supra* note 67, at 216-17.

107 *Id.* at 183.

108 Kauffman v. The Dreyfus Fund, Inc., No. 1348-68 (D.N.J. Dec., 1968); *see* CCH FED. SEC. L. REP., Jan. 2, 1969.

sional action, such as is now pending, the possibility of avoiding the effect of ratification as well as director approval seems remote. Indeed, even before the Commission's legislative proposals were set forth in its Report in December, 1966, and incorporated into legislation in 1967, the courts suggested that the problem of advisory fees results from an industry-wide pattern of external management which calls for legislative rather than judicial action.[109] Of the present fee structure the *Saxe* court declared, "If the fund-management company format is to be legally questioned, such inquiry must come from some other place."[110]

The SEC Report, moreover, apparently has reinforced this judicial disinclination to begin "an excursion into a judicial 'never-never' land."[111] The court in *Elster v. Dreyfus*, [112] approving a settlement order in an action charging that the adviser of Dreyfus Fund Inc. had received excessive advisory fees, first found full disclosure followed by overwhelming ratification, then applied the *Saxe* test that the plaintiff must therefore prove waste of corporate assets, and finally relied in part upon the SEC Report's conclusions that a plaintiff's chances of obtaining a favorable result under this standard are unlikely and therefore the most modest of settlements seems preferable to a trial.[113]

The effect of the SEC Report on the reluctance of courts to overturn or evade established judicial precedents in the area of advisory fees is twofold: (1) courts seemingly will readily approve very modest settlements in the most egregious cases because of the Report's conclusion that plaintiffs have little chance of success at trial under the waste standard; and (2) the fact that the Commission proposed specific legislative recommendations presently being considered by Congress will weigh heavily with judges who have previously indicated that the fee problem requires a legislative rather than a judicial solution. Therefore, an inquiry into legislative action is now appropriate.

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109 *See 1967 Senate Hearings* pt. 1, at 21.

110 40 Del. Ch. at 497, 184 A.2d at 616. *See also* Saminsky v. Abbott, 41 Del. Ch. at 323, 194 A.2d at 552 (settlement approved); Glicken v. Bradford, 35 F.R.D. 144, 159 (S.D.N.Y. 1964): "[I]t is quite conceivable that a court or jury would find that what plaintiffs were really challenging was the Fund System as a whole . . ."

111 Saminsky v. Abbott, 41 Del. Ch. at 322, 194 A.2d at 551 (settlement approved).

112 Elster v. Dreyfus, CCH FED. SEC. L. REP. § 91,914 (N.Y. Sup. Ct. March 3, 1967).

113. *Id.* at § 91,914.

V. LEGISLATIVE HISTORY

The SEC included specific legislative recommendations in its 1966 Report, based upon the findings of the Wharton Report in 1962 and the Special Study of Securities Markets in 1963.[114] Legislation to implement the SEC recommendations was introduced into both Houses of Congress on May 1, 1967.[115] The legislation included an explicit requirement that compensation received by investment advisers be "reasonable" and provided for judicial enforcement of that standard.[116]

Section 8 of the Senate bill (S. 1659) would have amended section 15 of the 1940 Act by adding a new section 15(d) to provide expressly that all compensation for services to a registered investment company received by any investment adviser, officer, director, and controlling person of or principal underwriter for such a company must be reasonable. Section 15(d)(2) would have required that reasonableness be determined in light of all appropriate and material factors, including, specifically, the nature and extent of the services provided, the quality of the services provided, the extent to which the compensation of the adviser takes into account economies of scale, and all benefits other than compensation directly or indirectly received by the investment adviser by virtue of its relationship to the company. In an action attacking the reasonableness of managerial compensation, the burden of proof would have been on the complaining party, and, in any event, liability would have been limited to only the recipients of unreasonable compensation, and only for the unreasonable portion of the compensation actually received by them. Proposed section 15(d)(4) would have established a two-year statute of limitations in all 15(d) cases, and section 15(d)(6) would have provided that no person would be liable to criminal prosecution or disqualification from participation in the investment company industry solely because his compensation was found to be unreasonable.

Extensive hearings were conducted on S. 1659 before the Senate Committee on Banking and Currency during July and August

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114 H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963).

115 S. 1659, 90th Cong., 1st Sess. (1967); H.R. 9510 and H.R. 9511, 90th Cong., 1st Sess. (1967).

116 S. 1659, 90th Cong., 1st Sess. § 8 (1967).

1967 and on H.R. 9510 and H.R. 9511 before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce of the House of Representatives during October 1967. In addition, the Commission and representatives of the mutual fund industry discussed revision of certain of the proposals in an attempt to find a satisfactory solution to some of the industry's objections.[117] As a result of these Hearings and other discussions, the proposed "Investment Company Amendments Act of 1968," (S. 3724),[118] reported out of the Senate Committee on July 1, 1968, represented a weakened compromise version of its 1967 counterpart.[119] The proposed regulation of advisory fees underwent significant changes.[120] The Senate Committee adopted the fundamental suggestion that the statute contain an express requirement that advisory fees be reasonable:

> Under the general rule of law, advisory contracts which are ratified by the shareholders or approved by a vote of the disinterested directors may not be upset in the courts except upon a showing of "corporate waste." The fee must "shock the conscience of the court." Such a rule may not be an undue one when the protection of competition and hard bargaining is effective. But in the mutual fund industry where these marketplace forces do not operate as effectively, your committee believes that the standard of "corporate waste" is unduly restrictive and it should be changed.[121]

However, unlike S. 1659, section 15(d)(1) of S. 3724 did not attempt to specify all the factors affecting the reasonableness of advisory contracts because testimony at the Senate Hearings pointed out that the wide variety of factors makes it very difficult to specify the most relevant factors outside the context of a given case. Section 15(d)(1) stated merely that all other compensation re-

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117 33 SEC ANN. REP. 2 (1967).

118 S. 3724, 90th Cong., 2d Sess. (1968); H.R. 14742, 90th Cong., 2d Sess. (1968).

119 114 Cong. Rec. 9341 (daily ed. July 24, 1968) (remarks of Senator Sparkman); *id.* at 9342 (remarks of Senator McIntyre).

120 In addition to amending sections of the Investment Company Act pertaining to mutual fund management fees, sales commissions and periodic payment plans, S. 3724 also amends various provisions of the securities laws to permit banks to operate commingled managed agency accounts in competition with mutual funds and clarifies the status of bank collective funds and separate accounts established by insurance companies. 1968 SENATE COMMITTEE REPORT 2.

121 1968 SENATE COMMITTEE REPORT 5.

ceived by the adviser, the nature and extent of all services rendered to the fund, and such other factors as are relevant and material under all the circumstances shall be taken into account when determining reasonableness.[122] Section 15(d)(1) also provided that while the ultimate finding as to whether a fee is reasonable is for the court, a determination made by the board of directors that the fee is reasonable is to be given "substantial weight," and ratification or approval by the shareholder is to be given "such consideration as is deemed appropriate under all the circumstances." These provisions apparently were in response to the outcries of most of the industry that S. 1659 was based on an alien philosophy which shifted the responsibility for managing a corporate enterprise from the directors to the judiciary.[123]

As in S. 1659, the burden of proof remained on the plaintiff to prove to the satisfaction of a court that the challenged fee is unreasonable. The extent of liability, however, was considerably reduced. Recovery of past compensation was allowed only against recipients of the unreasonable portion of that compensation, and recovery also limited to only excessive compensation paid or accrued within *one* year prior to the date on which the action was instituted.[124] Furthermore, no recovery of *any* past unreasonable compensation was allowed if the court found that the directors of the fund determined in the exercise of due care that such compensation was reasonable.[125]

One other important change concerned the enforcement of actions under section 15(d). Proposed section 15(d)(6) explicitly provided that shareholders could bring derivative or representa-

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122 Notice that S. 3724 deleted the quality of service provided and the extent to which economies of size are taken into account. However, the Senate Committee explicitly states that such changes are not intended to suggest that these factors would not be relevant in a particular case, but rather they are designed to emphasize the responsibility of the courts to determine reasonableness in light of all relevant factors. 1968 SENATE COMMITTEE REPORT 13.

123 "By providing for an unprecedented governmental intrusion into business decisions, the bill rejects the basic representational structure of corporate form by which the Nation's business corporations have been managed for two centuries." 1968 SENATE COMMITTEE REPORT 47 (minority view).

124 Investment Company Act, proposed § 15(d)(5), S. 3724, 90th Cong., 2d Sess. § 8(d) (1968).

125 Investment Company Act, proposed § 15(d)(3), S. 3724, 90th Cong., 2d Sess. § 8(d) (1968).

tive actions, but only if the SEC refused or failed to bring an action within six months following the written request by such shareholder. The SEC, therefore, would have been encouraged to initiate litigation to require reductions in fees.[126] This provision was intended to provide for an orderly and efficient adjudication of the reasonableness of fees by reducing the possibility of a multiplicity of suits.

S. 3724 was actively debated on the Senate floor on July 24, 25, and 26, 1968. At that time Senator Bennett proposed an amendment which would have provided that no compensation could be found unreasonable under section 15(d) if such compensation had been approved or ratified by the affirmative vote of two-thirds of the outstanding voting securities of the investment company and by the unanimous vote of all directors who are not interested persons of such company.[127] The purpose of the amendment was to maintain the basic principles of corporate democracy under which the judgment of the independent directors and shareholders is binding[128] and to reduce the possibility of false charges and so-called strike suits.[129] Opposition to Senator Bennet's amendment by proponents of S. 3724 was immediate and vigorous. Even before the amendment was called up, Senator McIntyre stated:

> This amendment, very simply, guts and makes meaningless the single most important provision of the committee bill. It removes the single most important safeguard which we have tried to protect for shareholders: namely, the right to go to court to protect their own interests under a fair system of procedure.[130]

The Bennett amendment would nullify the reasonableness standard, resulting in a return to the "waste" test, for the very same

126 However, the Commission is not authorized to delay effectiveness of registration statements or to prevent sales of new shares pending the outcome of such litigation. 1968 SENATE COMMITTEE REPORT 14-15.

127 S. 3724, Amdt. No. 899, 90th Cong., 2d Sess. (1968); 114 Cong. Rec. 9484 (daily ed. July 26, 1968).

128 "But the basic problem that has arisen on the floor of the Senate in the last 2 days is as to the technical significance and legal effect of this particular proposal that the SEC have the right to overrule decisions of independent directors and stockholders, and that then that right be passed on to the courts." 114 Cong. Rec. 9482 (daily ed. July 26, 1968) (remarks of Senator Bennett).

129 114 Cong. Rec. 9473 (daily ed. July 26, 1968) (remarks of Senator Murphy).

130 114 Cong. Rec. 9425 (daily ed. July 25, 1968).

reason that new legislation is needed in the area of advisory fees: the effectiveness of the unaffiliated directors in this area is a myth, and shareholder voting is a meaningless gesture similar to voting in the Soviet Union — there is no choice between alternative candidates.[131]

After S. 3724 was passed by the Senate, the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce voted on September 10, 1968, not to give further consideration to the bill. However, on January 15, 1969, Senator Sparkman introduced in the 91st Congress precisely the same bill which passed the Senate during the 90th Congress.[132]

VI. THE INDUSTRY'S OBJECTIONS TO S. 34

Spokesmen for the industry opposed the provisions of this bill (S. 34) dealing with advisory compensation not only because such legislation is, in their judgment, unnecessary, but more importantly because "shorn of its camouflage," such legislation is dangerous to the investing public and the future development of the mutual fund industry. In their opinion, the bill would: (1) reject the fundamental principle of corporate democracy by which the nation's business corporations have been managed for two centuries; (2) produce uncertainty and confusion because of the

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131 An amendment to Senator Bennett's amendment, proposed by Senators Case and Javits, would originally have provided that if advisory compensation is approved or ratified by the affirmative vote of the holders of ⅔ of the outstanding voting securities of the investment company and by the unanimous vote of all directors who are not interested persons of the investment company, then such compensation shall be presumed reasonable unless rebutted by a preponderance of the evidence. But apparently unknown to Senators Case and Javits, such amendment would have left the defendant in a *worse* position regarding the burden of proof than he is under existing law or would be under the bill as reported by the Committee. Accordingly, Senators Case and Javits changed this amendment to read: "But any compensation or payments shall be presumed reasonable for purposes of this subsection if such compensation or payments have been approved or ratified by the affirmative vote of holders of a majority of the outstanding voting securities of such company and by the vote of a majority of directors of such company who are not interested persons of such company, but such presumption may be rebutted by a preponderance of the evidence." This amendment was passed and tacked on to the end of the section 15(d)(1). At best it restated the obvious, but it might very well have been interpreted so as to render the entire legislation ineffective in the area of advisory fees.

132 S. 34, 91st Cong., 1st Sess. (1969); 115 Cong. Rec. 289 (daily ed. Jan. 15, 1969).

vagueness of standards and uncertainty of judicial interpretations; (3) vest an inordinate amount of power in the SEC to regulate management compensation; (4) encourage time-consuming and expensive strike suits; and therefore (5), discourage new entries and competent people from serving the mutual fund industry, resulting in less competition and a decrease in the quality of service offered the investor.[133]

The most abstract of the objections to S. 34 was that the bill incorporated a philosophy alien to our own traditional economic and political system of permitting informed shareholder-consumers and independent directors, rather than a third party, to determine the cost of management in a competitive industry.[134] In answer to the SEC's arguments that the unique structure of the mutual fund industry requires special regulation, the industry asked why the paternalism inherent in the SEC's distrust of the intelligence of shareholders and the integrity of directors of mutual funds should not also be imposed in a multiplicity of relations involving corporations generally:

> Although the Commission tried to distinguish the funds from other enterprises, it succeeded only in describing the funds as members of a large class of management-controlled companies. The [SEC] Report failed to establish sufficient grounds for distinguishing the mutual fund management fees either in form or in size from the compensation legally paid to managements in other types of management-controlled enterprises.[135]

Proponents of the bill and the SEC have concluded, nevertheless, that the traditional safeguards of disclosure and competition as well as the existing regulatory safeguards of shareholder rat-

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133. 1968 SENATE COMMITTEE REPORT 47-50 (minority view); *1969 Senate Hearings* at 88 (testimony of Robert L. Aubenblick); *1967 Senate Hearings* pt. 1, at 197 (testimony of Robert E. Welch).

134 *E.g.*, 1968 SENATE COMMITTEE REPORT 48 (minority view); *1967 Senate Hearings* pt. 2, at 873 (testimony of Charles W. Steadman); *1967 House Hearings* pt. 2, at 618 (remarks of Representative Watkins); 114 Cong. Rec. 9408-09 (daily ed. July 25, 1968) (remarks of Senator Bennett); 114 Cong. Rec. 9475 (daily ed. July 26, 1968) (remarks of Senator Percy).

135 Note, *Management Compensation: The SEC Mutual Funds Report*, *supra* note 37, at 77-78; *see 1967 Senate Hearings* pt. 1, at 341 (testimony of Ralph H. Demmler, former chairman of the SEC); 114 Cong. Rec. 9473 (daily ed. July 26, 1968) (remarks of Senator Bennett).

ification and unaffiliated director approval are peculiarly ineffective in the area of mutual fund advisory fees, arguing that: (1) unlike a corporation, in which officers' salaries are easily ascertainable, the fund-adviser structure involves the overall profits of an outside corporation; (2) competition is entirely absent in this structure because of the built-in conflict of interest and the minimal likelihood that the fund will seek out another adviser, and (3) the purpose of S. 34 is not to determine what is reasonable compensation, but only what is unreasonable.[136]

A second objection to S. 34 concerned the reasonableness standard itself. Reasonableness is a normative standard to which everyone, including the fund advisers and management, subscribes (as opposed to *unreasonable* fees), but it is a standard which no one can precisely define. Who can apply this standard, asked the spokesmen for the industry, better than the independent directors and the informed consumer-shareholders of the fund itself? The courts, it was argued, are ill-equipped to evaluate such complex factors as the worth of non-fungible managerial talent, the proportion of an executive's ability and time devoted to the particular fund, and the degree of responsibility assumed and success achieved.[137]

Proponents of S. 34 replied that section 15(d) was not intended to substitute the judgment of the courts for that of corporate directors, and that this was ensured by the explicit requirement that a determination by the board of directors that the fee is reasonable be given "substantial weight."[138] Yet the problem, as pointed out by Senator Bennett, was that "substantial weight" is a term that can mean just about anything one desires it to mean.[139] The industry feared that the bill would "reduce the decisions of boards

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136 *See* testimony of Abraham Pomerantz, *1969 Senate Hearings* at 168-170.

137 *See, e.g.,* note 91 *supra; 1967 Senate Hearings* pt. 1, at 202 (remarks of Senator Percy; "What then might be reasonable for one [adviser] would be unreasonable [for another]. How does a person decide what a reasonable management fee is unless you really get to the heart of the matter and study every single company. . ."); 114 Cong. Rec. 9411 (daily ed. July 25, 1968) (remarks of Senator Bennett); Note, *Management Compensation: The SEC Mutual Funds Report, supra* note 37, at 76. *See generally* Modessitt, *supra* note 19, at 1260-74.

138 1968 SENATE COMMITTEE REPORT 5-6; 114 Cong. Rec. 9339 (daily ed. July 24, 1968) (remarks of Senator Sparkman).

139 114 Cong. Rec. 9410 (daily ed. July 25, 1968).

of directors to practical nullities."[140] On the other hand, it is possible that the courts, by giving too much effect to the words "substantial weight," would reduce the bill to a nullity.

A more direct answer to the objection that courts are ill-equipped to determine the reasonableness of management compensation is to recognize that courts are capable of making, and have made in the past, rational, informed judgments as to what constitutes reasonable compensation for personal services. Judge Henry J. Friendly explained in his testimony during the 1967 House Hearings that the functions which courts would be required to perform in a suit under proposed section 15(d) are analogous to their present functions in other areas.[141] Accordingly, Judge Friendly concluded:

> I think I can sum up my position by saying that while the courts are not looking for any more business . . . I perceive no reason why the courts could not effectively administer section 15(d) if Congress should decide that it wants us to do so.[142]

Opposition arguments to the reasonableness standard questioned not only the appropriateness of a judicial forum for determining reasonableness, but also whether such an indefinite standard could ever give sufficient guidance to both the enforcer and the enforced.[143] Representatives of both would-be plaintiffs and defendants in suits under section 15(d) have criticized the standard and the guidelines specified in S. 34 as an invitation to "an exercise in semantics"[144] with little more practical value than "a modern super-highway without road signs."[145] While the standard of reasonableness has been successfully used in several other regulatory statutes, this criticism does raise the very difficult question of articulating the factors to be considered in judging the legality of mutual fund advisory compensation.

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140 1968 SENATE COMMITTEE REPORT 49 (minority view).

141 *1967 House Hearings* pt. 2, at 609-611.

142 *Id.* pt. 2, at 609.

143 *1969 Senate Hearings* at 100 (statement of Investment Company Institute).

144 Remarks of Abraham Pomerantz, *Conference on Mutual Funds, supra* note 20, at 738.

145 Testimony of G. Keith Funston, president New York Stock Exchange, *1967 Senate Hearings* pt. 2, at 749.

Proposed section 15(d)(1) expressly provided that all compensation received by the adviser, the nature and extent of all services provided to the investment company, and "such other factors as are relevant and material under all the circumstances" shall be taken into account. Clearly, this bare minimum of specificity emphasized the responsibility of the courts in determining the reasonableness of advisory compensation in light of the relevant factors of each particular case.[146] Consideration of the "nature and extent of all services provided" would be required because of the great variety of services covered by the management fee.[147] While the cost of services might also be included under the "nature" of services provided, and in any event cost seemingly would always be a relevant factor, the Senate Committee explicitly rejected a cost-plus approach.[148]

Significant questions remain concerning the relevance of performance and comparisons with the advisory fees paid by non-fund clients and by other institutional investors. Although both these factors were included specifically in the guidelines proposed in S. 1659, the Senate Committee declared that their subsequent deletion from later versions of the reform legislation should not be construed to mean that such factors would not be relevant in a particular case.[149] However, with regard to comparative analyses, the Committee also stated that a general reduction of fees on an industry-wide basis was not contemplated.[150]

The proper role of performance in evaluating the reasonableness or unreasonableness of advisory compensation is especially troublesome to determine. Spokesmen for both the industry and the SEC agree that performance should be an important factor.[151]

146 1968 SENATE COMMITTEE REPORT 13.

147 *See* SEC REPORT 91.

148 1968 SENATE COMMITTEE REPORT 13. This cost approach is complicated by the fact that many advisers simultaneously act for both fund and non-fund clients or for several different funds.

149 1968 SENATE COMMITTEE REPORT 13.

150 *Id.* at 13.

151 "This bill would impose a reasonableness standard, a standard of reasonableness in the context of a particular situation. For example, I personally would not think a fee of one-tenth of 1 percent would necessarily be more reasonable than one, perhaps, of more than one-tenth of 1 percent, where the fellow charging one-tenth of 1 percent has the worst performance of all and he is just losing money, whereas

To make compensation dependent upon the degree of success achieved has considerable appeal from an economic viewpoint, in that it would create both an incentive for increased productivity and an identity of interest between management and investors. On the other hand, performance-related contracts encourage advisers to take undue speculative risks with the shareholders-investors' money on a "heads I win, tails you lose" basis.[152] Of course, the inclusion of penalty provisions for inferior performance would change this to a "heads *we* win, tails *we* lose" situation.[153] Nevertheless, the emergence of so-called "cult of performance" mutual funds has serious effects on market mechanisms, as noted by the SEC in the foreword to its 34th Annual Report.

The arguments on either side of the performance question are convincing, and as is so often the case with such controversial and close questions, the proposed bill was an ambiguous and uneasy compromise. Pursuant to section 25 of S. 34, the advisory contract could not provide for compensation to the investment adviser on the basis of a share of capital gains upon a capital appreciation of the client's funds. On the other hand, performance almost always would be a relevant factor in judging the reasonableness of advisory fees under section 8(d) of S. 34, and, moreover, section 25 itself expressly permited advisory contracts which provide for *proportionate increases and decreases* in compensation on the basis of the fund's investment performance as measured

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the fellow who may be charging more may have been producing the most remarkable performance. Because I think that this is one of the factors to be taken into account. . ." Testimony of Manuel F. Cohen, *1967 Senate Hearings* pt. 1, at 59.

"As for criteria for measuring the reasonableness of the management fee the directors should 'look at the record' to see how well the fund has performed in light of its stated objectives and investment policies — the real test is performance." Remarks of Joseph E. Welch, *Conference on Mutual Funds, supra* note 20, at 733.

152. 1968 SENATE COMMITTEE REPORT 44.

153 *See* note 154 *infra*. For example, the Berger-Kent Special Fund, Inc. (Preliminary Prospectus dated Dec. 4, 1968) pays its investment adviser a basic management fee of ½ percent per annum of the net asset value of the fund averaged daily over the year, which fee may be increased to 4 percent of net asset value or decreased to zero depending upon the performance of the fund relative to the New York Stock Exchange Composite index. As an additional penalty or incentive, the unapplied balances of such adjustments to the basic fee are, subject to certain limitations, carried forward for one year in the case of a negative adjustment and for three years in the case of a positive adjustment. Note that the decrease is not proportional to the increase but smaller.

against an appropriate index of securities prices.[154] The requirement that the penalty must be proportionate to the reward is equitable, although drastic fluctuations in the amount of advisory compensation would seem likely to have a harmful and unstabilizing effect on investment advisers.

In sum, these problems raised by the reasonableness standard and the very general guidelines of S. 34 indicate that the opponents of that bill were justified in criticizing it as vague, even given the fact that after the first few cases were decided intelligible guidelines would have become more apparent.[155] Of course, a serious defect in a bill is more likely to be characterized as a fatal defect if other alternative proposals are available. The problems of judging and enforcing the reasonableness of investment advisory fees in the courts have been examined and discussed by representatives of both the mutual fund industry and the SEC and by many professors and lawyers who have studied the fund industry in depth. Some of these people, acknowledging the need for corrective legislation to effectively regulate the fund-adviser relationship, have proposed various alternatives which they believe will more equitably and more efficiently achieve the results desired by proponents of S. 34. Before discussing the alternative which replaced S. 34 in the Congressional deliberations in 1969, we should examine other alternatives that may yet appear.

VII. The Alternative Proposals

Wide-ranging alternatives have been offered as a possible solution to the inadequacy of present economic and regulatory safeguards against excessive investment advisory compensation. Of course, one persistent view is that *nothing* should be done. Although conceding that advisory fees may be high, proponents of this view believe that market adjustments will correct any such abuses now that the period of initial fund growth is over and now that comprehensive studies and Congressional hearings have made shareholders, independent directors and courts aware of

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154 1968 Senate Committee Report 44.

155 Testimony of Friendly, J., *1967 House Hearings* pt. 2, at 612.

the nature and extent of the fee problem.[156] We have already considered this view in the initial sections of this article.

Not far from this end of the spectrum are proposals suggested by the minority of the Senate Committee on Banking and Currency and by the Investment Company Institute. The alternative supported by the minority of the Senate Committee would increase the number of unaffiliated directors from 40 percent to 60 percent, require approval of the management contract by the board of directors specifically charged with the responsibility of representing shareholder interest, and then have the courts adjudicate whether or not the directors have discharged that fiduciary responsibility.[157] The Investment Company Institute has offered a similar proposal: first, the number of independent directors would be increased from 40 percent to a majority of the board, and the standard for independence would be strengthened by substituting "disinterested" for unaffiliated; secondly, while the proposal accepts a federal standard of reasonableness, the directors would decide what constitutes a reasonable fee and the courts would in effect judge only the reasonableness of the directors' action. The advisory compensation must be specifically approved as reasonable by a majority of the disinterested directors "in the exercise of business judgment," and a shareholder can recover the unreasonable part of that compensation only if "the court shall find from clear and convincing evidence that the approval by directors . . . was a clear abuse of business judgment."[158]

The SEC rejects these methods of enforcing the reasonableness standard as illusory.[159] By relying upon measures to strengthen the number and the independence of the unaffiliated directors, the industry, it is suggested, is "propagating the myth that unaffiliated directors have served as an effective control over advisory fees."[160] As has been previously discussed, both the relationship between the adviser and the fund's directors (often the adviser effectively chooses even the independent directors) and the relation-

156 *See* testimony of Robert E. Welch, *1967 Senate Hearings* pt. 1, at 198.

157 1968 SENATE COMMITTEE REPORT 52.

158 *1967 Senate Hearings* pt. 1, at 100-01 (letter of the Investment Company Institute to SEC Chairman Cohen, Apr. 18, 1967).

159 *1967 House Hearings* pt. 1, at 46.

160 *Id.* at 46.

ship between the adviser and the fund's shareholders (shareholders in effect invest not in a fund but in its particular investment adviser) place obvious limits upon the power of disinterested directors to effectively deal with problems in the fee area.[161] The SEC maintains, moreover, that these proposals would have the effect of putting the directors, particularly the unaffiliated directors, on trial rather than the fees. This would inhibit effective enforcement while at the same time be unfair to the directors. The requirement of a finding that approval of directors was "a clear abuse of business judgment" would severely limit judicial action; and directors would be subject to a fiduciary duty without any clear standards to guide their conduct.[162] Beneath these alternatives offered by the minority of the Senate Committee and by the industry, lies a mixture of confidence in a laissez-faire economic system under which both investors and management seem perfectly happy, fear of the effects of a change in the direction of more federal regulation, and economic self-interest. These proposals would further insulate from judicial scrutiny the present level of investment advisory fees under the protective cloak of "business judgment."

At the other end of the spectrum are the possibilities of direct rate regulation with the imposition of a maximum-fee structure and of reorganizing the structure of the industry by eliminating the corporate shell and requiring each fund to be internally man-

161 The provisions of the proposed bill which attempt to strengthen the role of the unaffiliated directors as a check against adviser domination of the fund [§§ 2(3), 5, 8(c), 8(d), and 18 of S. 34] are at first glance inconsistent with the Commission's view of the inherent limitations on the effectiveness of independent directors other than to further insulate advisers from judicial scrutiny. However, the Commission believes that in certain areas of investment company affairs other than advisory fees independent directors are a helpful device. *See 1967 House Hearings* pt. 2, at 726.

162 *1967 House Hearings* pt. 1, at 46; *id.* pt. 2, at 726. By creating potential liability for directors, including independent directors, the industry is seemingly contradicting its earlier criticism that the "interested person" and "reasonableness" standards are so vague and restrictive as to discourage or preclude service by directors of competence and stature. *1967 Senate Hearings* pt. 1, at 315. However, a conflict exists only if one concludes the industry sincerely believes that courts would in fact find directors to have violated its proposed "business judgment" or bad faith tests, a conclusion which the Commission seriously doubts. *1967 House Hearings* pt. 1, at 47. For a brief discussion of the mounting liabilities for directors and the resulting shortage of competent men willing to serve as such, see Wall Street Journal, Mar. 13, 1969, at 1, col. 6.

aged. The Wharton Report concluded that the regulation of fee rates "would be disruptive, and would, in addition, raise extremely difficult problems of equitable rate fixing."[163] Compulsory internalization of the management function, on the other hand, is the choice of many as the simplest solution to the fee problem.[164] Nevertheless, the SEC explicitly rejects compulsory internalization as "too sweeping at this time," at least until the less drastic reasonableness standard is given a fair trial.[165]

Both the Wharton and SEC Reports found that the operating costs of larger internally managed funds are significantly lower than the costs of externally managed funds of comparable size. But while internalization would most likely cause some reduction in the amount of advisory compensation, the conclusions of Edward Herman, Associate Professor of Finance at Wharton, should be fully considered:

> Since internally managed funds have a simple structure and tend to have even lower fee rates, this [internalization] would probably accomplish something; but it is not clear how much would be achieved, given the fact that structural conditions would still be unfavorable to competition on the management fee. Since this would be a drastic action, especially in view of the widespread public sale of the stock of outside advisory companies, I doubt if this change would be worth the resultant disruption.[166]

Compulsory internalization of management, moreover, does not seem to be a politically feasible alternative, at least in the absence of a major economic crisis. For both these reasons, the speculative economic effects and strong political pressures, the SEC rec-

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163 WHARTON REPORT 35.

164 *E.g.*, *1969 Senate Hearings* at 179 (testimony of Abraham L. Pomerantz); *1967 Senate Hearings* pt. 2, at 723 (testimony of Manuel F. Cohen); *1967 Senate Hearings* pt. 1, at 358 (testimony of Prof. Paul A. Samuelson); *id.* pt. 2, at 693-94 (testimony of Abraham Pomerantz: "Well, if you were to honor me with the right to propose an amendment, I would strongly propose . . . that the externalization of the advisory function should be eliminated.").

165 SEC REPORT 147, 149; *1967 House Hearings* pt. 2, at 725; *see 1967 Senate Hearings* pt. 2, at 683 (testimony of Dr. Irwin Friend).

166 *1967 House Hearings* pt. 2, at 814. The Wharton Report also concluded that while internalization might provide a closer alignment of power and fiduciary responsibility, "it would also be a disruptive action with consequences that must be regarded as speculative." WHARTON REPORT 35.

ommends less drastic solutions than compulsory internalization, but with the proviso that should a more moderate solution prove inadequate, "more sweeping steps might deserve to be considered."[167]

The proposed S. 34 appears to have been such a compromise between the alternatives of doing nothing and compulsory internalization. Accordingly, variations on that compromise should be considered. The possible variables include (1) the role of the SEC, (2) the burden of proof, and (3) the extent of liability.

As pointed out by Judge Friendly, there are many alternate methods of mixing judicial and administrative participation in enforcing a reasonableness standard.[168] While the courts are capable of making rational, informed judgments concerning the reasonableness or unreasonableness of advisory compensation, an administrative agency might well be better equipped to cope with the complex problems involved in making such determinations. Both in terms of efficiency and uniformity, resort to the SEC in its quasi-judicial capacity for decisions, subject only to the usual judicial review, might be preferable to court actions.[169] The SEC, however, deliberately opted for a judicial forum as an independent and open-minded tribunal free of bureaucratic rigidity and accustomed to dealing with suits involving problems of compensation.[170] The SEC's explanation indicated a sensitivity to the political color of such an approach as well as its merits:

> We considered that [scrutiny of the reasonableness of advisory fees should be done in the first place by the SEC]. We abandoned it. We did not wish anyone to have any notion that the Commission was reaching for additional power, and we wished to make as clear as we possibly could that this issue, when it arose, would be in the hands of an independent body in the traditional American way, the courts of law.[171]

167 SEC Report 149; *1967 House Hearings* pt. 2, at 725.

168 *1967 Senate Hearings* pt. 2, at 1016.

169 Efficient utilization of the SEC's expertise would reduce the time before a final decision is reached, and before the conditions of the fund significantly change; and greater uniformity would give more predictability and guidance to the parties during the planning stage of their behavior.

170 *1967 House Hearings* pt. 1, at 132; *1967 Senate Hearings* pt. 1, at 21.

171 *1967 House Hearings* pt. 2, at 685 (testimony of former SEC Chairman Cohen). Judge Friendly agrees that modifying the present proposal to make the action an administrative one would create political pressures: "As I said, that

Yet, even if proceedings are to be brought in the courts, perhaps, as some have suggested, the marriage of the SEC and the courts successfully utilized in Chapter X of the Bankruptcy Act should be adopted in the advisory fee area as well.[172] The permissive or mandatory use of SEC advisory reports by all courts would ensure a more uniform and more vigorous development of judicial law in this area.[173] However, a similar balance between administrative expertise and uniformity and judicial flexibility may have already been struck in S. 34 by the addition to the original proposal of section 15(d)(6), discussed above, which would have given the Commission a right of first-refusal for six months after a request by a shareholder to bring a court action to enforce the standard of reasonableness. The likely result of this amendment would have been that the Commission would usually be a party to an action under section 15(d), albeit not an impartial party, and consequently the courts would have benefited from its expertise. In those actions in which the Commission chose not to intervene, perhaps the court should have been given the power to request an advisory report, especially because the Commission's refusal to act upon a shareholder's request could possibly have created unintended negative implications.

A second variation on S. 34 could have changed the burden of proof. S. 34 explicitly created a presumption in favor of the reasonableness of the advisory compensation in actions under section 15(d) with the burden of proof on the plaintiff, assuming

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would be a perfectly possible thing for Congress to do here, to give this to the SEC, subject to judicial review. I have a feeling the industry will dislike that even more than it dislikes this, but that is a solution." *Id.* at 619.

Werner believes that the Commission's reluctance to ask Congress to vest it with quasi-judicial power in the fee area results from the same limited conception of its role under the present Investment Company Act which is responsible for the Commission's disregarding its powers under section 36. *See* Werner, *supra* note 69, at 36-37, 42. The Commission does state, however, that although it has not sought such authority, it would be prepared to undertake such authority should Congress feel it desirable. *1967 House Hearings* pt. 2, at 727.

172 Letter of Warren Christopher, Deputy Attorney General, *1967 House Hearings* pt. 1, at 22; testimony of Friendly, J., *1967 Senate Hearings* pt. 2, at 1016. For a summary of judicial-administration collaboration under Chapter X, see 2 L. Loss, SECURITIES REGULATION 754-55 (2d ed. 1961).

173 Judge Friendly suggests that exclusive federal jurisdiction would likewise be a desirable step in the direction of uniformity, and the very fact that an action under section 15(d) is a substitute for what might have been made an exclusive remedy before the SEC is sufficient justification. *1967 Senate Hearings* pt. 2, at 1016.

approval by a majority of the independent directors and by the holders of a majority of the outstanding voting securities. A possible modification of S. 34 would have been to place the burden of proof upon the defendants, regardless of shareholder and director approval.[174] Although the adviser-defendants clearly have more access to the relevant information, and although in common law conflicts of interest cases the burden of proof is on the party defending the fairness of the transaction, the SEC believed that S.34 as proposed did not create undue obstacles to the prosection of an action under section 15(d).[175]

A third alternative to S. 34 as proposed could have included different provisions on the extent of liability. Just as the burden of proof provisions of S. 34 favored the industry, so did the provisions limiting liability to only those who had received unreasonable compensation and only for the unreasonable portion of that compensation paid or accrued within one year prior to the date on which the action was instituted. Moreover, even if the advisory compensation was found to be unreasonable, if the board of directors of the fund had determined in the exercise of due care that the compensation was reasonable, no recovery for past compensation was allowed.[176] While additional liability would have increased the deterrent effect of S. 34, such a modification was not strongly advocated in the hope of gaining industry's support for passage of the compromise bill. Proponents of S. 34 evidently believed that, regardless of the presumption in favor of the reasonableness of existing fee rates and regardless of the very limited liability provisions, the judicial application of a reasonableness standard would be a reform sufficient to reduce at least the most excessive advisory fees presently left untouched by existing judicial and regulatory doctrines.

Having described some of the various forms which the approach of S. 34 might have taken, we will now conclude with an assessment of a compromise bill which emerged from the Senate consideration

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174 *See* testimony of Prof. Ernest Folk III, *1969 Senate Hearings 154; 1967 Senate Hearings* pt. 2, at 1004.

175 *1967 House Hearings* pt. 2, at 738; *see 1967 Senate Hearings* pt. 1, at 22.

176 Investment Company Act, §§ 15(d)(3), 15(d)(5), S. 34, 91st Cong., 1st Sess. § 8(d) (1969). A violation of section 15(d) is not deemed to be a criminal violation. Proposed § 15(d)(7).

of S. 34 and which substitutes a fiduciary standard for the much-criticized reasonableness standard of S. 34.

VIII. S. 2224 — The Senate Compromise

During the Senate Hearings on S. 34 in April, 1969, mention was made of the continuing informal discussions between the SEC and industry representatives in an attempt to reach agreement on a method of evaluating and enforcing reasonable management fees.[177] The industry continued to object to the advisory fee provisions of S. 34 on the grounds that "reasonableness" is too vague an administrative and judicial standard, the SEC would in effect be given rate-making power, and the result would be expensive and time-consuming litigation. It was Senator Proxmire, on the final day of the hearings on S. 34 and only a few weeks before the revised bill was reported out of committee, who first publicly raised the possibility of a shift to a fiduciary standard: "If we made them [the director-advisers] fiduciaries, would any management fee section be necessary?"[178]

The bill that was reported from committee in May 1969 and passed by voice vote in the Senate with only minor floor amendments in June 1969 was S. 2224. It seems, at least on its face, to take quite a different approach to advisory fees than did its predecessors. Proposed section 15(d), which provided for the "reasonableness" standard first proposed by the Commission in its 1966 SEC Report, was deleted. In its place now stands a proposed new section 36(b) of the Investment Company Act, which is set forth in section 20 of the new bill.

Proposed section 36(b) provides as follows: (1) the investment adviser has a fiduciary duty with respect to compensation for services; (2) either the SEC or a shareholder of the fund may bring suit alleging breach of that fiduciary duty under a one-year statute of limitations; (3) it is not necessary to allege or prove that the defendant engaged in personal misconduct; (4) the plaintiff shall have the burden of proof; (5) approval of the board of directors and ratification or approval by the shareholders of the compensa-

177 *1969 Senate Hearings* 12-13.
178 *Id.* at 173.

tion arrangement shall be given such consideration by the court as it deems appropriate under all the circumstances; (6) suits may be brought only against the recipients of the excessive compensation; and (7) damages are limited to actual damages, but in no event exceeding the amount of compensation received by the defendant.

The most fundamental change is from a "reasonableness" test to a fiduciary standard.[179] Other significant changes from proposed section 15(d) include the deletion of the requirement that a shareholder must wait six months before bringing suit, of the provision that director approval be given substantial weight, and of the provision that approval by a majority of both the independent directors and shareholders shall create a presumption in favor of the defendants. It is noteworthy, however, that S. 2224, like its predecessor, places the responsibility of scrutinizing management fees on the judicary rather than in an administrative body; it leaves the burden of proof on the plaintiff; and it contains the same very strict limits on recovery for past actions.

The industry's acquiescence in the new section 36(b) may well have been based largely upon the possible political and practical effects of a change in the proposed bill rather than on any comparative legal analysis of the two standards. A court might interpret any decision of Congress to shift from the reasonableness test to the fiduciary standard to gain industry support for the bill as indicating an intent to enact legislation which is somewhat more permissive with respect to management fees than the reform legislation originally proposed. However, this same factor, the change from one standard to another, would seem to be the reason why S. 2224 is also acceptable to the SEC: the change from the present standard of waste to the fiduciary standard would probably be viewed as an attempt by Congress to enact legislation which is stricter than present law.

Another factor of indeterminable weight, but one which may account in part for the industry's preference of the fiduciary standard over the reasonableness standard, is that the decision-

179 For the SEC's interpretation of this change, see *1969 House Hearings* 187, 199-203. For the Investment Company Institute's analysis of the change, see *id.* at 441.

maker might be more reluctant to hold that a director-adviser has violated his fiduciary duty than to find that he had acted unreasonably. Although this distinction is based more on psychological factors than legal factors, the SEC feels that the implications of the gross abuse of trust language contained in section 36 of the 1940 Act have inhibited courts from finding that directors had violated that section. Likewise, it is not inconceivable that some courts would be reluctant to find that a director-adviser had violated his fiduciary duty with respect to advisory compensation, since such a finding implies unethical behavior rather than merely an error in judgment.

It should be noted, however, that if a breach of fiduciary duty does have more damaging overtones than does a violation of the reasonableness standard, such a finding might seriously damage the integrity and credibility of the director-advisers in the eyes of their shareholders, resulting in large scale redemptions. The industry certainly must have been bothered by this damaging connotation, and the Senate Committee specifically deals with these fears in its Committee Report:

> There is also concern that the nature of the disclosure of the litigation after it is commenced may, by including the allegation of a breach of fiduciary duty, given [sic] an inappropriate connotation to the public and the stockholders of the fund which would not be justified in the context of the purposes of section 36(b). The following should allay any such concerns . . . (2) Until the commencement of litigation it would not in the Commission's view, be appropriate to suggest to a registered investment company that it advise investors that the Commission staff believes that an action should be brought . . . (4) In any case where litigation has actually been commenced under section 36(b), the Commission believes that appropriate disclosures should be made . . . [but it] would not appear necessary in the overall context of litigation under section 36(b) to recite the allegation, until judicially determined, that the recipient of the compensation has engaged in a 'breach of fiduciary duty' in receiving the compensation.[180]

Whatever the reasons underlying the change from the reasonableness test to the fiduciary standard, the consequences of this change, assuming that the Senate bill is enacted, are most difficult

180 S. Rep. No. 184, 91st Cong., 1st Sess. 17 (1969).

to assess.[181] While the industry apparently believes that the new standard will permit a somewhat higher level of fees than the reasonableness standard, this might be true only if the decision-maker has considerable legal training and is attuned to the subtle distinctions which the industry considers significant, *i.e.*, the legislative context of the change to the fiduciary standard and the more damaging overtones of that standard. It is difficult, however, to visualize a jury giving much, if any, consideration to either of these factors.

This raises a most important factor which apparently has been consistently ignored both in the proposed bill and in the legislative hearings on the mutual fund reform legislation: the judge-jury question. While the SEC and proponents of reform legislation have insisted upon judicial scrutiny of the amount of advisory compensation, as opposed to allowing director and shareholder approval to create a conclusive presumption of the legality of such compensation, neither the SEC nor the industry has publicly discussed the merits of submitting the question to a judge rather than a jury. The industry, it would seem, would find little comfort in having a jury determine the legality of the level of their advisory compensation, whether the applicable standard be reasonableness or breach of fiduciary duty.

A logical explanation for the lack of discussion on this issue by the industry is their hope that suits under proposed section 36(b) will be treated in the same manner as are other stockholder derivative actions. Derivative actions have traditionally been considered to be creatures of equity to which the seventh amendment's right to a jury trial does not apply. However, the Supreme Court recently held in *Ross v. Bernhard*[182] that Ross was entitled to a jury in his attempt in a stockholder's derivative action to recover for a breach of fiduciary duty by directors of a mutual fund in which he was a shareholder: "We hold that the right to jury trial attaches to those issues in derivative actions as to which the corporation, if it had been suing in its own right, would have been entitled to a jury."[183]

In light of *Ross*, the judge-jury issue should be faced squarely

181 See note 179 *supra*.
182 38 U.S.L.W. 4143 (U.S. Feb. 2. 1970).
183 *Id.*

by Congress in the context of mutual fund advisory compensation. The nature of the decision-maker may alter one's judgment on such other variables as the standard by which advisory fees are to be judged, what additional factors are to be considered, the extent of liability, and the burden of proof.

IX. Can The Compromise Survive?

During House hearings in November and December of 1969, on Senate-passed S. 2224, it became apparent that the agreed compromise was in trouble, if it had not by that time totally dissolved. SEC Commissioner Owens said upon introduction of an SEC comment on November 11, 1969, "Some portions of this comment reflect certain understandings between the Commission and representatives of the industry which we thought were firm at the time the comment was prepared but which were later renounced by industry."[184] Mr. Augenblick, for the industry testified:

> To those who have watched the course of these bills, it must be obvious that our understanding with the SEC that we would not object to the management fee provisions now contained in H.R. 11995 [identical to S. 2224] was reached without any enthusiasm on our part in view of the fact that these provisions continue to be vague and will inevitably breed expensive, time-consuming and unnecessary litigation. * * * This committee should also know that some of our members have expressed the view that the management fee provisions of the present bill are still unacceptable to them.[185]

184 Testimony of Hugh F. Owens, *1969 House Hearings* 144. The House hearings also contain the following interchange:

"Mr. Moss [subcommittee chairman]: At the time of the agreement [on the fiduciary duty standard of S. 2224], was there any equivocation on the part of ICI or any industry representatives regarding the acceptability from their point of view of the fiduciary duty standard?"

"Mr. Budge [SEC chairman]: There may have been reservations, but they were not expressed to us."

"Mr. Loomis [SEC general counsel]: No reservations were expressed to us either." *Id.* at 184.

185 Testimony of Robert L. Augenblick, *1969 House Hearings* 429, 430. A few moments later he testified in answer to a question by subcommittee chairman Moss: "Now you are asking me, Mr. Chairman, why I believe that this [the existing standard] is an adequate standard and why I disagree with the chairman [of the SEC]. We disagreed with the chairman in the early stages of this bill.

"We have stated that we would not oppose the present management fee pro-

To further complicate the situation, after the Senate vote, Congressman Stuckey introduced another bill, H.R. 12867, that was also before the House subcommittee during the House hearings. It provides different provisions relating to management fees.[186]

However, the field seems to have been narrowed and the issue to have been joined. The SEC strongly supports S. 2224.[187] The industry prefers the S. 2224 fiduciary approach to the S. 34 reasonableness approach.[188] The industry wants to replace any judicial supervision with self-regulation.[189] The SEC rejects that alternative,[190] although it leaves open the possibility of later development of self-regulation.[191] Subcommittee Chairman Moss has indicated that the Congress will be able to act during 1970.[192] It is still unclear whether the Senate compromise will survive in the face of the latest disagreements. As SEC Chairman Budge stated in the second month of House hearings, "During this past month, however, the spirit of compromise seems to have dissipated."[193] Whether it will return should soon be apparent.

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visions which provide a different standard. So at this moment, while I am sure that I could expound at length as to why I think that state law should apply, I think it would be inappropriate inasmuch as the institute has agreed to a different standard or at least has said it will not oppose the present management fee provisions . . ." *Id.* at 438.

186 For a table comparing section eight of H.R. 12867, the management fee provisions, to S. 2224, see *id.* at 154-7.

187 *Id.* at 179.

188 *Id.* at 430.

189 *Id.*

190 *Id.* at 860 and 451-3.

191 See letter to the subcommittee from SEC chairman Budge written January 16, 1970. *Id.* at 451-3. See also *id.* at 862.

192 *Id.* at 181.

193 *Id.* at 854.

A MODEL TENANTS' REMEDIES ACT

JOHN A. DOOLEY*
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Introduction

The advancing urbanization of society in this country has directed increased attention to the landlord-tenant relationship.[1] In particular, with increasing numbers of persons living in multiple-family dwellings in urban areas, it has become necessary to determine whether the traditional rights and duties which flow from the landlord-tenant relationship practicably reflect the needs of society. This question becomes more critical when the problem of the urban poor is considered. Since most of the urban poor live in multiple-family dwellings, and since many of these dwellings offer substandard or uninhabitable living conditions,[2] it is essential that tenants living in substandard or uninhabitable premises be protected by the traditional landlord-tenant relationship, along with developing statutory or judicial theories.

This article proposes a Model Tenants' Remedies Act[3] which

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1 Not only has this problem received a great amount of attention in the legal journals, *see, e.g.*, Clough, *Pennsylvania's Rent Withholding Law*, 73 DICK. L. REV. 583 (1969); McElhaney, *Retaliatory Evictions: Landlords, Tenants and Law Reform*, 29 MD. L. REV. 193 (1969), but the problem has also received increased attention in traditional course materials. *See, e.g.*, J. KRASNOWIECKI, HOUSING AND URBAN DEVELOPMENT XI (1969); D. MANDELKER, MANAGING OUR URBAN ENVIRONMENT 655-87 (1966). In the recent revision of one popular property law casebook, the authors have devoted more than twice the number of pages to landlord-tenant problems as they did in the earlier edition. *Compare* A. CASNER & W. LEACH, CASES AND TEXT ON PROPERTY, Part VII (1st ed. 1950) *with* A. CASNER & W. LEACH, CASES AND TEXT ON PROPERTY, Part VI (2d ed. 1969).

2 *See* Berger, Goldston and Rothrauff, *Slum Area Rehabilitation by Private Enterprise*, 69 COLUM. L. REV. 739 (1969).

3 The act set forth in this article is not to be confused with the recently published Model Residential Landlord-Tenant Code. A.B.F., MODEL RESIDENTIAL LANDLORD-TENANT CODE (tent. draft 1969) [hereinafter cited as M.R.L.-T.C.]. This admirable work, prepared as a research project of the American Bar Foundation by Julian Levi, Philip Hablutzel, Louis Rosenberg, and James White, is much broader

will afford tenants adequate and realistic remedies to ensure that their leased premises satisfy a minimum level of habitability. Although the coverage of the Act is broader, it is primarily designed to afford relief to those urban poor who live in multiple-family dwellings. The Act is necessary for two reasons. First, it is almost universally recognized that the traditional rights and duties flowing from the landlord-tenant relationship are inadequate to afford the tenant relief.[4] Second, although some statutes have been enacted which are aimed at giving tenants relief in this area, these statutes do not offer a comprehensive selection of alternative remedies, nor have they advanced far enough on particular issues.

I. Common Law Remedies

The law governing landlord-tenant relations is founded on real property concepts, because courts have been unwilling to treat leases under contract law principles. Thus, aside from fictions created to reach equitable results, courts still view the covenants in lease agreements as independent.[5] Under this view, the material breach by the landlord of one of his covenants will not relieve the tenant from the duty of performing his covenant to pay rent. Thus, if the landlord is unable to continue to provide the premises leased (for example, where the building burns down), theoretically the tenant will still be liable for the rent.[6] Strict application of these concepts obviously causes unrealistic and inequitable results.

To combat such anomalous and inequitable results, the courts in the latter half of the nineteenth century and the first half of the twentieth century constructed fictions which sought to relieve

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in scope than the act proposed in this article. Moreover, where the scope of the M.R.L.-T.C. and the proposed Act overlap, any differences of approach will be explained later in this article.

4 *See* M.R.L.-T.C., *supra* note 3, at 5-6; Sax and Heistand, *Slumlordism as a Tort*, 65 Mich. L. Rev. 869 (1967).

5 *See, e.g.*, Stone v. Sullivan, 300 Mass. 450, 15 N.E.2d 476 (1938); 6 Williston, Contracts § 890 (rev. ed. 1936).

6 Several states have adopted statutes, applicable to this specific situation, which relieve the tenant of the duty to pay rent where the premises are destroyed. *E.g.*, Conn. Gen. Stats. Ann. § 47-24 (1960). However, these statutes also provide that this right may be waived by the tenant in the lease. *See Id.*

the tenant, in certain situations, of the duty to perform his covenant to pay rent. These fictions can be viewed only as "stop-gap" compromises — attempts to afford a tenant some relief from the harsh results of the strict real property concepts without adopting the contract-law concept of dependency of covenants.[7]

The courts evolved two basic fictions: (1) the concept of "constructive eviction"; and (2) the implied covenant of habitability (fitness for uses intended). Neither of these judicial creations is adequate to afford the urban tenant effective remedies to combat substandard housing. The concept of "constructive eviction" has several limitations. Traditionally this remedy can be applied only where the tenant quits the premises within a reasonable time after the conditions which create the "constructive eviction" occur.[8] Thus, this remedy is an ineffective tool for forcing the landlord to repair substandard or uninhabitable premises. There are also inherent limitations in the concept of the implied warranty of habitability. Traditionally, the courts have been willing to apply the doctrine only in those situations where the lease is of a short term nature and the premises are substantially furnished by the landlord.[9] These limitations inhibit the effectiveness of this doctrine as a remedy for tenants in urban leasehold situations.

Although recent litigation in this area has created greater pressure for modification of these traditional concepts,[10] the inroads that have been made are inadequate to effectuate the aim of obtaining repair of substandard housing conditions. The recent developments in this area have centered upon two basic theories which at least some courts appear increasingly willing to accept: (1) that the leases of buildings in violation of housing codes are *illegal contracts* and are therefore unenforceable;[11] and (2) that eviction

7 The M.R.L.-T.C. proposes the first substantial advance in this regard by making the tenant's covenant to pay dependent on the landlord's covenants. M.R.L.-T.C., *supra* note 3, § 2-102.

8 Pines v. Perssion, 14 Wis. 2d 590, 111 N.W.2d 409 (1961); Charles E. Burt, Inc. v. Seven Grand Corp., 340 Mass. 124, 163 N.E.2d 4 (1959). See also Reste Realty Corp. v. Cooper, C.C.H. POVERTY L. REP. ¶ 9572 (N.J. Sup. Ct. 1969).

9 *See* Horton v. Marston, 352 Mass 322, 225 N.E.2d 311 (1967); Ingalls v. Hobbs, 156 Mass. 348, 31 N.E. 286 (1892).

10 *See, e.g.*, Brown v. Southall Realty Co., 237 A.2d 834 (D.C. App. 1968); Edwards v. Habib, 397 F.2d 687 (D.C. Cir. 1968), *cert. denied*, 393 U.S. 1016 (1969). See Annots., C.C.H. POVERTY L. REP. ¶ 2330.

11 Brown v. Southall Realty Co., 237 A.2d 834 (D.C. App. 1968). For a more

actions brought in retaliation against the tenant's reporting of housing code violations constitute a chilling effect on first amendment free speech rights and are not enforceable.[12] These developments are insufficient to force repair of uninhabitable leased premises because these theories provide largely negative relief. They cannot be used as bases for legally compelling the landlord to repair the premises; rather, they serve as defenses to summary process proceedings or to suits for enforcement of lease obligations to pay rent. While these theories do have some effect in motivating the landlord to repair, such effect is secondary and incidental to the main result achieved, that the tenant can remain in the premises.[13]

II. Statutory Rights

Statutory attempts to provide relief from substandard housing by imposing affirmative duties on the landlord have not been notably more successful than common law theories.

Most states, through health and sanitary codes, have imposed some minimum standards regarding leased premises.[14] While these codes set up standards which are helpful in determining whether a dwelling is substandard or uninhabitable, their effectiveness in providing the tenant with a private affirmative remedy against the landlord is minor.[15] A violation of the code will subject the landlord to criminal liability. The courts, however, have been

extensive discussion of this development, see Comment, *The Failure of a Landlord to Comply with Housing Regulations as a Defense to the Non-Payment of Rent*, 21 BAYL. L. REV. 372 (1969).

12 Edwards v. Habib, 397 F.2d 687 (D.C. Cir. 1968). See Comment, 44 N.Y.U.L. REV. 410 (1969).

13 As an example, when it is clear that a landlord may not evict a tenant for reporting code violations to the proper authorities, more tenants will be willing to make such reports, and landlords, as a result, will come under increased pressure from administrative sources to repair. Or, in a different situation, a landlord will be more willing to repair if he knows that he will not be able to enforce a lease against his tenants if his buildings do not meet code standards. However, in both these situations, the landlord still retains the basic discretion to repair or not and these theories will generate no independent legal compulsion to repair.

14 *See, e.g.*, MASS. GEN. LAWS ANN. ch. 111, § 127A (Supp. 1969).

15 See Note, *Enforcement of Municipal Housing Codes*, 78 HARV. L. REV. 801 (1965).

reluctant to utilize these codes as a basis for allowing the tenant an affirmative private remedy against the landlord.[16] Thus, housing, sanitary, or health codes, in themselves, are not effective in providing the tenant with remedies against substandard housing. These codes do serve, however, as a standard for many of those statutes which give the tenant private remedies against the landlord. These codes are used in the proposed Model Act as such a standard.[17]

Recognizing that neither the traditional remedies nor the codes afford the tenant effective relief, several states have enacted legislation giving a tenant affirmative remedies when the dwelling he is inhabiting falls below a certain standard. These statutes afford several types of relief: (1) rent withholding;[18] (2) rent receivership;[19] (3) rent withholding by welfare agencies;[20] or (4) rent abatement.[21] The basic theory of these statutes[22] is that if rent is withheld from the landlord when the tenancy falls below certain minimum standards, the landlord will be motivated to repair. Thus, the statutes allow rent withholding as a defense to a summary process proceeding for eviction in such situations,[23] or rent withholding by a welfare agency when a welfare recipient is living

16 *See* Stapleton v. Cohen, 353 Mass. 53, 228 N.E.2d 64 (1967). *Cf.* Brown v. Southall Realty Co., 237 A.2d 834 (D.C. Cir. 1968) (defensive use). Michigan has recently enacted a statute giving the tenant power to enforce housing codes where violations exist in the premises he is occupying. MICH. COMP. LAWS ANN. § 125.534 (Supp. 1969).

17 See Section 3(b) *infra.*

18 *E.g.*, MASS. GEN. LAWS ANN. ch. 239, § 8A (Supp. 1969); N.Y. REAL PROP. ACTIONS & PROC. LAW, § 755 (McKinney Supp. 1969).

19 *E.g.*, MASS. GEN. LAWS ANN. ch. 111, §§ 127A-127J (Supp. 1969); CONN. GEN. STAT. ANN. § 19-347b (1969).

20 *E.g.*, N.Y. SOC. SERV. LAW 143-b (McKinney Supp. 1969).

21 *E.g.*, MASS. GEN. LAWS ANN. ch. 239, § 8A (Supp. 1969); N.Y. MULT. DWELL. LAW § 302-a (McKinney Supp. 1969).

22 Although there are other statutes of a similar nature, *e.g.*, ILL. ANN. STAT. ch. 23, § 11-23 (Smith-Hurd 1969) (rent withholding by welfare agency); R.I. GEN. LAWS ANN. § 45-24.2-11 (Supp. 1968) (rent withholding), the New York and Massachusetts statutes mentioned above generally cover the area, and the other statutes are variations on one or more of these. Therefore, in the comments to the proposed Model Act, the act will be compared to the New York and Massachusetts statutes only, and not to all of the existing legislation.

23 *E.g.*, MASS. GEN. LAWS ANN. ch. 239, § 8A (Supp. 1969).

in a building which falls below certain conditions,[24] or total or partial abatement of rent in certain situations.[25]

The problem with these statutes is that no one statute provides an affected tenant with a comprehensive list of alternative remedies. This lack of flexibility inhibits tailoring the remedy to the situation, thus limiting the possibility of motivating the landlord to repair. A second problem with existing statutes is that they rely on one means for motivating the landlord to repair — the withholding of money when conditions fall below a certain standard. None of the statutes go far in providing the tenant with other remedies to get the substandard conditions repaired, such as allowing the tenant himself to repair. A third problem is that, in many instances, the procedures to be followed by the tenant are highly technical and intricate. This retards the effectiveness of these statutes. Finally, some of these statutes force the tenant himself to determine whether the conditions of the premises are substandard and do not allow the tenant to seek a court declaration of rights before he begins withholding rents.

III. The Proposed Act

The proposed Model Tenants' Remedies Act seeks to eliminate, as much as possible, the deficiencies in the existing legislation. Consequently, the Act borrows heavily from the provisions of the existing statutes, adding certain remedies to supplement the ones already created. Moreover, all the remedies are put into one act, allowing the court some discretion in the granting of a remedy. The procedures to be followed have been simplified to a great extent.

As can be seen by the Act and its comments, the primary policy consideration inherent in the Act is that where substandard conditions exist they should be repaired as soon as possible. The primary consideration is not that the tenants save money or that the landlord be punished, but only that the tenant not be forced to live in substandard conditions any longer than is necessary. Thus, procedures have been simplified, and the courts have been given

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24 *E.g.*, N.Y. Soc. Serv. Law § 143-b (McKinney Supp. 1969).

25 *E.g.*, N.Y. Mult. Dwell. Law § 302-a (McKinney Supp. 1969).

great discretion in selecting a remedy which will effectuate this policy.

IV. Constitutional Considerations

The Model Act may present at least two constitutional problems. First, there is the possibility that the statute represents an overextension of the police power of the state and therefore results in a taking of the landlord's or mortgagee's interest without due process of law. Second, the notice requirements may be insufficient in the statute so that mortgagee or the landlord is not afforded procedural due process.

In *Farrel v. Drew*,[26] the New York Court of Appeals was faced with a determination of the constitutionality of the Spiegel Law[27] — the statute which provides for rent withholding by welfare agencies. The court reduced the question to determining the police power interest of the state. In making this determination, the court discussed the "evil of substandard housing" at great length.[28] It determined that it was clearly within the police power of the state to legislate to correct this evil.[29] Somewhat tersely, it went on to find that the Spiegel Law is the kind of remedial legislation that is necessary to correct the housing problem and, therefore, is a legitimate exercise of the police power.[30]

Farrel does not, of course, answer the police power question as to mortgagees. This question appears to be answered in the case of *In Re Dep't of Bldgs.*,[31] in which the constitutionality of a New York rent receivership statute[32] was considered. The statute provided that certain administrative agencies concerned with code enforcement could initiate proceedings to have slum buildings put into receivership. If receivership were allowed, the receiver would obtain as much money as he could from the rents; and if he needed more money, he could borrow or use his own

26 19 N.Y.2d 486, 281 N.Y.S.2d 1, 227 N.E.2d 824 (1967).
27 N.Y. Soc. Serv. Law § 143-b(2) (McKinney 1966).
28 19 N.Y.2d at 490-491, 281 N.Y.S.2d at 4-5, 227 N.E.2d at 826-827.
29 Id. at 492-493, 281 N.Y.S.2d at 5-6, 227 N.E.2d at 828.
30 Id. at 493, 281 N.Y.S.2d at 7, 227 N.E.2d at 828.
31 14 N.Y.2d 291, 200 N.E.2d 432 (1964).
32 N.Y. Mult. Dwell. Law § 309 (McKinney Supp. 1969).

money to rehabilitate. Any loans made to rehabilitate were given prior liens on the rents and profits of the building but not on the fee interest in the building. The court upheld the statute, stating that it was a valid exercise of the police power. The court noted that if the statute were struck down it would be financially impossible to rehabilitate slum property.

Whether *Farrel* and *In Re Dep't of Bldgs.* would support the constitutionality of the proposed act in all jurisdictions is unclear. There certainly are differences between the Model Act and the acts these cases considered. *Farrel,* for example, treats single-party rent withholding, whereas the Model Act provides for concerted action. *Dep't of Bldgs.* treats a statute that gives a prior lien only on rents, whereas the Model Act gives a prior lien on the fee also. The ultimate determination, however, must turn not on sterile legal analysis but on a broad policy decision: Can slum housing conditions be ameliorated and can the tenant be given a realistic choice in the market place, without a statute with this impact on the interests of the landlord and mortgagee? It is submitted that the answer to this is no; and, therefore, that the statute must be constitutional.[33]

More solid conclusions can be reached about the validity of the constitutional objection of lack of procedural due process. Again, *In Re Dep't of Bldgs.* appears to be the controlling case. The court held that as long as mortgagees, lien holders, and other interested parties were given notice of any proceeding that could affect their interest and opportunity to be heard, due process was satisfied. The holders of these interests do not have to be joined as parties. The Model Act adopts the approach of the New York statute discussed in *In Re Dep't of Bldgs.* and provides for notice and opportunity to be heard. For this reason there is authority to uphold its constitutionality.

V. Practical Considerations

It must be recognized that the conditions of the premises in which low income families live is a part of a much larger prob-

33 *See* Clough, *supra* note 1, at 584-86.

lem — the overall availability of housing to the urban poor. It is well recognized that the nation's urban areas are suffering from a housing shortage crisis, and of the housing that is available to low-income tenants, much of it is substandard.[34] The proposed Model Act is directed toward seeing that the housing that is available to the low-income tenant meets certain minimum standards and it is *not* directed toward solving the larger problem — the overall availability of housing for the urban poor.

The basic vehicle through which the proposed Model Act seeks to effectuate the repair of substandard leased premises is to allow or require tenants to withhold (or abate) their rent from the landlord, thereby making it economically undesirable for the landlord to maintain substandard premises. Considering this reliance on "economic coercion," it is desirable to explore the possibility that in achieving its immediate objectives — the repair of substandard premises — the Model Act may be contributing to diminishing the amount of housing available to low-income tenants.

The basic problem in the present housing shortage crisis is, in part, an economic one. Under our present economic system, the resources for providing and maintaining housing must come from the profits available to the landlord from his rents. The possibility of the landlord's acquiring the resources to repair, or generally rehabilitate, substandard premises by increasing the rents from his low-income tenants is both undesirable and infeasible.[35] Therefore, such resources must come from the presently-existing profit potential of the landlord. It may be argued that the withholding of income from the landlord until he spends money (necessarily from other sources) to repair the premises may force marginally profitable landlords out of business or into other investments. The net result would be a decrease in the amount of housing available to the urban poor.

It is not at all clear, however, that the effect of the Model Act will be to diminish substantially the present supply of housing

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34 Berger, Goldston and Rothrauff, *supra* note 1, at 739-40.

35 It has been suggested that most low-income tenants presently are devoting as much of their resources as they can to housing. C. ABRAMS, THE CITY IS THE FRONTIER 24 (1965); PRESIDENT'S COMMITTEE ON URBAN HOUSING, A DECENT HOME 46 (1968) (commonly called "Kaiser Committee Report"); Welfeld, *A New Framework for Federal Housing Aids*, 69 COLUM. L. REV. 1355, 1356 n.5 (1969).

available to the poor. First, there is less than universal agreement that the "slumlord" business is only marginally profitable,[36] even though the increasing abandonment of slum buildings in the urban core areas would seem to support that proposition.[37] Moreover, while it is recognized that the "economic coercion" employed by the proposed Model Act may "shake" some of the marginal landlords out of the market place, abandonment of the building (and, thereby, removal of the building from the supply of available housing)[38] does not have to be an inevitable result. The receivership provisions of the Model Act[39] may, in some instances, prevent abandonment which would otherwise occur. Also, since the courts are given wide discretion in determining what remedy to impose under the proposed act, it is anticipated that the court will look to the landlord's financial condition in making the determination.[40] Furthermore, the advent into the marketplace of

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36 *See, e.g.*, M.R.L.-T.C., *supra* note 3, at 8; *In the Inner Cities*, U.S. NEWS & WORLD REPORT, Jan. 26, 1970, at 54; G. STERNLIEB, THE TENEMENT LANDLORD 80 (1966). If, in fact, the landlord enjoys a high profit margin, then he has the resources available to him to repair substandard premises. The prevalence of substandard tenements should not be taken as conclusive evidence that there is a concomitant prevalence of marginally profitable landlords. It has been suggested that much of the substandard conditions of low income housing is not as reflective of the marginal profitability of the enterprise as much as reflective of provisions in existing tax law which make it advantageous to maintain the premises in substandard condition. *See* Note, *Depreciation Deduction on Used Residential Housing, Turnover Rates in Slum Housing Ownership, and the Tax Reform Act of 1969*, 38 U. CIN. L. REV. 539 (1969). While the Tax Reform Act of 1969 may not go far enough as a response to this problem, it does, at least, reduce some of the tax advantages for maintaining substandard premises. See Note, *id.* at 550-51. P.L. 91-172, 38 U.S. L.W. 6 (Dec. 30, 1969). While further tax reforms may create greater incentives for the construction of new housing or rehabilitation of substandard housing, see Note, *supra*, the elimination of the tax advantage should provide some incentive for repair.

37 *See* Schreiberg, *Home Ownership for Tenants: A Program to Use Tax-Foreclosed Properties*, 7 HARV. J. LEGIS. 67, 69 (1969) (New York City presently contains 10,000-15,000 abandoned buildings); *In the Inner Cities*, U.S. NEWS & WORLD REPORT, Jan. 26, 1970, at 54. *See* TIME, March 6, 1970, at 88.

38 Abandonment of the tenement *may* hasten the rehabilitation of the building and its return to the supply of *habitable* housing available to the low-income tenant. So long as the enterprise remains of marginal profitability and no impetus is put on the landlord to repair, he will not repair. However, if the landlord abandons, the property becomes susceptible to tax foreclosure and may be available to non-profit corporations for rehabilitation and return to the housing supply. *See* Berger, Goldston and Rothrauff, *supra* note 1, at 744-45; Schreiberg, *supra* note 37, at 67 (1969).

39 See § 9, *infra*.

40 Thus, in the case of a marginally profitable landlord where rent withholding

nonprofit corporations,[41] aided by government low-interest loans[42] and increased efficiency,[43] may serve to recapture some tenements, once abandoned as only marginally profitable or unprofitable, to rehabilitate them, and to bring them back into the supply of housing available to the poor.

Finally, it must be recognized that there are two problems — and concomitantly, two goals — that are involved: (1) the increase in the supply of housing available to the poor; and (2) the elevation and maintenance of the conditions of that available housing to minimum levels of health and decency. The proposed Model Act is limited to helping achieve that second objective. It is not intended to be a panacea for the well-recognized low income housing shortage. It is acknowledged that a possible effect of the operation of the Model Act could be to diminish, to some extent, the *existing* supply of housing available to the poor by "shaking out" marginal landlords. To the extent that these landlords cannot be replaced through the operation of private enterprise, then it will be necessary for them to be replaced through governmental action — through greater tax benefits for private investment in low-income housing, more governmental subsidies, or more public low-income housing units. It may be that the private sector of the economy is incapable of solving the massive housing crisis that is facing the urban core areas. In that case, the solution will undoubtedly have to come through the operation of the public sector of the economy. However, wherever the solution to the housing shortage is found, it remains necessary to ensure that whatever housing *is* available to the low-income tenant meets certain minimum standards of health and decency. Thus, the need for the

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by all the tenants under § 8 of the Model Act could drive the landlord out of business, the court could consider the landlord's condition and decline to issue an order requiring all tenants to withhold rents.

41 See Berger, Goldston and Rothrauff, *supra* note 1, at 739.

42 *E.g.*, Housing and Urban Development Act of 1968 § 106, 12 U.S.C. § 1701x (Supp. IV 1969). See Berger, Goldston and Rothrauff, *supra* note 1, at 749-61.

43 These nonprofit corporations are often formulated and sponsored by large corporations, exercising their "New Corporate Sense of Social Responsibility." See *id.* at 739-41. Many of the marginal landlords who were driven to abandon their buildings were private entrepreneurs. The replacement of the individual landlord with the more efficient corporate landlord could have some ameliorative effect on the housing supply.

legislative reform embodied in the proposed Model Act remains, independent of the problem of the housing shortage crisis.

A MODEL TENANTS' REMEDIES ACT

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Section 1. *Policy.*

It is the determination of the Legislature that the living conditions of many of the people in the state living in leased or rented dwellings and leased or rented multiple-dwelling units, are of a nature that seriously impairs the health, welfare, and safety of the people, and that the traditional remedies of tenants are insufficient to correct these conditions. It is, therefore, the declared policy of the Legislature that where such conditions exist, they by remedied as soon as is practicable in accordance with this act; and that this act be construed and applied to effectuate this policy.

COMMENT: The purpose of this section is to insure that the courts construe and apply the statute to effect its purpose. Since many of the remedies contained in the statute are in derogation of the common law, and since the courts traditionally have been un-

willing to apply creative remedies in landlord-tenant situations,[44] the legislative policy should be expressly stated in the act.

Section 2. *Definitions.*

As used in this act, unless the context otherwise requires:

(a) "Tenement" means any building, or part of a building, leased or rented as a dwelling for human habitation, including single-family and multi-family dwellings; or any hotel, motel, roominghouse, lodginghouse, boardinghouse, or inn.

(b) "Tenant" means any person inhabiting a tenement, but shall not include any person who has dwelled in a hotel, motel, roominghouse, lodginghouse, boardinghouse or inn for less than three (3) consecutive months; any person inhabiting a tenement pursuant to a court order staying a summary process proceeding shall be considered, for the purposes of this act, a "tenant."

(c) "Affected tenant" means any tenant whose health or safety, is, or reasonably may be, impaired by a defective tenancy. When a defective tenancy exists in a common passageway, common area, or any area under the control of the landlord, all tenants in the tenement shall be considered "affected tenants."

COMMENT: (1) By including single-family dwellings, hotels, motels, and the like in the definition of "tenement," the act covers all dwellings which are leased or rented for human habitation. Many types of dwellings, such as hotels and motels, are leased for long-term habitation, but are not usually classed with other types of premises because they receive different treatment under real property law. For purposes of this statute, there appears to be no reason to exclude such premises from coverage. Existing statutes are either unclear as to the scope of their coverage in this regard or expressly limit their application to a narrower coverage than is intended in this act.

In the Massachusetts Rent Receivership Law,[45] the operative wording in determining extent of coverage is "any building or any part thereof used for residential purposes . . . ."[46] This wording is inadequate in defining extent of coverage since it is unclear

44 *See* Stapleton v. Cohen, 353 Mass. 53, 228 N.E.2d 64 (1967), *noted in* 14 ANN. SURV. MASS. LAW § 5.2 (1968).

45 MASS. GEN. LAWS ANN. ch. 111, §§ 127C-127J (Supp. 1969).

46 *Id.* § 127C.

what is meant by the word "building." The term is never defined in the act. Moreover, it is not clear whether the provisions of the Massachusetts law are intended to cover hotels, motels, and the like. Nor does the Massachusetts law expressly extend its coverage to single-family dwellings. It would seem likely that without express inclusion of hotels, motels, single-family dwellings, and similar properties, the courts will be unwilling to extend coverage of these laws to such situations.

In the Massachusetts Rent Withholding Law,[47] the operative wording in defining extent of coverage is "tenement rented or leased for dwelling purposes . . . ." Hotels and motels are specifically excluded. Nowhere in the law is "tenement" defined. With the exception of the specific exclusion of hotels and motels, the same ambiguities are present in this statute as in the Massachusetts Rent Receivership Law.

The New York statutes suffer from the same limitations. In defining the extent of their coverage, the statutes use either the term "multiple dwelling"[48] or the phrase "building or part thereof used for dwelling purposes"[49] or "building containing . . . housing accomodations."[50]

(2) The definition of "tenant" excludes from the coverage of this act those temporary inhabitants of hotels, motels, etc., who inhabit such premises for less than three consecutive months. These persons are excluded from coverage since the purpose of the act is to provide some meaningful protection for long-term tenants. The nature of the act does not make it conducive to utilization by short-term tenants. Rent withholding, receivership, and other affirmative relief would appear singularly inappropriate in transient or short-term situations. Such activities anticipate, and are geared to, some degree of permanency in the landlord-tenant relationship. Moreover, the traditional property law concepts (and fictions) have treated short-term or temporary tenants in a manner different from other tenants.[51] The Massachusetts

47 MASS. GEN. LAWS ANN. ch. 239, § 8A (Supp. 1969).

48 N.Y. MULT. DWELL. LAW § 302-a(2)(a) (McKinney Supp. 1969); N.Y. REAL PROP. ACTIONS & PROC. LAW § 770 (McKinney Supp. 1969).

49 See former N.Y. REAL PROP. ACTIONS & PROC. LAW § 755(1) (McKinney 1963).

50 N.Y. SOC. SERV. LAW § 143-b(2) (McKinney 1966).

51 *Cf.* Horton v. Marston, 352 Mass. 322, 225 N.E.2d 311 (1967), *noted in* 14 ANN. SURV. MASS. LAW § 1.4 (1968).

Rent Withholding Statute has a similar provision, excluding from its coverage those persons who live in roominghouses or lodginghouses for less than three months.[52]

The definition of "tenant" also includes persons who are holding premises pursuant to a court order staying summary process proceedings. Since persons holding pursuant to such court orders remain for substantial periods,[53] there appears to be no reason why such tenants should not be able to avail themselves of the remedies set forth in the Act.

(3) The first sentence of the definition of "affected tenant" includes within its meaning not only those whose health or safety is presently being impaired by a defective tenancy, but also those tenants who can show that their health or safety, reasonably *may be* impaired. Thus, the provisions of this act may be invoked by a person before the harm to him has actually occurred, because the Act is intended to be preventive as well as remedial, in character. The definition of "affected tenant," with the exception of the situation described in the second sentence of section 2(c), is limited to persons "whose health or safety is, or reasonably may be, impaired." Thus, the class of persons who may invoke the operative provisions of the Act is limited to those who have a real and substantial interest in seeing the litigation successfully completed and the conditions repaired. This achieves a balance in allowing all those parties who have a real interest to invoke the Act while protecting the landlord from unwarranted harrassment.

The second sentence of the definition of "affected tenant" includes within its meaning all tenants in the tenement where a defective tenancy exists in a common passageway, common area, or any area under the control of the landlord. This "constructive effect," in fact, does not reflect any difference or extension of policy, but merely represents a legislative finding that where a defective tenancy exists in a common area or area controlled by the landlord, any tenant in the tenement reasonably may be affected since all tenants have access to such areas.

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52 MASS. GEN. LAWS ANN. ch. 239 § 8A (Supp. 1969).

53 *See, e.g.*, CONN. GEN. STAT. ANN. § 52-546 (Supp. 1969) (six months); MASS. GEN. LAWS ANN. ch. 239, § 9 (Supp. 1969) (three months).

Section 3. *Defective Tenancy.*

(a) Any condition of a tenement which substantially impairs the health or safety of any tenant in such tenement or of the public shall constitute a defective tenancy.

(b) Any violation of a sanitary code, health regulation, or ordinance or statute relating to health or safety shall create a rebuttable presumption that the tenancy is defective.

COMMENT: (1) This section is the major operative provision of the act. It creates the standard by which the landlord's duties to the tenants are to be judged. In determining whether the remedial provisions of this act are properly invoked (assuming the proper party is seeking to invoke the provisions), the court will use this standard of "defective tenancy."

The approach used in this Model Act is somewhat different from the approach used in the Model Residential Landlord-Tenant Code (MRL-TC). Rather than setting up a broad standard like "defective tenancy" and creating a presumption as is done in section 3, the MRL-TC imposes specific duties on the landlord,[54] and the tenants' remedies flow from the landlord's breach of one of those specific duties, the remedies varying depending on which duty is breached.[55]

(2) The standard of "defective tenancy" uses the term "*substantially* impairs." Since section 3(b) makes the violation of certain codes merely presumptive of creating a defective tenancy, the use of the word "substantially" prevents minor deviations from these code standards from being used to secure relief under the Act. It should be noted, however, that once a defective tenancy is found to exist, in order for one to be considered an "affected tenant," it is only necessary that his health or safety is impaired, not *substantially* impaired. The standard is specifically set out in the broad terms of health and safety in order to give the courts some latitude to construe liberally the Act to carry out its purposes. If those considering enactment of this statute suspect that the courts will construe these terms too strictly, the language may be expanded to include "health, safety, welfare, and well-being."

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54 *E.g.*, M.R.L.-T.C., *supra* note 3, § 2-203.
55 *E.g.*, *id.* §§ 2-204—2-208.

(3) Section 3(b) creates the presumption that a tenement containing a violation of a code, regulation, and the like is a defective tenancy. This presumption does not mean that all violations of such codes or regulations will, in fact, constitute defective tenancies, as was explained in comment 2 to this section. Nor will a defective tenancy result only from violations of such codes or regulations. Rather, the effect of this presumption is to shift the burden of proving the ultimate fact — that the condition substantially impairs the tenant's health or safety — to the landlord when the tenant can show a violation of one or more of these codes, regulations, or ordinances. In such situations, it is up to the landlord to prove that the violation *does not* create a condition that may substantially impair the health or safety to the tenant. The use of such codes as a presumptive standard is appropriate since in many states, the enabling legislation for such codes requires that they deal with matters "affecting the health and well-being" of citizens.[56]

A comparison with other statutes will illustrate the operation of section 3(b). Those statutes which require a code violation also require that the violation have some effect on the tenant.[57] These statutes also make some provision for the evidentiary effect of the agency finding of a code violation.[58] Although the operative wording in some of these statutes is similar to the wording in section 3, these statutes fall short of the intent and effect of this act since they require a finding of code violations as a prerequisite for relief.

56 MASS. GEN. LAWS ANN. ch. 111, § 127A (Supp. 1969).

57 MASS. GEN. LAWS ANN. ch. 111, § 127C (Supp. 1969) ("may endanger or materially impair the health or well-being of any tenant therein"); MASS. GEN. LAWS ANN. ch. 239, § 8A (Supp. 1969) ("may endanger or materially impair the health or safety of persons occupying the premises"); N.Y. REAL PROP. ACTIONS & PROC. LAW § 755(1) (McKinney Supp. 1969) ("If the condition . . . is . . . such as to constructively evict the tenant from a portion of the premises occupied by him"); N.Y. SOC. SERV. LAW § 143-b(2) (McKinney 1966) ("which is dangerous, hazardous or detrimental to life or health"); N.Y. MULT. DWELL. LAW § 302-a(2) (McKinney Supp. 1969) ("a fire hazard or serious threat to the life, health or safety of occupants thereof.").

58 MASS. GEN. LAWS ANN. Ch. 111, § 127E (Supp. 1969) (report of the agency shall be prima facie evidence of facts stated in the report); N.Y. REAL PROP. ACTIONS & PROC. LAW § 755(1) (McKinney Supp. 1969) (report of the agency given conclusive effect); N.Y. SOC. SERV. LAW § 143-b(5)(c) (McKinney 1966) (requirement that appropriate agency make a finding of code violation, but unclear as to evidentiary effect of finding); N.Y. MULT. DWELL. LAW §§ 302-a(2)(c), 302-a(3)(a) (McKinney Supp. 1969) (agency finding of violation given conclusive effect).

The showing of a code violation, however, can never be, of itself, sufficient to guarantee a plaintiff relief under any of these statutes. The plaintiff must still show the necessary effect on the tenant or the public. The Model Act is different in that it does not require a showing of a code violation in order to prove the ultimate fact that a defective tenancy exists. Rather, it creates the standard for determining whether a defective tenancy exists and makes the showing of a code violation presumptive of the existence of a defective tenancy. Thus, even if the plaintiff never could prove the violation of a code, he could still show that the conditions were such as to create a defective tenancy.

Moreover, none of the statutes discussed above go so far as to make a showing of a code violation presumptive of the ultimate fact to be proved — the existence of a defective tenancy. In each of the existing laws, aside from proving that a code violation exists, the plaintiff must carry the burden of proving some substantial effect on himself or the public. In the Model Act, section 3(b) shifts the burden of proof, so that if the tenant can prove a code violation, it is presumed that the health or safety of the tenant is substantially impaired, and the landlord must carry the burden of proving that the tenant is not so affected.

Section 4. *Remedies.*

(a) When a defective tenancy exists an affected tenant may:
(1) withhold his rent until such time as the tenancy is no longer defective as provided in section 5; or
(2) petition the superior court for the district wherein the tenant resides for the following relief:
(A) authority to withhold rent as provided in section 6; or
(B) authority for all or part of the tenants residing in the tenement to withhold rent as provided in section 7; or
(C) an order requiring all or part of the tenants residing in the tenement to withhold rent as provided in section 8; or
(D) appointment of a receiver as provided in section 9; or
(E) an order for rent abatement as provided in section 10; or
(F) appropriate restraining orders and injunctions as provided in section 11; or
(G) a determination and assessment of damages as provided in section 12;

Provided, **however, that an affected tenant may not avail himself of the remedies available created under this act if the defective tenancy was substantially caused by the affected tenant, his agent, or person within his control.**

(b) The remedies set forth in subsection (a) shall not be considered mutually exclusive, but may be applied, in the discretion of the court, cumulatively.

COMMENT: (1) This section sets forth the remedies that are available to an affected tenant if a defective tenancy is found to exist. As the proviso to subsection (a) indicates, even if a defective tenancy exists, these remedies are not available to an affected tenant if the defective tenancy was substantially caused by the tenant or by a person within his control. The qualification of "substantial" reflects a judgment that the tenant should be allowed to invoke the Act if his contribution to the defect was merely incidental. There are many circumstances where the landlord allows conditions to degenerate to such a significant extent that the tenant cannot help but contribute incidentally to the conditions which cause the defective tenancy. Thus, where the landlord fails to provide adequate waste removal, the tenant may be forced to leave his trash in an inappropriate place. Although the tenant contributed incidentally to the conditions causing the defective tenancy, the substantial cause was not the tenant but the landlord. Here, the tenant would be afforded relief under the Act. This provision departs from several of the existing laws. Several laws preclude the tenant from recovery where he caused the defect, making no mention of whether that cause was incidental or substantial.[59] Only the Massachusetts Rent Receivership Law has a provision similar to this one, in that it precludes the tenant from relief only where he is the substantial cause of the defect.[60]

(2) Subsection (a) allows the tenant relief in the form of self help under paragraph (a)(1) and relief from the court under paragraph (a)(2). These types of relief are more fully set forth in the succeeding sections, and will be more fully commented upon in those sections.

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59 *E.g.* MASS. GEN. LAWS ANN. ch. 239, § 8A (Supp. 1969); N.Y. MULT. DWELL. LAW § 302-a(3)(b) (McKinney Supp. 1969); N.Y. REAL PROP. ACTIONS & PROC. LAW § 755(1)(c) (McKinney Supp. 1969).

60 MASS. GEN. LAWS ANN. ch. 111, 127C (Supp. 1969).

(3) Subsection (b) makes it explicit that the relief provided by this act may be cumulated in the discretion of the court. The court is given wide discretion in determining how to apply relief creatively in any situation with which the court is confronted.

(4) Jurisdiction for judicial relief under this act is vested in the superior court. A court of record is the most appropriate tribunal for such proceedings. In this regard, this act departs from some of the existing law. Under the Massachusetts Rent Receivership Law, jurisdiction is in the district court,[61] but may be removed to the superior court.[62] However, there is concurrent jurisdiction in the superior court.[63]

Section 5. *Tenant's Rights to Withhold Rents.*

(a) When a defective tenancy exists, any affected tenant may withhold such rents as are due the landlord until such time as the premises are no longer defective.

(b) When a tenant withholds rent pursuant to this section, the landlord may petition the superior court in the district wherein the tenement is located to order the tenant to turn over all rents due the landlord to the clerk of the court to be dispersed by the clerk to the landlord, or his agents or assigns, in order to correct the defective conditions. This petition shall not be granted unless the landlord shall present to the court proof of contracts or agreements by the landlord with appropriate repairmen to commence correction of the defective conditions within thirty (30) days.

(c) Where the tenant has withheld rent pursuant to this section for more than sixty (60) days, or two (2) rental periods, whichever is less, the tenant shall have the right to correct or contract to correct any or all of the conditions causing the defective tenancy. The costs of correcting any or all of these defective conditions shall be deducted from the withheld rent; *provided*, however, that the tenant shall not be entitled to deduct any expenditures so made which are not reasonably necessary to correct the conditions causing the defective tenancy. If the withheld rents are not sufficient to reimburse the tenant for such reasonable repairs, the excess correction costs shall be deducted from subsequent rents as they become due until the tenant is fully reimbursed. If the tenant uses his own labor to correct any or

61 *Id.* § 127C.
62 *Id.* § 127G.
63 *Id.* § 127H.

all of the conditions, he shall be entitled to deduct the reasonable value of his labor.

COMMENT: (1) This section sets forth the right of an affected tenant to withhold rents when a defective tenancy exists. The important characteristic of the right created by this section is that the tenant need not obtain a court order or adjudication in order to exercise these rights. This right is strictly a right of self help. This provision reflects an awareness that, in many instances, the persons who are most critically affected by defective tenancies are the persons who are least likely to go to court or seek professional legal advice. Moreover, this right will provide some measure of relief for those persons who cannot afford even the minimal costs of going to court.

There are, of course, some drawbacks to the creation of this type of right. The tenant who exercises his rights pursuant to this section does so, to some extent, at his own risk. Without a court determination of whether or not a defective tenancy exists, whether he is an affected tenant, or whether he has substantially caused the defective tenancy, the tenant exercising these rights is in a somewhat precarious position. If, in fact, he is not rightfully withholding rents, the tenant will become liable to a summary action proceeding. On balance, however, it is felt that the creation of this right fills an important need for an affected tenant, if used in limited situations.

In providing this right, this act makes no substantial departure from existing legislation. Those provisions of the Massachusetts and New York statutes which make the withholding of rent a defense to a summary action proceeding, in certain situations, effectively create a similar right in the tenant.[64] The Spiegel Law also creates a right in welfare officials to withhold rent without court order or adjudication.[65]

(2) Subsection (b) creates a limited right in the landlord to stop the rent withholding upon a showing to the superior court that he is willing and able to repair the conditions which cause the

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64 *See* MASS. GEN. LAWS ANN. ch. 239, § 8A (Supp. 1969); N.Y. REAL PROP. ACTIONS & PROC. LAW § 755(1) (McKinney Supp. 1969). *See also* Brown v. Southall Realty Co., 237 A.2d 834 (D.C. Cir. 1968).

65 N.Y. SOC. SERV. LAW § 143-b(2) (McKinney 1966).

defective tenancy. This provision reflects one of the central policies of this act — to have the defective tenancy repaired as soon as possible. To accomplish this policy, the Act is aimed at motivating the landlord to repair the defective tenancy. The Act also seeks to make it as easy as practicable for the landlord to effectuate the repairs. Subsection (b) provides the landlord with a relatively simple procedure for acquiring the withheld rents to use them in repairing the premises, upon a showing that he is willing and able to do so.

Subsection (b), however, may be invoked by the landlord only upon a positive showing that he is about to undertake repairs within a reasonable time. This can be shown only by actual executory contracts between the landlord and appropriate repairmen to correct the conditions. The withheld rents are paid into the clerk of court and are dispersed by the clerk to the landlord, or his agent or assigns, only to correct the conditions. It is anticipated that any withheld rents in excess of the monies dispersed in order to make repairs will be retained by the clerk until all the repairs are completed. This use of the clerk as an intermediary to disperse the money to the landlord will protect the tenant by ensuring that the withheld rents will go toward making the repairs and that the landlord will not take the withheld rents and then not make the repairs. The procedures which the landlord must follow in invoking this subsection are set forth in section 13(c) of the Act. There are no provisions analogous to subsection (b) in any of the existing statutes.

(3) Subsection (c) gives the tenant the right to use the rents withheld to repair the conditions causing the defective tenancy. This again recognizes that the overriding consideration is to see that the conditions causing the defective tenancy are repaired.

The tenant may not avail himself of this right until he has withheld rents for sixty days or two rental periods. There are two reasons for this "waiting period." First, the withholding of rent over this period of time will give the landlord sufficient notice that there are conditions in the tenement which need repair. This will give the landlord time to repair the conditions on his own or under the provisions of subsection (b). Allowing the landlord this time period within which to repair or commence repairs reflects

the policy that whenever possible the landlord should be allowed to repair. Second, the waiting period prevents a "race to repair" between the tenant and the landlord. If there were no such waiting period, it is possible that a tenant would withhold rent and commence repairs simultaneously. It would allow the landlord no opportunity to repair himself. Although it is the policy of the Act that the defective conditions should be repaired as soon as possible, if both the landlord and the tenant commence repairs on or about the same time, much confusion and potential litigation may result. The "waiting period" eliminates, to a great extent, this possibility.

The proviso limiting the tenant to deductions only for such expenditures as are reasonably necessary to correct the defective tenancy is based on the view that the tenant should not be allowed to utilize the provisions of this act to improve the premises, but should only be allowed to correct the conditions creating the defective tenancy.

In repairing the defective tenancy under the provisions of subsection (c), the tenant will have to expend his own money. It is not intended that the tenant make repairs, or contract to have them made, and have the bills sent to the landlord. Instead, the tenant may recover the monies expended by him by deducting these sums from the rent withheld from the landlord. If the rents withheld by the tenant are greater than the sums expended by him in repairing the premises, the excess is to be turned over to the landlord when the defective tenancy is completely repaired. If the sums expended by the tenant to repair the defective tenancy are greater than the rents withheld, he may deduct the excess repair costs from subsequent rents due the landlord until the tenant is fully reimbursed.

Since the reimbursement to the tenant for sums expended in repairing the defects is deducted from the rents, the tenant is in the better bargaining position if there is any conflict as to the reasonableness of the rents withheld or the reasonableness of any value the tenant has placed on his own labor. Thus, if the landlord and the tenant cannot agree, it is the landlord who must sue the tenant for any excess deductions made from the withheld rent or subsequent rents.

If a tenant is found rightfully to have withheld rents pursuant to this section, but to have deducted unreasonable amounts for repairing the defective conditions, section 14(a) protects him from a summary action proceeding by the landlord. If the tenant is found to have unlawfully withheld rents he will be liable to a summary action proceeding. If, in that event, the tenant has expended sums to repair the defective conditions, it is anticipated that the tenant may still recover the reasonable sums so expended under a quantuum meruit theory.

Subsection (c) marks a significant departure from existing law. With the exception of the new Michigan legislation,[66] none of the existing rent withholding, rent receivership, or rent abatement statutes have any provisions similar to this one. Some states do have statutory provisions allowing the tenant to deduct from rents due the landlord amounts necessary to repair conditions that constitute code violations.[67] Under these statutes, however, it has been held that the tenant can waive this right, either in the lease or orally.[68] Under section 16 of this act the right granted to the tenant can not be waived.

(4) As to the tort liability of the tenant for injuries incurred due to repairs made by him pursuant to subsection (c), see section 15.

Section 6. *Authority to Withhold Rent.*

When a defective tenancy exists, an affected tenant may petition the superior court for the district wherein he resides for authority to withhold rent until such time as the conditions causing the defective tenancy are repaired. Upon proof of the existence of the defective tenancy and that the tenant was not the substantial cause of such condition, the superior court shall grant the tenant the right to with-

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66 MICH. COMP. LAWS § 125.534(5) (Supp. 1969). The Michigan statute allows a tenant to repair "unsafe, unhealthy or unsanitary" conditions that he is not the cause of, but *only* pursuant to court authorization. The costs of repair may be deducted from the rent. The M.R.L.-T.C. permits tenants to repair (and deduct from the rent the cost of repair) only minor defects. M.R.L.-T.C., *supra* note 3, § 2-206. The amount a tenant can deduct is limited to $50, or, if the tenant submits a written estimate to the landlord at least 4 weeks prior to repair, one month's rent. *Id.*

67 *See, e.g.*, CAL. CIV. CODE § 1942 (West 1954).

68 *See, e.g.*, Curtis v. Arnold, 29 Cal. App. 706, 184 P. 510 (1919).

hold rents. When a petition is granted pursuant to this section, the landlord and the tenant shall have the additional rights provided in sections 5(b) and (c).

COMMENT: (1) This section grants to a tenant the right to seek a court determination of his right to withhold rent. Essentially, the tenant's rights under this section are identical to his rights under section 5. The only purpose of this section is to allow the tenant to seek prior court approval of his right to withhold rent. The effect of this procedure is to remove doubts as to the legal position of the tenant when the tenant seeks to exercise rights under section 5. If the tenant seeks to exercise these same rights pursuant to section 6, his legal position will be determined prior to his withholding of rent. This section effectively permits the tenant to obtain a declaratory judgment that a defective tenancy exists, that he is an affected tenant, and that he was not a substantial cause of the conditions creating the defective tenancy.

(2) Upon a judicial determination favorable to the tenant, the tenant and landlord have the rights set out in section 5. Thus, the landlord may petition the court to have the rents turned over to the clerk and dispersed to the landlord so that he may repair. The tenant himself may repair pursuant to section 5(c). It should be noted that in exercising the right to repair, the tenant is governed by the provisions of section 5. Thus, the tenant need not seek an adjudication as to the reasonableness of the repair.

In permitting the tenant to seek a declaratory judgment as to his right to withhold rent, section 6 departs from existing law. No existing legislation vests such a right in the tenant, although it is arguable that a general declaratory judgment statute would provide such a right. The existing statutes either make rent withholding a defense to summary eviction proceedings[69] or require that the withheld rents be turned over to a clerk of court.[70]

(3) The procedures to be followed by a tenant in exercising his rights under this section are set out in section 13.

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69 *See, e.g.,* MASS. GEN. LAWS ANN. ch. 239, § 8A (Supp. 1969); N.Y. SOC. SERV. LAW § 143-b(5)(a) (McKinney 1966); N.Y. REAL PROP. ACTIONS & PROC. LAW § 755(1) (McKinney Supp. 1969).

70 *See., e.g.,* MASS. GEN. LAWS ANN. ch. 111, §§ 127F, 127H (Supp. 1969).

Section 7. *Authority to Withhold Rents: Other Tenants.*

(a) When a defective tenancy exists, any affected tenant may petition the superior court for the district wherein he resides to grant authority to any or all tenants in the tenement, whether or not affected by the defective tenancy, to withhold rents until such time as the conditions causing the defective tenancy are corrected.

(b) All persons who are withholding rent under a grant of authority from a superior court pursuant to subsection (a) shall have the additional rights of an affected tenant under section 5(c). Such tenants may exercise the rights set forth in section 5(c) either jointly or independently.

(c) If a petition is granted pursuant to subsection (a), the landlord shall have such additional rights against any tenant or tenants who are in fact withholding rent pursuant to subsection (a), as are provided in section 5(b).

COMMENT: (1) This section sets out one of the most effective remedies available to tenants under this act. Upon the petition of one affected tenant, the court in its discretion may grant authority to any or all tenants, whether or not affected by the defective tenancy, to withhold rents and exercise additional rights pursuant to section 5(c). This section reflects the legislative judgment that there may be situations in which the withholding of rent by one tenant will not be sufficient to induce the landlord to make the repairs necessary to correct the conditions causing the defective tenancy. Where this situation exists, the court, upon the petition of an affected tenant, may authorize any or all of the tenants to withhold their rent until the defective tenancy is repaired. It should be noted that under this section the court may only authorize, not order, the tenants to withhold rents. Once the authority is granted, the tenants may determine for themselves whether or not they wish to exercise their rights pursuant to section 5.

(2) The remedies created by this section should be considered in connection with the remedies created in section 8 and section 9. Section 8 grants the power to the court, upon the petition of one affected tenant, to *order* all or part of the tenants in the tenement to withhold rents and turn such rents over to the clerk of court. There are two differences between this section and section 8. First, under this section, the court merely grants all or part of the tenants

the authority to withhold rent; it has no mandatory effect on the tenant. However, If the court acts pursuant to section 8 the effect of its order is to require the withholding of rents by all or part of the tenants. The tenants' discretion to withhold or not is removed. The second difference is that under this section the tenant withholds the rent pursuant to the procedures of section 5. Under section 8 the tenant turns the rents over to the court. This puts an added burden on the court.

Section 9 grants the court the power, upon the petition of an affected tenant, to appoint a receiver. There are several differences between this section and section 9. First, as with section 8, any court orders issued pursuant to section 9 are mandatory on the tenant and remove his discretion to withhold rent. Moreover, the withholding of rent pursuant to section 9 is accomplished through a third party (the receiver), and the withheld rent does not remain with the tenant.

Under the provisions of each of these sections, the court may grant or refuse to grant the relief in its discretion. It is anticipated that a tenant seeking relief under this act will request of the court all appropriate relief as well as specific relief under one specific section. Thus, in many instances the court will be faced with deciding which is the appropriate relief. There are several factors the court should take into consideration in deciding this issue: (1) the nature of the conditions causing the defective tenancy; (2) the past history of the landlord with respect to such situations; (3) the likelihood that the withholding of rent by a single tenant will be effective in motivating the landlord to repair the defective tenancy; (4) the ability of the tenant or tenants effectively to withhold rents themselves or whether a third party is needed to manage the withholding of the rent; (5) the burden put on the court by handling the withheld rents through the clerk of court; and (6) the profit margin of the landlord, *i.e.*, the likelihood that he will be driven out of business.

In determining which is the most appropriate remedy, the court should seek to apply the remedy which will best effectuate, with the least inconvenience to the tenants, the central policy of this act — the speedy repair of the defective tenancy. There are two situations in which it is anticipated that the court will grant

relief pursuant to section 6. The first is where, because of the landlord's past conduct or other factors, the court determines that if only the affected tenants withhold rent, the landlord will not be motivated to correct the defective tenancy and where there is a sufficient number of other tenants who desire to withhold rent to motivate the landlord to correct the defective tenancy. The second situation is where the court determines that the affected tenant or tenants, alone, are incapable of correcting the defective tenancy with their withheld rents and that there is a sufficient number of other tenants willing to withhold rent whose rent, combined with the affected tenants' rents, would be sufficient to correct the defective tenancy.

(3) Subsection (c) reflects the policies that were discussed in the comments to section 5(b).

(4) The remedies available under this section depart significantly from existing law. Massachusetts legislation gives the court the power to authorize any or all tenants, whether or not affected, to pay their rents over to the clerk of court.[71] The Massachusetts statute is similar to this section in leaving the question of whether to withhold to the tenants discretion, but it is dissimilar in that the rents are to be paid over to the clerk of court, and thus they may not be retained by the tenants to pool together to correct the defective tenancy. The Spiegel Law is similar to this section only in that it allows rent to be withheld by the welfare official when there are defective conditions, regardless of whether the welfare recipient is affected by the defective condition.[72]

(5) The procedures to be followed in seeking relief under this section are set forth in section 13.

Section 8. *Order Requiring Tenants to Withhold Rents.*

When a defective tenancy exists, any affected tenant may petition the superior court for the district wherein he resides to order any or all tenants in the tenement, whether or not affected by the defective tenancy, to withhold their rents and turn over all rents due the landlord to the court. The clerk of court may disperse such rents to the landlord, his agents or assigns, in order to correct the defective condi-

71 MASS. GEN. LAWS ANN. ch. 111, § 127H (Supp. 1969).
72 See N.Y. SOC. SERV. LAW § 143-b(2) (McKinney 1966).

tions; *provided,* however, that such funds may be dispersed only upon proof of contracts or agreements by the landlord with appropriate repairmen to commence correction of the conditions causing the defective tenancy within thirty (30) days.

COMMENT: (1) As indicated in the comment to section 7, the court should look to this section in conjunction with sections 6, 7 and 9 in determining what relief is appropriate in a given situation. An order granted pursuant to this section is mandatory on the tenant, removing the tenant's discretion as to whether he will withhold rent. The order can require all tenants, whether affected or not, to withhold rents and turn over all rents due the landlord to the clerk of court.

It is anticipated that relief is most appropriately granted under this section in those situations where the past conduct of the landlord or other factors indicate that the landlord will not be motivated to repair the defective tenancy if only one tenant, or the affected tenants, withhold their rents, *and* where the number of tenants willing voluntarily to withhold their rents is insufficient to motivate the landlord to repair. Thus, the court may require a sufficient number of tenants to withhold their rent to motivate the landlord to repair. Since under an order pursuant to this section some tenants may be required to withhold rents against their wishes, it is necessary that the rents be turned over to the court, rather than remain with the tenant. Since the rents are no longer with the tenants, the additional rights of a tenant set forth in section 5(c) are not incorporated into this section.

(2) The last sentence of this section is included for the same purpose and is intended to have the same effect as section 5(b). The only difference is that in this section, the landlord need not bring a petition; the court may initiate action at its own discretion by requesting the landlord to execute contracts or agreements to commence repairs. Of course, the court under this section has no power to force the landlord to comply with these requests.

(3) This section does not depart significantly from existing statutes.[73]

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73 *See, e.g.,* MASS. GEN. LAWS ANN. ch. 111, §§ 127H, 127F (Supp. 1969); N.Y. REAL PROP. ACTIONS & PROC. LAW § 776(b) (McKinney Supp. 1969).

Section 9. *Appointment of Receiver.*

(a) When a defective tenancy exists, an affected tenant may petition the superior court for the district wherein he resides for the appointment of a receiver to collect and hold such rents as are due or shall become due the landlord from all tenants in the building. The court may grant such a petition in its discretion and appoint a receiver to collect, hold, and use such rents as the court may direct.

(b) The powers of a receiver shall include, but shall not be limited to, the following:

(1) to use monies collected and held to repair or to contract to repair the conditions causing the defective tenancy or any conditions in the building which constitute a violation of the state or municipal sanitary code, health ordinance or regulation;

(2) to evict tenants for the following reasons:

(A) non-payment of rent;

(B) waste;

(C) material breach of the lease;

provided, however, that the receiver shall not have the power to evict a tenant without cause;

(3) to borrow money from any source, with the approval of the court, in order to correct the conditions causing the defective tenancy or to otherwise effectuate his duties, where the monies collected and held by him will not be sufficient to correct such conditions or effectuate such duties within a reasonable period of time. Such loans may be secured, with the approval of the court in a proceeding in which the owner and outstanding mortgagees and lienholders are allowed to participate, by a lien on the rents as they become due, or by a prior lien on the tenement or tenements put into receivership.

(c) The duties of the receiver shall include, but shall not be limited to, the following:

(1) to maintain the premises; *provided*, however, that the receiver shall not have the power or duty to pay any municipal or state property taxes, nor any part of the interest or principal on any mortgages or liens;

(2) to put up a bond, in an amount the court shall deem fit, in order to secure his performance;

(3) to keep a record of all income and expenditures and to make accountings to the court of all income and expenditures at such intervals as the court shall deem advisable.

(d) Any natural person, corporation, partnership, or unincorporated organization, other than the owner of the tenement under receivership, or his family, agents or employees, is qualified to be appointed a receiver. Subject to the approval of the court, the receiver shall have the power to draw a reasonable salary from the rents collected and held.

(e) The court may, at any time, terminate the receivership, or appoint one or more additional receivers, or may remove a receiver and appoint a new receiver. In no event may a receivership continue beyond the time necessary to effectuate the purposes of this section and to discharge all debts and loans incurred in the course of his performance.

COMMENT: (1) This section creates one of the most important of the tenants' remedies. Because of the great number of possible situations and because the appointment of a receiver is traditionally an equitable remedy, the court in its discretion is given the power to determine when this remedy is appropriate. Since this act is intended to provide an effective vehicle for repair, however, it is intended that the remedy will be liberally granted in spite of its extraordinary character.

(2) This section explicitly allows one tenant to petition for a receivership in which all tenants will be required to pay their rent to the receiver. The same result can be obtained under the existing Massachusetts statute.[74] The New York statute, however, requires that one-third of the tenants petition for a receiver.[75] Organization of one-third of the tenants in a building may often be an insurmountable burden. In addition, this requirement is inconsistent with the traditional nature of the receivership remedy that would allow, for example, one creditor to petition to put a corporation in receivership.

(3) Subsection (b) is much more explicit than existing statutes in describing the powers of the receiver.[76] In addition to any other powers the court may grant, subsection (b) provides for three specific powers: repair, eviction, and solicitation of additional funds.

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74 MASS. GEN. LAWS ANN. ch. 111, § 127H(d) (Supp. 1969).

75 N.Y. REAL PROP. ACTIONS & PROC. LAW §§ 770, 776(b), 778 (McKinney Supp. 1969).

76 *Compare* MASS. GEN. LAWS ANN. ch. 111, §§ 127I, 127J (Supp. 1969); N.Y. REAL PROP. ACTIONS & PROC. LAW § 778(1) (McKinney Supp. 1969).

Repair. The receiver has the power to use the rent monies to repair the conditions causing the defective tenancy *and* any other violations of the state sanitary code. The receiver is given the power to correct violations of the sanitary code, even though these may not cause a defective tenancy, because the sanitary code imposes on the landlord the duty to correct these violations, and the violations may cause the occurrence or recurrence of a defective tenancy. Massachusetts now gives the receiver the power to correct these additional defects;[77] New York does not.[78] This subsection is not intended to limit the receiver's power to correcting existing defects if the court feels that the power to correct conditions that will result in defects in the future is necessary.

Eviction. Three specific grounds for eviction are included. The subsection also expressly limits the receiver's power to evict to situations where some cause exists. Since the receiver holds the property only temporarily, he should not be given the power to disturb a landlord-tenant relationship without some showing of cause. The present Massachusetts statute gives the receiver the power to evict, but only for non-payment of rent.[79] The New York statute has no provision giving the receiver the power to evict.[80] In the absence of a specific grant of this power, it is not clear that the receiver would have it, even though it is necessary to ensure that the receiver will obtain all the rent to repair the defects and will be able to stop tenants from creating or aggravating defective conditions.

Power to Borrow Money. The power to borrow money is a crucial part of the receivership process. Experience has shown that the available rent money is often insufficient to correct defective conditions within a reasonable time.[81] Receivers in New York are collecting an average of $920 a month to correct defects costing an average of $13,800.[82] In such situations, the receiver must be able to borrow additional funds or receivership will go on indefinitely.

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77 MASS. GEN. LAWS ANN. ch. 111, § 127J (Supp. 1969).

78 N.Y. REAL PROP. ACTIONS & PROC. LAW § 778(1) (McKinney Supp. 1969).

79 MASS. GEN. LAWS ANN. ch. 111, § 127I (Supp. 1969).

80 *See* N.Y. REAL PROP. ACTIONS & PROC. LAW § 778 (McKinney Supp. 1969).

81 Stang, *Tenant-Initiated Repairs: New York's Article 7-A*, 2 HARV. CIV. RIGHTS-CIV. LIB. L. REV. 201, 206 (1967).

82 *Id.*

In order to obtain loans, the receiver must have the power to give a lien on the rents or on the building itself. Since the tenement will often be mortgaged, this lien will have to be prior to these mortgages to be of any value. In addition, the lien will have to be on the tenement itself in most cases since it would take a very long period to liquidate the lien out of the monthly rents.

This act, while recognizing the need for additional funds, requires that specific court approval be given to any loans. If the loan is to be secured by a lien, this approval can be given only after a proceeding in which the landlord and any mortgagee or lien holder are given the opportunity to be heard. These safeguards were included to remove any procedural due process objections and to insure that loans will be obtained only where they are necessary to effectuate the policies of this act.

None of the existing statutes provide for the obtaining of private loans. New York has no provision for loans to the receiver.[83] Massachusetts gives the receiver the power to obtain public loans, but has never provided for private loans.[84] Although public loans would effectuate the policy of this act, indeed, may be essential for the maintenance of an adequate supply of housing available to the low-income tenant,[85] provisions for making these loans are outside the scope of this act since they require funding by the legislature.

(4) In addition to any duties the court may put on the receiver, subsection (c) imposes three specific duties: (1) maintenance of the tenement, (2) the filing of a bond, and (3) maintenance of an account.

Maintenance of the tenement. The receiver, in addition to repairing the defects, is given the duty of maintaining the premises to insure that other conditions will not deteriorate during the receivership. For two reasons, however, the receiver may not pay taxes or any lien or the principal or interest on any mortgage. First, these payments represent increases in the landlord's investment that in no way benefit the tenants. Second, these payments would seriously decrease the funds available for rehabilitation of the

83 *See* N.Y. REAL PROP. ACTIONS & PROC. LAW § 778(1) (McKinney Supp. 1969).
84 MASS. GEN. LAWS ANN. ch. 111, § 127J (Supp. 1969).
85 See notes 33-41 *supra* and accompanying text.

tenement. Existing statutes are unclear on this point. Neither Massachusetts nor New York appear to give the receiver the power to maintain the property.[86]

The Filing of a Bond. All existing statutes require the filing of a bond in an amount determined by the court.[87] It does not appear wise to set the amount of the bond in the statute, since situations vary and the court is in a good position to calculate how large a bond is necessary to protect the landlord.

Maintenance of an Account. The New York statute requires that the receiver file a full accounting of all receipts and expenditures at the completion of receivership.[88] Massachusetts does not require an accounting.[89] An accounting is necessary at intervals during the receivership and at the end of the receivership so that the landlord and the existing mortgagees and lien holders may obtain information on the receivership.

(5) Subsection (d) specifies who may be appointed receiver. The requirements for appointment are negligible; only the landlord and his family, agents and employees are excluded. The Act is necessarily vague as to who should be appointed since different types of expertise may be needed for different types of receiverships. For example, a contractor may be appropriate in one case while a lawyer may be appropriate in another. However, because of his opposing interest, the landlord or a person connected with him is probably never a good choice. The Massachusetts statute is less restrictive than this act since it does not even exclude the landlord or persons connected with him.[90] New York, on the other hand, is unnecessarily strict, limiting the appropriate party to an attorney, certified public accountant, or real estate broker.[91]

(6) Subsection (e) was added for clarity. No existing law has a comparable section.[92]

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86 *See* MASS. GEN. LAWS ANN. ch. 111, § 127I (Supp. 1969); N.Y. REAL PROP. ACTIONS & PROC. LAW § 778(1) (McKinney Supp. 1969).

87 *See, e.g.*, MASS. GEN. LAWS ANN. ch. 111, § 127J (Supp. 1969); N.Y. REAL PROP. ACTIONS & PROC. LAW § 778(1) (McKinney Supp. 1969).

88 N.Y. REAL PROP. ACTIONS & PROC. LAW § 778(1) (McKinney Supp. 1969).

89 *See* MASS. GEN. LAWS ANN. ch. 111, § 127I (Supp. 1969).

90 MASS. GEN. LAWS ANN. ch. 111, § 127I (Supp. 1969).

91 N.Y. REAL PROP. ACTIONS & PROC. LAW § 778(1) (McKinney Supp. 1969).

92 *See* MASS. GEN. LAWS ANN. ch. 111, §§ 127I, 127J (Supp. 1969); N.Y. REAL PROP. ACTIONS & PROC. LAW § 778 (McKinney Supp. 1969).

Section 10. *Rent Abatement.*

When a defective tenancy exists, any affected tenant may petition the court for an order abating any portion or the entirety of the rent due the landlord until the conditions which cause the defective tenancy are corrected. The court may grant such a petition in its discretion.

COMMENT: This section provides for abatement of all or part of the rent in proper circumstances. The section does not attempt to set out rules for determining where abatement should be granted. It is intended, however, that this remedy will not be used to defeat the proper remedial effect of the preceding sections. That is, where the rent can profitably be used to rehabilitate the premises, the preceding remedies should be used. Where the condition is such that the rent cannot be used to rehabilitate, rent abatement may be a proper remedy.

Rent abatement, like rent withholding, is a comparatively new remedy. In only a few cases has rent abatement been allowed on a common law theory of partial constructive eviction.[93] New York has enacted legislation providing for this remedy.[94] The problem with the New York statutes is that they provide only for the rent abatement remedy. Unless the tenant or welfare agency decides to release the rent voluntarily, the rent will not be used to remedy the defective conditions. Thus the statutes take on more of a punitive objective rather than a long term remedial objective. This statute attempts to correct this deficiency by allowing rent abatement as an alternative to withholding and rehabilitation.

Section 11. *Appropriate Restraining Orders and Injunctions.*

When a defective tenancy exists, an affected tenant may petition for equitable relief in the superior court in the district wherein he resides. In its discretion the court may issue such orders or injunctions, including but not limited to orders to repair, as it deems appropriate.

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93 *See, e.g.*, Gombo v. Martise, 41 Misc. 2d 475, 246 N.Y.S.2d 750 (Civ. Ct. 1964), *rev'd*, 44 Misc. 2d 239, 253 N.Y.S.2d 459 (Sup. Ct. 1964).

94 N.Y. SOC. SERV. LAW § 143-b(5)(b) (McKinney 1966); N.Y. MULT. DWELL. LAW § 302-a(3)(a) (McKinney Supp. 1969). *See* N.Y. ADMIN. CODE § Y51-5.0(h)(3) (New York City Rent Control Statute which allows the rent ceiling to be lowered where there are uncorrected code violations that endanger the health or safety of the tenants).

COMMENT: This section is not a significant change from prior law. Courts have been willing to give equitable relief in some very limited circumstances.[95] This section does not attempt to interfere with the discretion of the court in imposing this remedy.

Section 12. *Damages.*

Upon the presentation to the superior court of a petition seeking relief pursuant to sections 6 through 12 of this act, the court in its discretion may determine damages due to the petitioning tenant caused by the defective tenancy and assess such damages against the landlord.

COMMENT: This section is not intended to change the common law in any way other than to ensure that the court will consider a damage remedy even if the tenant has not expressly asked for it.

Section 13. *Procedures.*

(a)(1) Before an affected tenant may withhold rent pursuant to section 5(a), the landlord shall have had notice for at least thirty (30) days or one (1) rental period, whichever is less, of the defective tenancy. For the purposes of this subsection, the landlord will be considered to have had notice of the defective tenancy if the landlord, his employee, agent or person within his control, has actual knowledge of the conditions causing the defective tenancy, regardless of the source from which such knowledge has come.

(2) Before initiating repairs pursuant to section 5(c), Section 6 or section 7(b), the tenant shall give the landlord fourteen (14) days notice in writing of his intention to commence correction of the condition causing the defective tenancy.

(b)(1) Upon the filing of a petition by a tenant pursuant to sections 6 through 12 of this act, the court shall issue an order of notice requiring the owner to appear within fourteen (14) days to file an answer to the petition. Such order of notice shall be served by delivering an attested copy thereof to the landlord or by leaving such a copy thereof at his last and usual place of abode or at the address to which the rent is sent or, if the landlord is a corporation, to the place provided by law. If none of the above methods are possible, service may be effectuated by posting such order of notice in a public place in the

95 *See* Schoshinski, *Remedies of the Indigent Tenant: Proposal for Change*, 54 GEO. L.J. 519, 538 (1966).

tenement wherein the petitioning tenant resides. The answer shall include the names and addresses of all persons having a legal or beneficial interest in the tenement, including all persons having mortgages or liens of record.

(2) At least seven (7) days before any scheduled hearing or any petition filed pursuant to section 6 through 12 of this act, the petitioner shall send to all persons having a legal or beneficial interest in the tenement, including all persons having a lien or mortgage of record, a copy of the petition and notice of the date and time of the hearing.

(3) When a petition is filed pursuant to sections 6 through 12 of this act, the petitioner shall notify other tenants in the tenement in which the defective tenancy exists by the posting of the petition and order of notice in a common area in the tenement.

(c) Upon the filing of a petition of a landlord pursuant to section 5(b), Section 6, or section 7(c), the court shall issue an order of notice authorizing any tenant withholding rents to appear within fourteen (14) days to file an answer.

(d) No costs shall be assessed against any party in any proceedings pursuant to this act.

COMMENT: (1) The section provides special procedures to be used with this act. The normal procedures are inadequate because of the necessity of a speedy remedy and the desirability of notifying third parties of the action, even though these third parties are not parties to the action.

(2) Paragraph (a)(1) of this section deals with rent withholding without court approval. The conditions required to invoke section 5(a) rights reflect a balancing of two policy interests. The first is that the landlord should be notified that conditions causing a defective tenancy exist so that he may have the opportunity to repair. On the other hand, to require a tenant to give written notice would defeat the purpose of section 5(a) to protect tenants who in ignorance of the law engage in self-help. The resulting compromise of these two interests is embodied in the paragraph (a)(1) requirement that the landlord have notice of the defective tenancy, but that the notice need not be in writing nor need it come from the tenant.

The existing legislation differs from the approach adopted by the Model Act. The Massachusetts statute requires written notifi-

cation from either the tenant or the appropriate municipal health or safety official.[96] The New York statute does not require notification to the landlord.[97]

Since none of the existing statutes provide for tenant repair using the withheld rent, paragraph (a)(2) is new. It is consistent with the purpose discussed above.

(3) Subsection (b) provides for service of process in a tenant-initiated court proceeding pursuant to this act. It also specifies the requirements of the landlord's answer and provides for notice to the mortgagees, other lienholders, and other tenants.

The requirements for service of process on the landlord are substantially those of the Massachusetts statute.[98] It provides for maximum notice and ease of use. The only substantial deviation from the Massachusetts statute is the addition of posting in a common area in the tenement as the last alternative method of service. This method is added to insure that the tenants' rights will not be cut off by inability to serve process by the traditional means. Because of considerations of fairness and constitutional limitations, its use is expressly limited to cases where other methods have proved ineffective.[99]

The landlord's answer must contain the names of all persons holding a legal or beneficial interest in the tenement. This provision was added because the holders of these interests must receive notice to meet constitutional requirements and because the burden of ascertaining whether there are any interests and who holds them might otherwise be very great.[100]

Subsection (6) requires that the petitioner notify holders of a legal or beneficial interest of any hearing seven days before that hearing. As noted above, due process requires that these interests be notified or joined. Since mandatory joinder was felt to be impractical in this situation, the notice requirement was used.[101]

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96 MASS. GEN. LAWS ANN. ch. 239, § 8A (Supp. 1969).

97 See N.Y. REAL PROP. ACTIONS & PROC. LAW § 755(1) (McKinney Supp. 1969).

98 See MASS. GEN. LAWS ANN. ch. 111, § 127D (Supp. 1969).

99 See Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306 (1950); In re Dep't of Bldgs., 14 N.Y.2d 291, 200 N.E.2d 432 (1964); Central Savings Bank v. New York, 279 N.Y. 266, 18 N.E.2d 151 (1938).

100 See MASS. GEN. LAWS ANN. ch. 111, § 127D (Supp. 1969).

101 See MASS. GEN. LAWS ANN. ch. 111, § 127H (Supp. 1969); Pratt, *Receiverships*

The timing of the notice provisions is set so that the tenant will not have to provide notification to the lien holders, etc. until he has received a complete list of their names from the landlord.

The subsection (b) requirement that the other tenants be notified of an impending proceeding is new. It is clear that other tenants have an interest in a proceeding even if the petitioner is not seeking receivership. For example, the facts found in the proceeding may demonstrate that other tenants could initiate out-of-court rent withholding. For this reason, it is desirable that the tenants receive some notice of proceedings under this act.

(4) Subsection (c) sets out the process requirements when the landlord initiates a proceeding to have withheld rent released for repairs. The notice requirements are almost identical with those of subsection (b).

(5) Subsection (d) states that costs will not be assessed against any party in proceedings under this act. The petitioning tenants in proceedings under this act will often have insufficient resources to bear the financial burden of protracted litigation. Thus, the fear of being assessed with such costs may inhibit the tenant from seeking a remedy under this act.

Section 14. *Right of Landlord to Withheld Rent, to Evict, to Raise Rents.*

(a) For the period of time that a tenant is rightfully withholding rent from the landlord or paying such rent to the court or a receiver pursuant to this act, the landlord shall have no right to evict the tenant for the non-payment of such rent; nor shall the landlord have any claim against such tenant for such rents during that period of time. If the tenant initiates repairs pursuant to sections 5(c), 6 and 7(b), he may not be evicted for repairing beyond that authorized in sections 5(c), 6 and 7(b).

(b) For the period of time that a tenant is rightfully withholding rent from the landlord or is paying the rent to a court or receiver pursuant to this act, or for ninety (90) days thereafter, the landlord shall have no right to evict such tenant without cause.

(c) In any eviction or summary process proceeding brought by the landlord, a finding by the court that the proceeding is in retaliation

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in the Rehabilitation of Urban Housing, 2 HARV. CIV. RIGHTS-CIV. LIB. L. REV. 219, 220-22 (1967).

against the exercise of rights by the tenant under this act shall be a complete defense. Any eviction or summary process proceeding brought by the landlord against any tenant exercising rights pursuant to this act, or for ninety (90) days thereafter, will be presumed to be retaliatory against the exercise of rights by the tenant under this act. The presumption that an eviction or summary process proceedings is retaliatory may be overcome by the landlord only on a showing that (1) there is cause for the eviction or summary process proceeding and (2) that the landlord is not acting pursuant to a course of conduct that is different from his normal course of conduct in such circumstances.

(d) For the period of time that a tenant is rightfully withholding rent from the landlord or is paying rent to a court or receiver pursuant to this act, the landlord shall have no right to raise the rent of such tenant. The landlord shall at no time have the right to raise the rent in retaliation against the exercise of rights by the tenant under this act. Any increase in rent within ninety (90) days of the exercising of rights under this act will be presumed to be retaliatory. The presumption that a rent increase is retaliatory can be overcome by the landlord only on a showing that (1) increased costs require an increase in rents in order to maintain a reasonable profit and (2) that the rent increase is in relation to increases in rent in other rental units of the landlord or comparable rental units in the area.

COMMENT: (1) This section sets out the rights of the landlord when tenant seeks a remedy pursuant to this act. Under normal circumstances, when a tenant fails to pay his rent, he may be evicted in a summary process proceeding,[102] even if the condition of the premises does not satisfy code standards. Without this section, the tenant who withholds rent pursuant to this act could be evicted in a summary process proceeding. This section provides that the landlord may not evict the tenant through a summary process proceeding if the eviction is based on failure to pay rent pursuant to this act. It also provides that the landlord may not sue the tenant for the withheld rent as long as the conditions causing the defective tenancy still exist.

This section also governs, in part, the landlords' right to evict a tenant who is exercising his rights under the Act for reasons other than non-payment of rent. In addition, this section restricts

102 *E.g.*, MASS. GEN. LAWS ANN. ch. 239, § 1 (1959).

the landlord's right to evict either for non-payment of rent or for any other cause after the conditions have been corrected.

(2) Subsection (a) provides that a tenant may not be evicted for non-payment of rent that is being withheld pursuant to this act. In this respect the subsection is substantially identical to the existing statutory provisions.[103] The statute further states that the landlord does not have any claim against the tenant for rent while it is being withheld pursuant to this act. This does not mean that the landlord will never have a claim for the withheld rent. In fact, it is the intent of the drafters that the landlord will have a claim for the withheld rent after the conditions are corrected unless the court has ordered a rent abatement. All subsection (a) does is delay the landlord's right to the rent until such time as the defective tenancy is repaired. If the rent is used to correct the defects, however, the landlord's claim for the rent is extinguished to the extent of the rent so used. To the extent the existing statutes use a rent withholding or receivership remedy, rather than a rent abatement remedy, they seem to adopt this approach.[104]

The last sentence of subsection (a) is new because the tenant's right to repair and subtract the cost of repairs from the rent is new. The tenant, necessarily, is in a difficult position. It is unlikely that he will know exactly how much repair work is necessary to correct the defects without in any way improving the tenancy beyond that. It is likely that the tenant may unknowingly spend too much to repair the premises. Under existing law, if he subtracts too much money from the rent for repairs, he can be evicted for non-payment of rent. This possibility could discourage the tenant from initiating repairs. Therefore, this act modifies the existing law by eliminating the landlord's right to evict where the tenant has the right to withhold and repair but has withheld too much for repair.

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103 *E.g.*, MASS. GEN. LAWS ANN. ch. 111, § 127F (Supp. 1969); MASS. GEN. LAWS ANN. ch. 239, § 8A (Supp. 1969); N.Y. SOC. SERV. LAW § 143-b(5)(b) (McKinney 1966); N.Y. REAL PROP. ACTIONS & PROC. LAW § 755(1)(b) (McKinney Supp. 1969); N.Y. MULT. DWELL. LAW § 302-a(3)(c) (McKinney Supp. 1969).

104 See MASS. GEN. LAWS ANN. ch. 111, § 127F (Supp. 1969); MASS. GEN. LAWS ANN. ch. 239, § 8A (Supp. 1969); N.Y. REAL PROP. ACTIONS & PROC. LAW § 755(1) (McKinney Supp. 1969).

(3) Subsections (b) and (c) are intended to regulate retaliatory evictions. In many instances when tenants have attempted rent withholdings or similar actions, the landlord's reaction has been to evict the tenants in order to deter other tenants from withholding.[105] To permit such retaliation would destroy the effectiveness of the remedies under this act.

Only two of the existing statutes have attempted to deal with this problem. The Massachusetts rent withholding statute provides that if a tenant is rightfully withholding rent, the landlord cannot terminate the tenancy without showing some fault on the part of the tenant.[106] The statute does not, however, provide the tenant any protection after the conditions are corrected. The Massachusetts Rent Receivership Statute, however, provides that the landlord may not evict any tenant for nonpayment of rent being paid into the court while defective conditions exist, nor may he evict for non-payment of rent during the nine months following the correction of the defects.[107] The statute provides no protection against evictions without cause.

The approach taken by the Model Act is somewhat different from the approach employed by either of the Massachusetts statutes. Rather than creating a blanket prohibition against evicting tenants while the tenant is exercising rights under the act, or for a limited period thereafter, the Model Act limits the landlord's power to evict in two ways: (1) under subsection (b) while the tenant is exercising rights under the Act and within 90 days thereafter, the landlord may evict *only* for cause; and (2) under subsection (c) *at no time* may the landlord evict in retaliation against rights exercised pursuant to the Act. While rights are being exercised under the Act, and for 90 days thereafter, it is *presumed* that an eviction action is retaliatory, thus shifting the burden of proof to the landlord. The evidence required to overcome the presumption is strictly limited, as described in subsection (c). After the 90 day period has elapsed, the burden of proving that the eviction is in retaliation against the exercise of rights protected by this act shifts back to the tenant. However, if the tenant

105 *See* Schoshinski, *supra* note 95, at 541.
106. MASS. GEN. LAWS ANN. ch. 239, § 8A (Supp. 1969).
107 MASS. GEN. LAWS ANN. ch. 111, § 127F (Supp. 1969).

can carry that burden, a valid defense to a summary process proceeding will be established.

(4) It is recognized that rent increases, if made in retaliation against the exercise of rights under this act, can seriously undermine the effectiveness of this act. Therefore, the landlord's power to raise rents, like the landlord's power to evict, is limited by subsection (d) in two ways: (1) during the time when a tenant is withholding rents, paying rents into a court or to a receiver pursuant to this act, the landlord has no right to raise rents; and (2) *at no time* may a landlord raise rents in retaliation against the exercise of rights under the act. In a manner similar to the provisions concerning retaliatory evictions, subsection (d) creates a presumption of a retaliatory motive with respect to rent increases made within 90 days of a tenant's exercising rights under the act, thus shifting the burden of proof to the landlord. Subsection (d) also describes the evidence necessary to overcome the presumption.

Section 15. *Tort Liability.*

A tenant shall incur no liability as a result of negligence in his repair of defective tenancies pursuant to sections 5(c), 6, and 7(b). Any liability resulting from such negligent repair shall be incurred by the landlord.

COMMENT: The purpose of this section is to shift the liability for the negligent repair of the defective tenancy from the tenant to the landlord when the tenant repairs the premises pursuant to sections 5(c), 6, and 7(b). There are two basic reasons for shifting this liability. First, the repair of the premises is primarily the landlord's responsibility. The landlord should not be relieved of liability when the tenant has repaired the premises because of the landlord's wrongful failure to do so. Second, placing the liability on the landlord will help effectuate the ultimate purpose of this act — the speedy repair of the premises — in two ways: (1) the tenant will not be inhibited from exercising his rights to repair pursuant to sections 5(c), 6, and 7(b) for fear of incurring liability, and (2) the landlord may be motivated to correct the defective tenancy for fear of incurring liability for the negligent repair by the tenant. It is the intention of this section to shift the

liability to the landlord only for simple negligence. In situations of gross negligence and willful and wanton conduct, the liability will remain with the tenant. No existing statutes have provisions similar to this one.

Section 16. *Waiver.*

No provision of this act may be waived by any oral or written agreement. Any attempted waiver shall be considered void.

COMMENT: The public policies which this act manifests are of a nature which should not be waivable by agreement. In any bargaining situation the tenant is generally in a much weaker position. This section does not expand upon existing law.[108]

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108 *See, e.g.*, N.Y. REAL PROP. ACTIONS & PROC. LAW § 780 (McKinney Supp. 1969).

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AN ANTI-BLOCKBUSTING ORDINANCE*

Introduction

In recent years, increasing numbers of blacks and other minorities have been moving from ghetto neighborhoods into nearby all-white, middle-class neighborhoods.[1] The causes of this migration include overcrowding in ghettos, increased minority income, urban renewal, and enactment of fair housing laws.[2] While this exodus from the ghetto is necessary and desirable, it typically causes fear and hostility among white citizens.[3] The white middle-class homeowner often views the arrival of even a single minority family as the start of a massive influx of minority residents. The white homeowner may also envision a rising crime rate, a decline in the quality of neighborhood life, diminished property values, and the ultimate transformation of the area into a ghetto.[4] This belief, initially erroneous, becomes a self-fulfilling prophecy, at least as to the area's racial composition, as white residents flee.[5] Neighborhood change is reinforced as buyers seeking a long-term investment avoid the area because they fear rapid transition[6] and because potential mortgagees demand high interest rates.[7] What

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*Prepared by Gregory W. Byrne and Benjamin I. Berman, members of the Class of 1971, and Harold B. Obstfeld and Jonathan Davis, members of the Class of 1970, at the Harvard Law School.

1 CHICAGO MAYOR'S COMMISSION ON HUMAN RELATIONS, THE MANAGEMENT OF NEIGHBORHOOD CHANGE 4 (1959); N.Y. Times, Dec. 9, 1969, at 49, col. 4.

2 CHICAGO MAYOR'S COMMISSION ON HUMAN RELATIONS, *supra* note 1, at 4; C. RAPKIN & W. GRIGSBY, THE DEMAND FOR HOUSING IN RACIALLY MIXED AREAS 1-3 (1960).

3 R. HELPER, RACIAL POLICIES AND PRACTICES OF REAL ESTATE BROKERS 3, 58-68 (1969); *see also* E. GRIER & G. GRIER, PRIVATELY DEVELOPED INTERRACIAL HOUSING 210-211, 214 (1960); CHICAGO MAYOR'S COMMISSION ON HUMAN RELATIONS, *supra* note 1, at 28-33; N.Y. Times, Sept. 12, 1969, at 25, col. 1, Dec. 9, 1969, at 49, col. 4.

4 R. HELPER, *supra* note 3, at 93-101; E. GRIER & G. GRIER, DISCRIMINATION IN HOUSING 30-33 (1960); As to threats of declining property values, there is evidence that, indeed, the contrary occurs when former ghetto residents buy homes in previously white middle class neighborhoods. L. LAURENTI, PROPERTY VALUES AND RACE (1960); *See* Pearl & Turner, *Fair Housing Laws: Halfway Mark*, 54 GEORGETOWN L. REV., 156, 168 (1965); *compare* R. HELPER, *supra* note 3, at 94-95.

5 C. RAPKIN & W. GRIGSBY, *supra* note 2, at 72; N.Y. Times, Dec. 9, 1969, at 49, col. 4.

6 Singer, *How We Beat the Blockbusters*, SAT. EVE. POST, March 23, 1960, at 50.

7 CHICAGO MAYOR'S COMMISSION ON HUMAN RELATIONS, *supra* note 1, at 22.

begins as a step toward integration often ends as an expansion of the ghetto.[8]

Homeowners in such areas are particularly vulnerable to realtors and speculators who engage in a practice called "blockbusting."[9] The blockbuster's aim is to buy a home at a price below fair market value and then to sell it to a minority buyer at an inflated price.[10] The blockbuster's tactics for panicking the white homeowner are varied. They may include blatant references to current of future changes in the neighborhood's racial composition, or subtler allegations as to crime rates, recent sales, property values, and school conditions. The mechanics of blockbusting campaigns include mass solicitation by letters, telephone calls, face-to-face conversations, and the proliferation of "for sale" signs, and even of realtors' offices, in the neighborhood.[11] Thus, homeowners who have no intention of selling are subjected to the harassment of repeated solicitation.[12]

The blockbuster usually is prepared to offer cash as an inducement to sell.[13] After purchasing a house, the blockbuster will attempt to sell it to a minority-group buyer who is often willing to pay a price above fair market value in order to escape the ghetto. The buyer may be burdened with mortgage payments he cannot meet. Loss of the house, with any improvements the buyer may have installed, and resale to another minority-group buyer may follow.[14]

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8 R. HELPER, *supra* note 3, at 298; *see also* N.Y. Times, Dec. 9, 1969, at 49, col. 4.

9 E. GRIER & G. GRIER, *supra* note 4, at 36-37 (1960); *see generally* C. RAPKIN & W. GRIGSBY, *supra* note 2, 77-105; R. HELPER, *supra* note 3, at 172-182.

10 Brown v. State Realty 304 F. Supp. 1236. (N.D. Ga. 1969); U.S. v. Mintzes 304 F. Supp. 1305 (D. Md. 1969); CHICAGO MAYOR'S COMMISSION ON HUMAN RELATIONS, *supra* note 1, at 12; Peck & Stratton, *Tort Liability of Blockbusters*, in OPEN OCCUPANCY v. FORCED HOUSING UNDER THE 14TH AMENDMENT 236-237 (A. Avins ed. 1963); N.Y. Times, Jan. 25, 1970, at 57, col. 3-5; memorandum from Leon Deutsch, Chairman, Housing Maintenance and Code Enforcement Committee, Mayor's Urban Action Task Force for East Flatbush (New York City) to Harvard Student Legislative Research Bureau, October 14, 1969.

11 Memorandum from Leon Deutsch, *supra* note 10, at 1; N.Y. Times, Sept. 12, 1969 at 25, col. 1; *see, e.g.*, Patner v. Williams, 11 RACE REL. L. REP. 1032 (Chicago Comm. on Human Rel. 1966); for an example of the proliferation of signs and the effect on neighborhood homeowners see "Findings of Fact" in Brown v. State Rty. Co., 304 F. Supp. 1236 (N.D. Ga. 1969).

12 HUD News, HUD-No. 69-0998, Dec. 12, 1969; Newsweek, Dec. 1, 1969, at 55; N.Y. Times, Dec. 9, 1969, at 75, col. 1.

13 See N.Y. Times, Dec. 9, 1969, at 49, col. 4.

14 Memorandum by Charles Ortner under covering letter from Diana Gordon to

Blockbusting is especially harmful because it aggravates racial antagonisms. The white homeowner is made to feel threatened by the minority-group buyer. The latter, in turn, may see himself as a blight on the community.[15] If he is among the first of a minority group to buy into a white neighborhood, he is often exposed to harassment by fearful and hostile neighbors.[16]

Most current anti-blockbusting laws fail to prevent blockbusting because they prohibit only the grossest violations.[17] An effective solution calls for greater restrictions on the conduct of real estate brokers and dealers, particularly in neighborhoods which experience substantial blockbusting activities,[18] but these restrictions should not prevent legitimate dealers from earning a fair profit. Furthermore, legislation must avoid inhibiting minorities from moving into white neighborhoods and yet assure white homeowners that when a minority family does move into a neighborhood, it will not become a ghetto.

The proposed ordinance attempts to balance the realtor's interest in the pursuit of his business against the public interest in racial harmony and the homeowner's interest in being free of harassment and exploitation. While an outright ban on all forms of solicitation of homeowners throughout the city would be the most effective check on blockbusting activities, such a law would penalize honest real estate brokers and their clients. Moreover, most forms of solicitation are not usually harmful *per se*. Yet certain kinds of solicitation are potentially harmful. The most obvi-

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Donald Elliott, Chairman, New York City Planning Commission, Sept. 17, 1969, on file at Harvard Student Legislative Research Bureau; N.Y. Times, Jan. 25, 1970, at 35, col. 1.

15 Sumner v. Teaneck 53 N.J. 548, 251 A.2d 761 (1969).

16 See H. Stetler, Racial Integration in Private Residential Neighborhoods in Connecticut (1957) and H. Lees, *Not Wanted*, The Atlantic Monthly, Jan. 1956, at 59-63, both cited in C. Rapkin and W. Grigsby, *supra* note 2, at 74; HUD News, *supra* note 12.

17 *See, e.g.*, St. Louis, Mo., Ordinance 52328, Feb. 6, 1964, reported in 9 Race Rel. L. Rep. 372 (1964); Chicago, Ill., Ordinance ch. 198.7-B, Sept. 11, 1963, reported in 8 Race Rel. L. Rep. 1208 (1963); Ohio Code § 4112.02 (Page's Supp. 1969); N.Y. Real Prop. Law art. 12-A, rules and regulations § 175.17, promulgated by Dept. of State; N.Y. Exec. Law § 296 (McKinney Supp. 1969-70).

18 Blockbusting may also occur far from the ghetto, even in suburban areas. See Chicago Mayor's Commission on Human Relations, *supra* note 1, at 12. Implementation of efforts toward this goal would be the responsibility of the Commissioner under sections 2 and 5 of the proposed ordinance.

ous example is a solicitation which includes warnings of declining property values due to an anticipated influx of minority-group residents. Section 3 of the proposed ordinance proscribes such forms of solicitation.

However, even normally innocent methods of solicitation may be harmful when used in a neighborhood whose residents are very sensitive to current or prospective changes in home ownership.[19] Brokers' solicitations in the neighborhood may increase already existing fears of a sudden change in the character of the neighborhood. Frequent visits of speculators and repeated letters and phone calls to homeowners in such neighborhoods may provoke panic-selling. Hence, it is essential to curtail even normally legitimate solicitation methods in these areas. Section 4 is designed to achieve this by authorizing the administering officer or agency to designate such areas as Restricted Solicitation Areas, in which the activities specified in section 5 are prohibited.

Another major defect in existing legislation besides incomplete standards of liability is the failure to provide adequate remedies. Some regulations provide only for loss of a broker's license in the event of violation.[20] This limited approach does not cover the real estate "dealer," the person who buys and sells property for his own account.[21] Moreover, many existing statutes fail to provide criminal sanctions, relying instead on persuasion by an administrative agency or on agency-sought injunctions.[22] The criminal sanctions that have been enacted are often not sufficiently severe to deter violations.[23] Section 8 of the proposed ordinance imposes a fine of $10,000 and/or imprisonment for 90 days for each offense. Section 9 permits civil suits by persons who have been induced to sell their home by methods of solicitation prohibited by sec-

19 This state of mind is typical of residents of white neighborhoods near black ghettos. See note 18 *supra;* N.Y. Times, Dec. 9, 1969, at 49, col. 4.

20 *See, e.g.,* CHICAGO, ILL., ORDINANCE ch. 198.7-B, § 9, Sept. 11, 1963, reported in 8 RACE REL. L. REP. 1208 (1963); N.Y. REAL PROP. LAW art. 12-A, § 441-c (McKinney 1968), rules and regulations § 175.17, promulgated by Dept. of State.

21 For a definition of "dealer" see § 2(g) of the proposed ordinance.

22 *See, e.g.,* OHIO CODE § 4112.05 (Page's 1965). For a study of enforcement of antidiscrimination provisions in housing laws by administrative agencies see Witherspoon, *Civil Rights Policy in the Federal System: Proposals for a Better Use of the Administrative Process,* 74 YALE L.J. 1171 (1965).

23 *See, e.g.,* SHAKER HEIGHTS, OHIO, ORDINANCE 61-97, August 29, 1961, reported in 8 RACE REL. L. REP. 262 (1963), which provides a fine of $50 for the first offense.

tions 3 and 5. Such homeowners may sue to recover double the amount of gain the blockbuster has realized on a subsequent disposition of the property.[24]

The ordinance contains two other important features. Section 6 empowers the administering agency to conduct research on blockbusting and to recommend changes in the law. Section 7 empowers the agency to conduct anti-blockbusting informational campaigns and to stimulate action by neighborhood groups opposed to blockbusting. Experience has shown that blockbusting can best be defeated by a cohesive, organized community.[25]

The drafters considered but rejected two other approaches to the problem of blockbusting. The first was a government insurance program which would set a floor under the market value of houses in areas subjected to blockbusting. This proposal was rejected for several reasons. First, administration would be complex; for example, it would be difficult to devise an objective standard of market value that could be kept current. Second, financing would be difficult. If coverage were voluntary, with each insured paying a premium, many homeowners might prefer to bear the risk themselves rather than to pay the premium, thus limiting the resources available for payment. In any event, the program would have to be underwritten by local, state, or federal government, and this would add to the tax burden. Third, any program involving government price maintenance runs the risk of abuse. For example, an owner might sell to a friend or relative for less than the insured value of the dwelling, relying on the government, not the buyer, to make up the difference between sale price and insured value.

Another possible approach would be to subject real estate brokers to regulation similar to that imposed on liquor retailers.[26] An agency would grant licenses to operate real estate offices unless

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24 For other remedies available see Title VIII of the Civil Rights Act of 1968, § 804(e), 42 U.S.C. 3604(e) (Supp. 1968); N.Y. EXEC. LAW, § 297(4)(c)(iv) (McKinney Supp. 1969-70). For two recent cases involving findings of liability under Title VIII see note 10 *supra*. For a discussion of remedies at common law see Peck and Stratton, *supra* note 10.

25 See, *e.g.*, NEWSWEEK, Dec. 1, 1969, at 55; HUD News, *supra* note 11.

26 See N.Y. ALCOHOLIC BEVERAGE CONTROL LAW § 50 *et seq.* (McKinney 1968). For an example of the inadequacy of enforcement through state licensing systems see Abel v. Lomenzo 25 App. Div. 2d 104, 267 N.Y.S.2d 265 (1966).

the operation of an office in a particular location was not in the public interest. Several problems are presented by this proposal. First, unless the rather harsh technique of license revocation was employed, this approach would not affect currently operating offices. Second, the administrative burden would be considerable. The licensing agency would have to maintain a staff to examine and pass upon all applications; and denial of an application would probably require a hearing, possibly resulting in burdensome litigation. Third, the scope of such a scheme is too broad for the limited objective of deterring blockbusting. Requiring realtors in mid-town Manhattan to obtain licenses would be an unnecessary burden on both the licensing agency and the realtors.

Finally, a question necessarily considered by the drafters was whether the state laws dealing with the blockbusting problem may have preempted the area, thus preventing the municipality from legislating on the subject. The proposed ordinance was drafted for New York City. Although section 27 of the New York City Charter grants a broad police power to the city to enact legislation for the general welfare of its inhabitants, a municipal ordinance is invalid if it conflicts with a state law which specifically prohibits the adoption of municipal laws on the subject or if the legislative history of the state act shows a clear intention on the part of the legislature to cover the field.[27] The New York State anti-blockbusting legislation does not explicitly preempt the field;[28] and there is good reason to believe that the state statute does not implicitly preclude the proposed ordinance since the ordinance is designed to supplement and to strengthen the policy of the state law. The ordinance should be upheld under the general rule that a city law dealing with a subject on which there is also state legislation is valid as long as it is not inconsistent with that state law.[29]

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27 *See* Wholesale Laundry Bd. of Trade v. City of N.Y. 43 Misc. 2d 816, 252 N.Y.S.2d 502, 506 (Sup. Ct. 1964); Jewish Consumptives' Relief Soc. v. Town of Woodbury, 230 App. Div. 228, 243 N.Y.S. 686, 696 (2d Dept. 1930).

28 N.Y. EXEC. LAW § 296 (McKinney Supp. 1969-70).

29 City of N.Y. v. Clafflington, Inc., 243 N.Y.S.2d 437, 439 (Sup. Ct. 1963) held that § 296 of the N.Y. EXEC. LAW (McKinney Supp. 1969-70) was not intended by the legislature to exclude further local legislation. *See also* S.H. Kress Co. v. Dept. of Health, 283 N.Y. 55, 27 N.E.2d 431 (1940); Feigenblum v. Commission on Human Rights of N.Y.C., 53 Misc. 2d 360, 278 N.Y.S.2d 652 (Sup. Ct. 1967); Grimm v. City of New York, 56 Misc. 2d 525, 289 N.Y.S.2d 358 (1968). In *Grimm* the court upheld

AN ANTI-BLOCKBUSTING ORDINANCE

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Section 1. *Declaration of Policy*

It is the policy of the City of .... and the purpose of this ordinance to promote fair dealing in real estate transactions, to maintain community stability and security, and to foster racial and social harmony.

Section 2. *Definitions*

When used in this ordinance, unless the context requires otherwise:

(a) "Commissioner" means ....

(b) "Dwelling" means any building, structure, or portion thereof which is occupied as a residence by one or more individuals and any vacant land which is offered for sale or lease for the construction or location thereon of any such building, structure, or portion thereof.

(c) "Legal notice" means publication for one week in a newspaper of citywide circulation.

(d) "Real estate broker" means a real estate broker as defined in

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the constitutionality of New York City's gun licensing law despite a state law requiring the certification of mentally-ill persons and previously-convicted felons in order to possess rifles or shotguns and the licensing of all persons to possess handguns. The court found that, despite the breadth of the state law, the legislature had not indicated an intention to occupy the entire field of gun control to the exclusion of local law. New York State's anti-blockbusting law is not nearly so elaborate as its gun control law; it should provide little evidence of an intention to preempt the anti-blockbusting field. *But see* Bon-Air Estates, Inc. v. Building Inspector of Town of Ramapo, 31 App. Div. 2d 502, 298 N.Y.S.2d 763 (2d Dept. 1969).

Section 440, N.Y. Real Property Law, Article 12-A, as from time to time amended.

(e) "Real estate dealer" means any person, firm, partnership, association, or corporation who has within the preceding twelve months, sold, traded, or exchanged two or more dwellings other than his own personal residence.

(f) "Real estate office" means an office or other place of business which is used for selling, buying, leasing, or renting real property; for listing real property for sale, purchase, lease, or rental; or for providing brokerage services in connection with such selling, buying, leasing, renting, or listing.

(h) "To solicit" means to request, invite, or induce, for profit, by any means, including, but not limited to:

(1) going in or upon the property of the person to be solicited, except when invited by such person;

(2) contacting the person to be solicited by mail, telephone, telegraph, or messenger service, except when requested by such person;

(3) canvassing in streets or other public places;

(4) distributing handbills, circulars, cards, or other advertising matter;

(5) using loudspeakers, soundtrucks, or other voice-amplifying equipment;

(6) displaying signs, posters, billboards, or other advertising devices other than signs placed upon a real estate office for the purpose of identifying the occupants and services provided therein. *Provided*, however, that the term "to solicit" shall not include advertising in newspapers of citywide circulation, magazines, radio, television, or telephone directories.

COMMENT: Subsection (a) should specify an appropriate official or agency.

Subsection (b) is identical to the definition used in section 802(b) of the Civil Rights Act of 1968,[30] except that the word "individuals" has been used instead of "families" in order to assure that residences are not excluded from the operation of the ordinance on formalistic grounds, such as the fact that they may house mainly single (*e.g.*, elderly) people.

The definition of "broker" in subsection (d) incorporates by

30 42 U.S.C. 3604 (Supp. 1968).

reference the definition used in the state licensing statute. Thus future changes in the state law will automatically produce similar changes in this ordinance. It is hoped that this method will prevent gaps in the law should the present state definition be expanded beyond its present scope. A similar procedure is recommended for any jurisdiction in which the ordinance is adopted.

"Dealers" are covered by the ordinance in subsection (c) because they often create panic in neighborhood residents by using the same techniques as blockbusting brokers.[31] This subsection is new.

The definition of "to solicit" in subsection (h) is not limited to the practices specifically mentioned in the subsection in order to give the definition as broad a meaning as possible.[32] The reasons for the limitation on "to solicit" imposed by the words "for profit" are discussed in the comment to section 3 *infra:* The reasons for excluding solicitation in newspapers of citywide circulation, magazines, radio, television, and telephone directories are discussed in the comment to section 5 *infra.*

Section 3. *Unlawful Real Estate Practices*

(a) It shall be unlawful for any real estate broker or dealer or any agent or employee of a real estate broker or dealer, for profit, [except in honest reply to an unprompted question by a prospective buyer or seller,]

(1) to represent, explicitly or implicitly, for the purpose of inducing or discouraging the purchase, sale, or rental, or the listing for purchase, sale, or rental, of any real property, that a change has occurred or will or may occur in the racial, religion, or ethnic composition of any block, neighborhood, or area;

(2) to represent, explicitly or implicitly, for the purpose of inducing or discouraging the purchase, sale, or rental, or the listing for purchase, sale, or rental of any real property, that the presence of persons of any particular race, religion, or ethnic backgound in an area will or may result in:

(A) a lowering of property values in the area;

(B) a material change in the racial, religious, or ethnic composition of the area;

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31 Letter from Leon Deutsch, Chairman, Housing and Maintenance Code Enforcement Committee, Mayor's Urban Action Task Force for East Flatbush (New York City) to Harvard Student Legislative Research Bureau, Nov. 12, 1969.

32 See Introduction, *supra.*

(C) an increase in criminal or anti-social behavior in the area; or

(D) a decline in the quality of schools serving the area.

(b) It shall be unlawful for any real estate broker or dealer or any agent or employee of a real estate broker or dealer, for profit,

(1) to make any misrepresentation, express or implied, concerning the purchase, sale, or rental, or the listing for purchase, sale, or rental, of any real property, for the purpose of inducing or discouraging the purchase, sale, or rental, or the listing for purchase, sale, or rental, of any real property located in the same area.

(2) to refer to race, religion, or ethnic background in any advertisement offering or seeking real property for purchase, sale, or rental.

(c) It shall be unlawful for any person, firm, partnership, association, or corporation, for profit, to aid, abet, or coerce the commission of any act which would be unlawful under subsections (a) and (b) of this section if committed by a real estate broker or dealer or by any agent or employee of a real estate broker or dealer.

COMMENT: Although subsection (a) is specifically aimed at brokers, dealers, and their agents and employees, the words "for profit" have been added to make it clear that the ordinance is not designed to reach persons who may discuss neighborhood conditions innocently, without any real intention of causing panic-selling, such as a professor of sociology speaking to neighborhood groups on the blockbusting problem. Comments made by dealers and brokers in a clearly nonbusiness context are similarly excluded. Moreover, the absence of a phrase such as "for profit" might raise constitutional questions concerning limitations on the freedom of speech.[33] With the phrase included, however, the well-accepted body of constitutional law allowing reasonable regulation of commercial speech applies.[34]

The section has the effect of limiting not only the activities of blockbusters, but also activities of realtors who in good faith promote integration of all-white neighborhoods. Such a realtor might, for example, talk with those in the neighborhood who are interested in selling their houses but who are immune from racial

33 U.S. v. Mintzes, 304 F. Supp. 1305 (D. Md. 1969).

34 Valentine v. Chrestensen, 316 U.S. 52 (1942); *Developments in the Law—Deceptive Advertising*, 80 HARV. L. REV. 1005, 1027-1038 (1967).

prejudice or from informal community pressures against selling to minority-group members. In explaining his activities and purposes, the realtor might violate section 3(a)(1) or 3(a)(2) of the ordinance. Although limiting such activities is an unfortunate result, such realtors are likely to be very few. Moreover, the provision does not limit the activities of organizations which purchase homes in white neighborhoods and sell to blacks in order to foster integration, because such organizations will probably not be acting "for profit." Furthermore, it should be possible, and perhaps it is generally advisable, for the "good faith" realtor to work for the integration of a neighborhood without mentioning race or ethnic background. Finally, the legislature may reasonably conclude that, in general, realtors acting for profit should be prohibited from making such comments because the benefits from integration activities by the few "good faith" realtors are outweighed by the risks of opportunities for blockbusting.

The bracketed exception in subsection (a) for the honest answer to an unprompted question permits the prospective customer to obtain information from a real estate broker concerning changes in the composition of a neighborhood, if the prospective customer requests such information. Absent the exception, a broker would have some difficulty in answering a number of questions asked by prospective buyers or sellers. For example, a person interested in buying into a neighborhood might choose to ask whether the area residents will continue to be persons of his own ethnic group. Although other sources of information are available, the prospective purchaser would be deprived of his most expert source of information if the broker is not able to answer the question. Moreover, it would be difficult for the broker to refuse to answer the question without conveying the impression that his answer, if permitted by law, would be negative. Of course, this argument assumes that there is an interest worth protecting in allowing the customer to choose a neighborhood on the basis of ethnic factors and in allowing the broker's information to assist in that choice. The drafters recognize that this decision must be made by the political body considering the enactment of this ordinance.

One problem raised by an "honest answer" exception is that it may provide an opportunity for some blockbusters to evade the

ordinance. However, the requirement that the honest answer be in reply to a question which was "unprompted" by the broker should make such evasion difficult. Difficult factual problems may arise as to what is or is not prompted by the broker. But blockbusters work on a fairly large scale. A single blockbuster will generally solicit a number of homeowners at a time. The court may be able to find a violation of section 3 if there is evidence of a pattern of instances in which a broker's statements have bordered on prompting. Also, where such cases become numerically significant, the administering agency may be justified in designating the area a Restricted Solicitation Area pursuant to section 4. Finally, it should be noted that the federal blockbusting law, which on its face does not exempt the honest reply, has been interpreted not to prohibit such replies.[35] Since the weight of the various factors relating to the exception for the honest answer will probably differ from locality to locality, the exception was placed in brackets.

The list of unlawful practices itself is patterned on that contained in the Detroit, Michigan, anti-blockbusting ordinance.[36] The four criteria of subdivision (a) (2) are among the factors most likely to cause panic among the residents of a neighborhood which is ripe for blockbusting.[37]

The bar on misrepresentation is intended to be read broadly by the courts. Blockbusters have resorted to practices such as falsely stating to residents that most of their neighbors are moving, thus implying that the area is undergoing radical changes without making overt references to race, religion, or ethnic background. Other "scare" tactics may include placing false "for sale" signs in the neighborhood or leaving "for sale" signs in place for an unreasonably long time after the dwelling has been sold.[38]

Although this section applies to newspapers, television, and other media which involve interstate commerce, it is doubtful that the limitations which it imposes on advertising in such media

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35 U.S. v. Mintzes, 304 F. Supp. 1305 (D. Md. 1969).

36 DETROIT, MICH., ORDINANCE 753-F reported in 7 RACE REL. L. REP. 1260 (1962).

37 R. HELPER, *supra* note 3, at 58-68; see also Introduction, *supra*.

38 *N.Y. Times*, Dec. 5, 1969, at 35, col. 2; *Id.*, Dec. 9, 1969, at 75, col. 5; letter from Bernard Kabak, New York City Planning Commission, to Harvard Student Legislative Research Bureau, Nov. 25, 1969; memorandum from Leon Deutsch, *supra* note 10; see Black, *Ludlow: A Lesson in Integration*, READER'S DIGEST, Sept. 1968, at 193-4; Singer, *supra* note 6, at 50, 52.

are an unconstitutional interference with interstate commerce.[39]

Forms of subsection (c) appear in many ordinances.[40] The purpose is to enable enforcement officials to prosecute the real estate brokers and dealers who do not personally violate the ordinance but who direct the actions of others who do.

Section 4. *Designation of Restricted Solicitation Area*

(a) The Commissioner may designate an area a Restricted Solicitation Area upon making a determination, supported by written findings of fact,

(1) that the practices described in section 5 are likely to cause residents of the area to believe:

(A) that property values in the area are rapidly declining;

(B) that the area is deteriorating; or

(C) that a material change will or may occur in the racial, religious, or ethnic composition of the area;

(2) that the practices described in section 5 are likely to cause an unusually large number of dwellings in the area to change ownership within a relatively short period of time; or

(3) that practices made unlawful by section 3 are occurring or are likely to occur in the area.

(b) A designation made pursuant to subsection (a) shall take effect thirty-six hours after the time of its initial publication by legal notice and shall terminate eighteen months after its effective date unless terminated earlier by the Commissioner upon making a written finding that the condition upon which the designation was based no longer prevails with respect to the area designated.

(c) The Commissioner shall report to the Mayor and City Council and shall publish by legal notice all designations and terminations of Restricted Solicitation Areas. The Commissioner shall also maintain and make available to interested parties a current listing of Restricted Solicitation Areas. Each such notice or listing shall describe the boundaries of the area to which it applies by references to named streets or landmarks.

(d) Any person aggrieved by a designation or termination made by the Commissioner pursuant to subsection (a) or subsection (b) may obtain review of such order in the .... Court by filing a petition for review in such court not later than thirty days after the effective

39 *See, e.g.*, Head v. New Mexico Bd. of Examiners, 374 U.S. 424 (1963); *but see* Bibb v. Navajo Freight Lines, 397 U.S. 520 (1959).

40 *E.g.*, OHIO CODE § 4112.02(J) (Page's Supp. 1969).

date of the order. Unless the court finds that the determination upon which the order was based was without basis in fact, it shall affirm the order of the Commissioner. No suspension or termination of a designation shall be ordered by any court except as provided in this subsection.

COMMENT: The concept of Restricted Solicitation Areas is the most significant departure from other anti-blockbusting ordinances. Subsection (a) gives the administering agency the authority to impose a very strict set of restrictions, listed in section 5, in an area vulnerable to blockbusting.

A designation is made upon written findings of fact which will create a record for possible use in subsequent judicial review proceedings authorized by subsection (d).

The section does not require a hearing prior to a designation because it is expected that the need for designating a Restricted Solicitation Area will arise under circumstances requiring immediate action.[41] In most cases, a hearing will delay designation and further expose homeowners to harassment by blockbusters. Moreover, a prolonged hearing attended by publicity might itself unnerve homeowners in the area under consideration.

Omission of a pre-designation hearing should not present procedural due process problems in view of the provision for post-designation judicial review in subsection (d).[42] A standard concept of administrative law also supports the conclusion that hearings are not constitutionally required in making designations under this section. This concept divides administrative functions into the categories of "quasi-legislative" and "quasi-judicial" action.[43] The former are determinations that involve the production of rules of general applicability, or "public administration" as they are called in New York,[44] and hearings are no more required than they are in the case of a legislature passing a statute. The latter category

41 *See* Fahey v. Malonee, 332 U.S. 245 (1947).

42 *See* Nickey v. Miss. 292 U.S. 393, 396 (1934); Bourjois Inc. v. Chapman 301 U.S. 183, 189 (1937); Bowles v. Willingham 321 U.S. 503, 520 (1944).

43 DAVIS, ADMINISTRATIVE LAW TREATISE § 7.02 (1958); Gonzales v. United States, 348 U.S. 407, 413 (1955); *but see* JAFFE, JUDICIAL CONTROL OF ADMINISTRATIVE ACTION 18-20 (1965).

44 O'Brien v. Comm'r of Educ., 4 N.Y.2d 140, 173 N.Y.S.2d 65 (1958), *appeal dism'd*, 361 U.S. 117 (1959).

includes administrative action which determines rights as between specific contesting parties, and must conform to due process requirements in procedure similar to those imposed on courts. The commissioner in using the power of designation will be making determinations for the welfare of broad segments of the city. Moreover, he will be imposing restrictions not on specific real estate operators, but actually against all those in the entire state engaged in the business. For these reasons, the decision to designate an area is properly viewed as a quasi-legislative act, and formal hearings need not be held.

Any designation or termination of a Restricted Solicitation Area will remain in effect unless and until a court finds that the Commissioner's determination has no basis in fact. The last sentence of subsection (d) is intended to prevent a restraining order or similar relief *pendente lite.*

Judicial review of a termination order is authorized only when the order is issued by the Commissioner prior to the normal expiration of a designation. Should such an order be nullified by the court, the designation will expire eighteen months after the effective date of designation.

The Commissioner, through his rule-making power under section 6, may wish to make additional rules for notifying the real estate business community of his designations.

Section 5. *Activities Prohibited With Respect to Restricted Solicitation Area*

(a) It shall be unlawful for any real estate broker or dealer or any agent or employee of a real estate broker or dealer:

(1) to solicit, directly or indirectly, the sale, purchase, or rental of any dwelling which such person knows is located within a Restricted Solicitation Area;

(2) to solicit, directly or indirectly, any agreement authorizing any person, firm, partnership, association, or corporation to render real estate brokerage services involving the sale, purchase, or rental, or the listing for sale, purchase, or rental of any dwelling which such person knows is located within a Restricted Solicitation Area.

(b) Within a Restricted Solicitation Area, it shall be unlawful for any real estate broker or dealer or any agent or employee of a real estate broker or dealer:

(1) to place on any dwelling a sign advertising the sale of such dwelling or advertising that such dwelling has been sold;

(2) to establish a real estate office.

(c) For purposes of this section, all real estate brokers and dealers and agents and employees of a real estate broker or dealer shall be deemed to have knowledge of the boundaries of all Restricted Solicitation Areas and the addresses of all dwellings located therein.

COMMENT: The activities described in subsection (a) are prohibited regardless of where they are undertaken; the broker or dealer does not have to be within a Restricted Solicitation Area to engage in solicitation with respect to dwellings located therein. *Example*: Neighborhood X is designated a Restricted Solicitation Area. O owns a house in Neighborhood X and is employed in Neighborhood Y. B, a broker, visits O at work and, knowing the address of O's house, solicits the sale of his house. B has violated subsection (a). Compare, however, the case where O goes to B and asks B to sell his house. B accepts the offer. Neither O nor B has violated any provision of the ordinance.[45]

Solicitation in newspapers of citywide circulation, magazines, radio, television, or telephone directories is not prohibited (see definition of "to solicit" in section 2(h)) because the likelihood that it would induce panic is slight, and the task of enforcing a ban which extends to these media is virtually impossible. Furthermore, the exclusion provides alternatives to brokers and dealers who normally advertise through other media such as billboards and circulars.

Subsection (b) prohibits the described activities only within a Restricted Solicitation Area. Paragraph (2) prohibits establishing a new real estate office as defined in section 2(f) in such an area. Offices currently in use are not affected; and a broker or dealer is not prevented from vacating an office previously established in a Restricted Solicitation Area and moving to a new office in the same area. In other words, mere change of location within a Restricted Solicitation Area does not "establish" an office.

Determination of *when* an office is established may, however, present some difficulties for the administrator. Thus, if a licensed

45 *See* section 2(h)(1) and (2).

real estate broker leases a storefront a day or two before the Restricted Solicitation Area designation is effective, may the broker proceed with his plans despite the designation? Variations on this situation can easily be imagined. Such problems should be resolved by issuing rules pursuant to section 6.

It should be noted that the section limits solicitation only with respect to dwellings as defined in section 2(b) and thereby allows solicitation related to nonresidential property. Thus, the restriction goes no further than is necessary effectively to curtail blockbusting. Moreover, the limitations on solicitation by brokers under this ordinance are no more stringent than those imposed on medical practitioners and lawyers by other statutes.[46]

The validity of this section under the Constitution and laws of the United States and the State of New York is discussed in the Introduction and the comment to section 3.

Section 6. *Hearings; Rules; Enforcement*

(a) The Commissioner may conduct investigations, studies, and hearings concerning practices prohibited by this ordinance. In conducting hearings, the Commissioner shall have the power to subpoena witnesses, to compel their attendance, to administer oaths, to examine witnesses under oath, and to require the production of documents. A written record shall be made of every such hearing.

(b) The Commissioner shall report to the Mayor and the City Council the results of such investigations, studies, and hearings. He shall also report from time to time on the effectiveness of this ordinance, including recommendations for amendment.

(c) The Commissioner shall have the authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this ordinance.

(d) The Commissioner or his designated representative shall have the power to enforce the provisions of this ordinance by signing criminal complaints against any person, firm, partnership, association, or corporation for trial before the .... Court for violation of this ordinance.

(e) The Commissioner shall report to the Secretary of State of .... all violations of this ordinance.

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46. *See, e.g.*, N.Y. EDUC. LAW § 6514(2) and N.Y. JUDICIARY LAW § 479-82 (McKinney 1968).

COMMENT: The Commissioner may find it desirable to conduct hearings in determining whether to designate an area a Restricted Solicitation Area or in carrying out his responsibility to develop and disseminate information on blockbusting. This provision gives the Commissioner powers similar to those granted the state official charged with enforcement of state antidiscrimination legislation.[47] This will allow the Commissioner to develop a genuine expertise in the field to enable him to use the ordinance with maximum effectiveness.

The rule-making power conferred by subsection (c) presents the Commissioner with an opportunity to use the information he gathers through hearings and studies to establish guidelines for the administration of the ordinance. It is anticipated that he may, for example, establish increasingly more definite criteria for the designation of Restricted Solicitation Areas, define what constitutes "establishment" of a real estate office for the purposes of section 5, and perhaps develop procedures for notifying brokers and dealers of designations of Restricted Solicitation Areas.

Subsection (d) should be keyed to the proper enforcement official for the particular locality.

The purpose of subsection (e) is to allow the Secretary of State to use violations of this ordinance as a basis for suspending or revoking the licenses of offending brokers if he has powers such as those provided by New York statutes.[48]

Section 7. *Citizens' Information Program*

The Commissioner may conduct programs of education and community organization throughout the city in order to enhance community pride, strengthen attitudes of toleration and cooperation, and build the confidence of all residents in the continued peace, security, and stability of their neighborhoods.

COMMENT: The section enables the Commissioner to publish informative literature to aid community groups in resisting campaigns by blockbusters.[49] Of course, the section will require adequate funding to be effective.

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47 *See* N.Y. EXEC. LAW § 295(7) (McKinney Supp. 1969-70).
48 N.Y. REAL PROP. LAW § 441-c (McKinney 1968).
49 See note 25 *supra;* Singer, *supra* note 3, at 50, 52.

Section 8. *Criminal Liability*

(a) Any person, firm, partnership, association, or corporation convicted of violating this ordinance shall be punished, for each such violation, by a fine of not more than $10,000 or by imprisonment for a period of not more than 90 days, or by both.

(b) No action shall be maintained under this section unless commenced not later than one year from the date of the alleged violation.

Section 9. *Civil Liability*

(a) Any owner of a dwelling who is induced to sell his dwelling to a real estate dealer or through a real estate broker or their agents or employees by acts committed by such persons in violation of Section 3 or Section 5 of this ordinance may institute a civil action in the .... Court against such persons.

(b) If, in an action instituted pursuant to subsection (a), judgment is rendered in favor of plaintiff, he shall be awarded as damages his reasonable attorneys fees, court costs, and

(1) if defendant is a real estate dealer or his agent or employee, twice the amount of all gains realized by defendant upon a subsequent sale or exchange of the dwelling at arm's length, such gains to be calculated without regard to any expenses incurred by the defendant;

(2) if defendant is a real estate broker or his agent or employee, twice the amount of any commissions earned by defendant through the sale of such dwelling.

(c) No action shall be maintained under this section unless commenced not later than one year from the date of the sale from which liability is alleged to arise. For purposes of any action against a real estate dealer or his agent or employee, the sale from which liability is alleged to arise shall be the first subsequent sale or exchange to a purchaser at arm's length.

COMMENT: The section is designed to supplement the threat of official action with enforcement by injured homeowners. It is anticipated that allowing original owners to recover twice the blockbuster's profit will be a sufficient inducement for potential plaintiffs. Indeed the inducement may be so attractive as to stimulate an undesirable number of nuisance suits. Should this occur, such suits might be inhibited by an amendment allowing success-

ful defendants to recover costs or, perhaps, legal fees. The phrase "at arm's length" is intended to prevent avoidance of the liability provision by use of dummy sales yielding no profit.

The question has been raised as to whether a municipality has the power to create civil liability.[50] Obviously, the answer for any given jurisdiction will depend upon the breadth of its home rule provisions and the attitude of its courts. New York City, for which this ordinance was drafted, appears to have broad legislative powers under a liberal home rule provision in the New York State Constitution,[51] a sweeping state home rule statute,[52] and recent case law that is generally favorable to a broad exercise of municipal powers.[53] Thus there is substantial support for the view that enactment of this section would be a valid exercise of the municipal powers of the City of New York.

The ordinance does not give a remedy of rescission as an alternative to damages in the case of a sale to a dealer who has not resold the property to a third party. In favor of allowing rescission, it might be argued that neighborhood stability would be promoted if sellers were encouraged to return to the neighborhood. On the other hand, it is quite possible that a seller who moves back into the neighborhood may simply provide a good target for blockbusters. Moreover, rescission would be open to abuse by sellers who might come back into the neighborhood only to use blockbusting techniques to resell their houses to minority-group persons at large profits. In most cases such sellers would not be subject to sections 3 and 5 since they would not be "brokers" or "dealers" within the meaning of section 2(d) and (e). Finally, it is unlikely that a remedy of rescisson would be used often. The seller would usually await the resale by the dealer so that a suit for double damages could be brought. Moreover, the dealer will often have already resold the property before the seller is aware of his remedies.

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50 *See* MICHELMAN AND SANDALOW, MATERIALS ON GOVERNMENT IN URBAN AREAS, CASES-COMMENTS-QUESTIONS 314 (1970).

51 N.Y. CONSTITUTION art. 9 §§ 1, 2(b), 2(c)(ii).

52 *See* MUNICIPAL HOME RULE LAW, §§ 10(i)(a)(6), 10(1)(a)(11), 10(1)(a)(12), 50, 51 (McKinney 1968).

53 See note 29 *supra*.

This section is not intended to cut off remedies provided by existing state or federal statutes or by the common law.[54]

Section 10. *Severability*

If any provision of this ordinance or any portion thereof or any application of any provision or portion to any person or circumstance shall be held invalid, the remainder of this ordinance and its application to persons or circumstances other than those to which it is held invalid shall not be affected thereby.

54 See note 24 *supra.*

REALLOCATION UNDER NONFAULT AUTOMOBILE INSURANCE: COMMENTS AND PROPOSED REGULATIONS*

Introduction

Industry planners and government regulators have often searched for methods to restructure private insurance systems to satisfy a sense of an equitable allocation of the burden of losses. Frequently such inquiries have been directed toward allocation of the losses created by high-risk insureds in order to make these persons insurable in a private system, while at the same time assuring an equitable distribution of the burden. Property insurance in urban core areas and flood insurance have encountered such problems.[1] Even more notably, the specters of the uncompensated traffic victim and the "uninsurable" driver have focused attention on inequities in private automobile insurance and have led to such devices as compulsory insurance and assigned risk plans.[2] As the superior equities of a system of comprehensive compensation over the present system have become more evident in this area, proposals for compensation without regard to fault have become more numerous and more popular.[3] These proposals in

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*Prepared by Donald D. Kozusko, member of the Class of 1970 in the Harvard Law School.

1 *E.g.*, Federal Flood Insurance Act of 1956, 42 U.S.C. §§ 2401-21 (1964). No programs were instituted under the Act, however, for the reason, among others, that adverse selection and the potential magnitude of flood damages would make costs prohibitive, 103 CONG. REC. 9529-41 (1957); Overman, *The Flood Peril and the Federal Flood Insurance Act of 1956*, 309 ANNALS 98, 99 (1957); HART & SACKS, THE LEGAL PROCESS 970-80 (temp. ed. 1958). *Compare* Urban Property Protection and Reinsurance Act of 1968, 12 U.S.C. § 1749bbb *et seq.* (Supp. 1968); Current Legislation, *Insurance in Urban Core Areas*, 10 B.C. IND. & COM. L. REV. 650-687; Kisch, *State FAIR Plans and Civil Disorder Back-up Legislation*, 1969 INS. L.J. 135-141.

2 MASS. GEN. LAWS ANN. ch. 175, § 113H, ch. 90, § 1A (1969).

3 *See, e.g.*, the recommendations of the Columbia Report, COLUMBIA UNIVERSITY COUNCIL FOR RESEARCH IN THE SOCIAL SCIENCES, REPORT BY THE COMMITTEE TO STUDY COMPENSATION FOR AUTOMOBILE ACCIDENTS (1932), discussed in Smith, Lilly & Dowling, *Compensation for Automobile Accidents: A Symposium*, 32 COLUM. L. REV. 782 (1932), and Grad, *Recent Developments in Automobile Accident Compensation*, 50 COLUM. L. REV. 300 (1950); Full Aid Plan described in Ehrenzweig, *Full Aid Insurance for the Traffic Victim*, 43 CALIF. L. REV. 1 (1955); Compulsory Comprehensive Loss Insurance described in GREEN, TRAFFIC VICTIMS: TORT LAW AND INSURANCE (1958); a proposal to pay losses up to $800 without regard to fault described in Morris & Paul, *The Financial Impact of Automobile Accidents*, 110 U. PA. L. REV. 913 (1962); the American Mutual Insurance Alliance Guaranteed

turn give rise to a sharpened awareness of the equities to be satisfied in reallocating the initial burden of compensating the traffic victim. No longer is it appropriate — if it ever was — to depend upon rudimentary instruments of reallocation, such as the assigned risk plans commonly used with liability insurance systems and the subrogation right of nonfault collision insurers against negligent drivers and their liability insurers.

These comments and draft regulations are primarily concerned with new techniques to resolve two problems of reallocation under the proposed Optional Basic Protection Act,[4] which establishes Keeton-O'Connell basic protection insurance on an optional basis.[5] Under optional basic protection insurance, companies offer to each policyholder a choice between, first, liability plus basic protection coverage or, second, liability-only coverage; the policyholder is required by statute to purchase one form of insurance or the other.[6] An insured who elects basic protection

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Benefits Plan first announced in 1967 and outlined in R. KEETON, COMPENSATION SYSTEMS: THE SEARCH FOR A VIABLE ALTERNATIVE TO NEGLIGENCE LAW 16-17 (1969) [hereinafter cited as COMPENSATION SYSTEMS]. The most prominent of the current proposals are summarized in notes 5 and 10 *infra*. See also notes 40 and 46 *infra*. *See generally* ROAKES, AUTOMOBILE INDEMNIFICATION PROPOSALS: A COMPENDIUM (1968).

4 The optional plan passed the Massachusetts House of Representatives July 1, 1968, but was defeated in the Senate. Mass. H.B. 4820. A slightly revised bill was submitted again in the House in the current session. Mass. H.B. 610 (1970) [hereinafter cited as Optional BPI]. Section 30 is reprinted in section III *infra*, for convenience because the issues considered in these comments concern that section primarily.

5 Under compulsory basic protection insurance, the victim claims against the insurer of his own car, or his host's car if he is a guest, or the car striking him if he is a pedestrian. Benefits are payable without regard to fault, but benefits are not payable to one who intentionally suffers injury. Benefits compensate for reasonable expenses and work loss less compensation from other sources. Standard policy limits per accident are $10,000 per person. Optional added protection coverage provides more benefits, *e.g.*, higher limits and compensation for pain and suffering. Property damage coverage is treated separately and is not relevant here. The statute bars the insured's tort claim up to $5,000 for pain and suffering and $10,000 for other bodily injury damages, principally out-of-pocket loss. R. KEETON & J. O'CONNELL, BASIC PROTECTION FOR THE TRAFFIC VICTIM 273-483 (1965) [hereinafter cited as BASIC PROTECTION]; COMPENSATION SYSTEMS, *supra* note 3, at 13-15; Keeton & O'Connell, *Basic Protection Automobile Insurance*, 1967 U. ILL. L. FORUM 400, 408-439 (1968), published also in CRISIS IN CAR INSURANCE 40, 48-79 (Keeton, O'Connell & McCord eds. 1968).

6 The optional basic protection plan cited herein is adapted for compulsory insurance states. Optional basic protection could also be offered in states with financial responsibility statutes, which in general require insurance only under certain circumstances, such as after failure to satisfy a tort judgment for negligent driving. A motorist who must insure under these statutes would elect either liability cover-

waives his tort claim up to the limits of $5000 pain and suffering and $10,000 of all other damages, just as under the compulsory plan.[7] Although basic protection provides a complex system of benefits, $10,000 coverage approximately replaces the claim for economic and other losses which has been waived. Two additional options are available. First, added protection insurance provides greater benefits for bodily injury victims. With this coverage, the waiver of the tort claim extends to sums over the basic limits but only when two added protection insureds collide and then only up to the lower limit of the two added protection policies.[8] Second, vehicle protection insurance provides optional nonfault coverage for the vehicle, associated with a complete waiver of any tort claim for damage to the vehicle.[9]

Although optional basic protection insurance is only one of the current proposals for nonfault automobile insurance,[10] the two problems considered below are representative of the reallocation problems involved in any system of nonfault automobile insurance.[11] Moreover, similar problems exist under the present liability insurance system, though they are rarely identified and examined with care. For example, reallocation is necessary if rates are to be equitable as between high-earning and low-earning

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age or a combination liability-basic protection coverage. Reallocation problems under such an optional plan would be similar to those discussed here under an optional plan in a compulsory insurance state, but the details of the solutions might be different depending on the coverage involved. Massachusetts, New York, and North Carolina have compulsory insurance systems. The other 47 states have financial responsibility laws. COMPENSATION SYSTEMS, *supra* note 3, at 52-53.

7 Optional BPI § 3(c)(1).

8 *Id.* § 6.

9 *Id.* § 8.

10 These current proposals include the compulsory Basic Protection Act described in note 5 *supra*, and the American Insurance Association Complete Personal Protection Plan. The AIA plan differs from basic protection primarily in that tort recovery (including all pain and suffering damages) is barred entirely, and no limit is placed on benefits payable for medical expenses and economic loss. AMERICAN INSURANCE ASSOCIATION, REPORT OF THE SPECIAL COMMITTEE TO STUDY AND EVALUATE THE KEETON-O'CONNELL BASIC PROTECTION PLAN AND AUTOMOBILE ACCIDENT REPARATIONS 5-7 (1968) [hereinafter cited as AIA REPORT]. Key passages of the AIA REPORT are reprinted in COMPENSATION SYSTEMS, *supra* note 3, at 17-21, 25-32 (1969). The AIA plan has been introduced in the Massachusetts House of Representatives. Mass. H.B. 1928 (1970).

11 The first reallocation problem discussed below would arise under any nonfault proposal which is implemented on an optional basis. See note 31 *infra*. The second is common to nonfault insurance in general. See note 33 *infra* and accompanying text.

policyholders, who withdraw respectively from the insurance pool very different amounts for injuries of equal severity.[12]

I. Reallocating Cost Savings on Liability-Only Policies Arising from Releases by Basic Protection Insureds Under Optional Basic Protection Insurance

A. *The Problem*

This problem is often described in terms of "no-cost" and "double-cost" accidents.[13] If a significant number of drivers do not purchase optional basic protection insurance, a company will pay "double-costs" in an accident where its basic protection insured negligently collides with a liability-only insured because it will have to pay its basic protection insured regardless of fault and still defend against the liability suit by the liability-only insured. In contrast, a company escapes costs entirely in an accident where its liability-only insured negligently damaged a basic protection insured because the basic protection insured, who has waived his tort action, claims against his own insurance company.

Actually the shorthand characterization of accidents as "double-cost" and "no-cost" somewhat obscures the problem, which is one of misallocation of premiums between liability-only policies and basic protection policies. The company issuing the liability-only policy has collected a premium which is disproportionate to the risk of liability on the policy. The risk has been reduced because in any collision with a basic protection insured, the basic protection insured will not sue on the liability policy since he has waived his tort claim. If the company correspondingly reduced its premium, the benefit from the reduced risk attributable to the waiver by the basic protection insured would simply be passed on to the liability-only insured. Either the liability-only company or its insured would gratuitously benefit from the waiver by the basic protection insured.

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12 COMPENSATION SYSTEMS, *supra* note 3, at 48-49. See section II, A *infra*.

13 AIA REPORT, *supra* note 10, at 8-9; R. Keeton and J. O'Connell, Memorandum on a Plan of Optional Basic Protection Insurance, July 15, 1968 (unpublished memorandum in the Harvard Law School Library) [hereinafter cited as Keeton-O'Connell memo]. Vehicle protection insurance also involves this problem, but only basic protection insurance will be referred to in these comments for purposes of simplicity. See comments to draft regulations in section III *infra*.

Of course, two factors tend to alleviate the problem. First, many accidents will involve either all LO's or all BP's.[14] Second, even where LO's and BP's are involved, the gains from those accidents in which a company has issued the LO policy ("no cost") may be balanced out by the losses in accidents where it has issued the BP policy ("double cost"). To this extent, there is no need to reallocate savings among companies; and the Optional Basic Protection Act requires a company to transfer the savings from its LO policies to its BP policies to comply with the obligation to charge nondiscriminatory rates.[15] Nevertheless, a statutory solution should be provided because (1) the number of LO's will be large enough in the early years after the optional plan is enacted to create a significant number of LO-BP accidents, and (2) the "no-cost" and "double-cost" accidents may not balance out for particular companies in particular years even in a large-scale insurance operation.

B. *Suggested Solutions*

Two basic statutory solutions have been suggested: (1) the Optional Basic Protection Act provides a case-by-case reallocation in the event that the insurance commissioner does not exercise his authority to issue regulations on the problem,[16] and (2) Keeton and O'Connell have suggested that the insurance commissioner issue regulations to establish a pool through which insurance companies will reinsure against the risk that their "double-cost" and "no-cost" accidents will not cancel out.[17]

1. Case-by-Case Reallocation by a Constructive Waiver Theory

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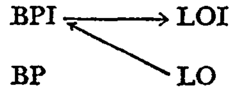
14 The following abbreviations are used where convenient:
LOI — liability-only insurer
BPI — basic protection insurer
LO — liability-only insured
BP — basic protection insured
LO insurance — liability-only insurance
BP insurance — basic protection insurance

15 Optional BPI § 30(a). (§ 30 is reprinted section III *infra*). This not only distributes the savings to the BP's, but it also eliminates the incentive for companies to compete for LO policies — an incentive that would exist if the premium was not reduced to take account of the smaller risk. The same "cream skimming" incentive arises under the second reallocation problem discussed in section III *infra*.

16 Optional BPI § 30(d)(1), § 30(c).

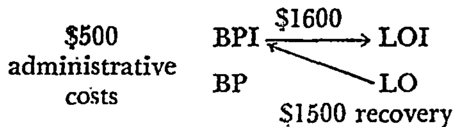
17 Keeton-O'Connell memo, *supra* note 13.

The case-by-case procedure in the Optional Basic Protection Act provides for an action by the BPI against the LOI for reimbursement of an "equitable percentage" of the cost of disposing of the tort claim[18] brought by the LO which would have been waived if the LO had elected BP insurance. To illustrate:



The reimbursement action treats the BPI as if it also received a waiver of liability from LO. If the LO and the BP are in the same class of risks, the constructive waiver by the LO should give the BPI the same savings as the waiver by the BP has given the LOI. The BPI will correspondingly reduce its premium to the BP when the LOI pays for the constructive waiver. Reimbursement is limited to that claim or portion which the LO could have waived — $10,000 economic loss, $5000 pain and suffering[19] — since it should cancel out no more than the benefit to the LOI from the similarly limited waiver by the BP.

However, at least two refinements are necessary. First, the "equitable percentage" of the cost of the LO's claim which the BPI recoups from the LOI is limited to a maximum 80 percent. To illustrate:



This limit actually discourages an election of BP insurance in the optional plan. If the LO and the BP are in the same class of risks, reimbursement should be total — 100 percent of claims under the $10,000/$5,000 limits which the LO could have waived — because the two waivers produce equal savings and the LOI has benefited from a total waiver. While this weighs the option against BP insurance since the BPI will have to close the 20 percent gap by higher premiums, Keeton and O'Connell proposed this max-

18 Cost includes costs of defense, administration, overhead, and tort recovery or settlement.

19 Optional BPI § 3(c)(1).

imum to curb any tendency of the BPI to overpay claims and ignore administrative costs which may exist if the BPI was fully reimbursed by the LOI.

The second refinement deals with reimbursement when the LO and the BP are not in the same class of risks. The "equitable percentage" for reimbursement of the cost of the LO's tort claim which could have been waived is presumed to be 80 percent. However, the 80 percent will be reduced if the LOI can prove that the benefit from the BP's waiver is not as great as the benefit from the LO's constructive waiver. In other words, the LOI can show that the BP's waiver did not save it as much as 80 percent of the LO's claim because its cost of defending against the BP's claim would have averaged less than 80 percent of the LO's claim against the BPI based on the accident frequency and probability of fault in the BP's class of risks.

In short, these two refinements taken together establish the 80 percent figure as a maximum but not as a minimum.

Three objections can be raised against this reallocation system as established by the Optional Basic Protection Act: (1) "optional basic protection" is no longer "optional" because the two-party system of basic protection is forced on LO insurance to the extent that the LOI indirectly pays for the LO's damages, (2) case-by-case reallocation is inefficient, and (3) the constructive waiver approach unnecessarily complicates the process.

As to the first objection, the reimbursement action does establish a disguised two-party structure, but the argument made against the two-party element in the basic protection system does not apply here. There will not be the same tendency to overpay claims because the insured is still claiming against another insurance company.[20] The related-insurer factor in basic protection gives rise to the argument of overpayment rather than the two-party system itself.[21] While the insured's own company (LOI) reimburses the other company (BPI), the reimbursement can be no more than 80 percent.

As to the second objection, Keeton and O'Connell concede

20 *See* BASIC PROTECTION, *supra* note 5, at 347. *Cf.* industry experience under Uninsured Motorist Coverage and Medical Payments Coverage. AIA REPORT, *supra* note 10, at 14.

21 BASIC PROTECTION, *supra* note 5, at 345.

that case-by-case reallocation is inefficient even though many claims between companies would probably be settled. The case-by-case reallocation is offered merely as a backstopping alternative to be used if the insurance commissioner does not establish a more efficient system.[22]

The third objection, which argues against the constructive waiver approach, is more serious. To compensate for the BP's waiver by trying to reimburse the BPI as if it had received a waiver by the LO necessarily involves adjusting the reimbursement when the waivers are not worth the same because either the LO or the BP is a poorer risk. This factor of differing risks so complicates the constructive waiver approach that it is difficult to establish a pooling system based on this approach to replace the inefficient case-by-case reallocation. For example, if the percentage of reimbursement was always 80 percent, all companies could automatically pay into a fund 80 percent of the recoveries by their LO's plus a statewide average of defense and administrative costs per claim. Each company could accordingly be reimbursed from the fund for each BP claim it pays out. But because of the differing risk factor, the percentage of reimbursement could not be fixed at 80 percent.

Furthermore, the constructive waiver approach not only complicates the possibility of a pooling formula, but it also discriminates against BP insurance. The 80 percent reimbursement can be reduced by proof that the LO was a better risk than the BP, but it is not open to the BPI to increase the 80 percent by proving that the BP was a better risk than the LO. As noted above, an 80 percent maximum reimbursement is set to discourage overpayment and excessive administrative expenses by the BPI in defending the liability claim. Thus the full benefit of the BP's waiver will not be returned to the BPI when, for example, the BP is in the same or a better class of risks than the LO.

2. A Pooling System to Transfer Directly the Savings on Liability-only Policies

The first solution, discussed above, attempts to compensate for the waiver benefit to the LOI by giving a waiver to the BPI

22 Interview with Professor Keeton at the Harvard Law School, November, 1969.

paid for by the LOI. This second solution, in contrast, attempts to transfer to the BPI the amount which the LOI actually saves due to the BP's waiver. Consequently, this solution avoids the problem of comparing the values of the waivers in each case, although the American Insurance Association (AIA) has still criticized this solution for being "overly complicated" and has seemed to reject optional basic protection on this ground.[23]

To implement this solution, the insurance commissioner would establish a pooling system as outlined in the regulations below. The formula for this pooling system proposed by Keeton and O'Connell[24] is an attempt to transfer from the LOI to the BPI an amount equal to what the claim by the BP would have been if he had not made the waiver. That is, through the fund the LOI pays over to the BPI the amount it would have paid out *but for* the BP's waiver. Of course, to speak of the LOI and the BPI as distinct insurance companies is realistic only in a case-by-case reallocation. All insurance companies will be issuing both kinds of policies,[25] and thus transfers under this formula are allocated among the insurance companies according to the number of each kind of policy issued by each company.

The formula employs three variables:

$$\text{average claim cost} \times \text{claim frequency} \times \text{number of LO policies above or below average} = \text{payment due or received}$$

Average claim cost: Statewide average cost of disposing of claim brought on a LO policy including settlement, recovery, defense, and overhead costs. In calculating the average claim cost, the following are not included: (1) claims brought on the LO policy by a BP, and (2) any portion of a recovery or settlement above the amount which a BP waives under BP insurance.[26]

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23 AIA REPORT, *supra* note 10, at 9. The AIA encountered a similar problem in its initial proposal for a "Complete Personal Protection" plan because it provided for optional nonfault coverage for damage to one's own car. The problem of reallocation is discussed in COMPENSATION SYSTEMS, *supra* note 3, at 50-51.

24 Keeton-O'Connell memo, *supra* note 13.

25 See text to note 6 *supra*.

26 The definition given by Keeton and O'Connell reads "average amount . . . in disposition . . . of an . . . insurance claim *under minimum limits Bodily Injury Liability Insurance Coverage* . . ." (emphasis added). Keeton-O'Connell memo, *supra* note 13. This average is easier to calculate than an average which excludes any portion of recovery above the amount which a BP can waive. The average

Claim frequency: Number of claims made per policy statewide on an LO policy by other than a BP but adjusted to take account of claims waived. Claim frequency must be adjusted to take account of claims waived when data are collected after the Act has passed. For example, assume that 8/100 was the claim frequency on the 100,000 liability policies before the Act was passed. Thus 3200 claims were filed on 40,000 of those policies. If after the Act is passed, only 1280 claims are filed on 40,000 LO policies while 60,000 are BP policies, the adjusted claim frequency is still 8/100. Since $2/5\ x = 1280$, $x = 3200$. The claim frequency is the same even though the number of claims has been reduced due to the fact that 60,000 policyholders (BP's) are no longer claiming on liability policies. Claim frequency must be measured as if there were no waivers since the formula transfers to the BPI what the LOI would have paid on the LO policy but for the waiver.

Number of LO policies above or below average: If the statewide average is 60 percent, company X has 1000 LO policies above average if it has 7,000 LO policies and 3,000 BP policies.

Some examples will illustrate how the pooling formula allocates the benefits from the BP's waiver among the insurance companies:

Statewide average claim cost = $1000
Claim frequency statewide = 8/100
State wide average of LO policies = 60%

(1) Company X has 7000 LO policies and 3000 BP policies. $1000 × 8/100 × 1000 = pays into fund $80,000. Company X, but for the waiver, would have had to pay out $80 per policy per year for those 1000 LO policies. Company X pays nothing to the fund on the other 6000 policies because all companies are receiving the benefit of waivers on that percentage of policies. The savings on those policies need only be passed on within the company to its 3000 BP policies in reduced premiums through that provision of the Act which requires nondiscriminatory rates.[27]

(2) Company Y has 3000 LO policies and 7000 BP policies. $1000 × .8/100 × 3000 = received from fund $240,000. Company Y has 3000 LO policies below the statewide average and 3000 BP policies above the statewide average. It withdraws from the fund because it is contributing comparatively more waivers in relation to its number of LO policies on which it saves through reduced risk. The savings

proposed here, however, is much more accurate for determining what the LOI is saved, even though it requires an actuarial calculation of the number of claims that exceed the waiver limits so that only that portion up to the limits is counted in the average.

27 Optional BPI § 30(a).

on its 3000 LO policies plus the $240,000 from the fund is allocated to reduce premiums on its 7000 BP policies.

One difficulty with the formula arises in those cases where the BP has a tort claim of a few hundred dollars preserved over the limits of his waiver, *e.g.*, $200 from damages of $8,000 of which $5,200 is for pain and suffering. If the BP decides it does not pay to bring this small claim, the company issuing the LO policy will save by this ad hoc waiver over and above the savings from the formal waiver, which is calculated by the formula. On the other hand, the company will save less than the formula indicates if the BP is overcompensated for his small claim because of its nuisance value. Overcompensation is more likely,[28] but in any event it may be difficult to integrate this factor into the pooling formula. However, claims studies indicate that the number of claims near the dollar limits of the waiver would be negligible for purposes of the formula,[29] even if juries exaggerate pain and suffering to circumvent the waiver.[30] Consequently, the possibility of ad hoc waivers or overcompensation can be ignored.[31]

II. Reallocating the Extra Premium Charged on Basic Protection Policies for Risk of Loss to Persons Other than the Basic Protection Insured

A. *The Problem*

This problem is present under both optional and compulsory basic protection insurance[32] as well as under other nonfault pro-

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28 *See* AIA Report, *supra* note 10, at 16 and exhibit X: Columbia University Council for Research in the Social Sciences, Report by the Committee to Study Compensation for Automobile Accidents 266, 276, 277 (1932); Conard, Morgan, Pratt, Voltz, & Bombaugh, Automobile Accident Costs and Payments 6, 196, 197, 250-252 (1964); James & Law, *Compensation for Auto Accident Victims*, 26 Conn. B.J. 70 (1952); Morris & Paul, *supra* note 3, at 913, 933 (1962). These studies are compared in Basic Protection, *supra* note 5, at 34-69. *See also* Compensation Systems, *supra* note 3, at 24, n.11.

29 *See, e.g.*, AIA Report, *supra* note 10, at 16 and exhibit X.

30 The AIA suggests that juries will increase pain and suffering awards since the BP will not recover for pain and suffering under his BP policy, which does compensate him for the economic and other losses he has also waived. AIA Report, *supra* note 10, exhibit VIII.

31 Implementation of the AIA plan on an optional basis avoids this problem entirely since under the AIA plan, the insured waives all recovery in tort. See note 10, *supra*.

32 Opponents of basic protection insurance often raise this problem in their arguments. *E.g.*, Jung, *The Keeton-O'Connell Plan: How Many People Know What*

posals, such as the AIA plan.[33] Unlike the first problem, the inequity arises here in collisions between basic protection insureds. Commercial vehicles probably cause more damage than they suffer. A collision between a long-haul truck and a private passenger car is the classic example. In these collisions, the long-haul trucker is less severely injured because he collided with an automobile. The automobile operator is more severely injured because he collided with a truck rather than another automobile. Unless the premium rate for basic protection insurance on long-haul trucks is increased to take account of this loss-causing risk, this burden will remain with the basic protection insured in the private auto, whose premium charges must cover these losses because he claims against his own insurer and not against the insurer of the truck.[34]

The Optional Basic Protection Act[35] provides that premium charges for basic protection insurance will take this loss-causing capacity into account. However, without any provision for reallocation of the extra premium charge, companies would gain by selling to proportionately more commercial vehicles than other companies. It is unlikely that all companies could compete equally for commercial vehicle policies, and thus a reallocation among insurance companies is needed to correct the resulting disproportion.

Before we consider the several available solutions to this problem, it should be made clear that this need for reallocation is not peculiar to the two-party or nonfault elements of basic protection insurance. Reallocation issues are involved in any insurance system whenever equitable adjustments in premium rates are conveniently made in the first instance by an insurer other than the insurer of the policyholder who should benefit from the adjustment. Here higher premiums are collected from classes of

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It Is?, 1968 INS. L.J. 606; Kemper, *Automobile Insurance: The Criteria for Survival*, 1968 INS. L.J. 264, 266; Tinker, *Guaranteed Benefits v. the Keeton-O'Connell Plan*, 1968 INS. L.J. 732, 739.

33 AIA REPORT, *supra* note 10, at 9.

34 AIA REPORT, *supra* note 10, at 9; COMPENSATION SYSTEMS, *supra* note 3, at 48. Vehicle protection insurance and added protection insurance, which are also part of the Keeton-O'Connell approach, involve the same problems of reallocation as basic protection insurance, but these comments will refer only to basic protection insurance for purposes of simplicity.

35 Optional BPI § 30(d)(1).

drivers that create proportionately higher costs to the insurance system. A similar problem would prevail in the present three-party liability insurance system if equities in rating were more refined. Unlike most other kinds of insurance, rating in automobile liability insurance currently does not take into account average claim cost as a variable associated with characteristics of the policyholder, but uses instead a system-wide average claim cost in setting rates. Accident and claim frequency are the key variables associated with characteristics of the policyholder. As a result, a high-wage earner does not pay proportionately more for insurance than the low-wage earner even though he receives proportionately greater benefits through larger recoveries when he is compensated for loss of past and future wages.[36]

The negligence system itself functions in the same manner to some extent, but under a negligence system unmodified by the effects of liability insurance, fault prevails as the primary equity. The unfairness between high-wage earners and low-wage earners does not arise until liability insurance, having been held not to contravene the public policy of a fault system, introduces the equities of risk-bearing.

There is no pressure to correct this inequity under the present liability insurance system because the insurer who collects premiums from the high-wage earner does not pay for his recoveries.[37] But if the rating system did not choose to ignore this inequity, reallocation would be necessary. The insurer of the high-wage earner would collect higher premiums to account for the higher cost to the system. If insurers did not insure proportionately the same number of high-wage earners, allocation among insurance companies would then be needed to eliminate inequity among companies and to distribute the premium to effect lower rates for low-wage earners.[38]

B. *Some Tentative Solutions*

1. The Statutory Case-by-case Reallocation

The Optional Basic Protection Act provides for a case-by-case reallocation of the premium increments required by the Act to

36 R. KEETON & J. O'CONNELL, AFTER CARS CRASH 85-92 (1967).

37 *Id.*

38 COMPENSATION SYSTEMS, *supra* note 3, at 48-49.

account for risk of loss to persons other than the basic protection insured.[39] In an accident between vehicles of the same class of loss-causing risk, there is a presumption against reimbursement between the basic protection insurers. In an accident between vehicles of different classes, it is presumed that each BPI is entitled to partial reimbursement of the costs of disposing of the claim of his BP according to an equitable rate of reimbursement such that each BPI bears the loss proportionate to his premium charge. To illustrate:

	BPI of truck		BPI of auto
premium	$600		$200
loss	$200		$1400
		$1000 ←	
loss after reimbursement	$1200		$400

Note that a limit like the 80 percent maximum in case-by-case reallocation of the waiver benefit is unnecessary here, even though the BPI is dealing with its own insured because each BPI recovers only a portion of the amount paid out to compensate each claim.

2. A Pooling System

Of course, case-by-case reallocation is inefficient. As in the statutory case-by-case solution to the waiver problem noted above, part of the answer is that this system will be used only if the insurance commissioner fails to develop a better process. Furthermore, insurance companies are more likely to settle these reimbursement claims than the reimbursement claims in the waiver problem because the process is more mechanical; the premium rates have already resolved the largest issue of potential dispute. However, precisely because the formula is mechanical, it seems that a statewide fund could replace case-by-case reallocation. The most variable factor in the case-by-case reallocation is what classes of vehicles will collide with what other classes, but the premium rates should already reflect this factor.

Thus regulations might provide for the operation of a statewide

39 Optional BPI § 30(d)(2).

fund to allocate the premium variance created by the loss-causing factor among insurance companies in proportion to the magnitude and frequency of benefits paid out on the various classes of policies they write. To illustrate with hypothetical premiums:

	long-haul truck	low-risk private automoible driver
premium not adjusted for loss to others	$650	$350
premium adjusted for loss to others	$750	$250

The pool would provide for transferring the additional premium collected by the truck insurer to enable the insurer of the low-risk private automobile driver to charge $250 even though that insurer pays out benefits which would require a $350 premium. Careful attention should be paid to allocating only the premium increase or decrease attributable to loss-causing potential. The differences in total premiums are not relevant because such differences may result from other factors besides loss-causing potential, such as different marketing costs. The presumptive case-by-case reallocation provided for in the Act itself is imperfect in this respect since each insurer bears the loss in proportion to the total premium charged.

3. Alternative Forms of Case-by-case Reallocation

A Loss-Added Formula. Pending the development of a formula to operate this pool, a compromise approach may be available which can be instituted with less preparation. Under this approach, the insurers of the basic protection insureds of different classes involved in an accident would share the cost of the benefits paid out on a case-by-case basis as in the reallocation scheme now provided in the Act. In contrast to the statutory reallocation, however, the insurers would share the cost according to fixed percentage schedules which apply in all cases. These percentages would be set by the insurance commissioner to allocate loss according to the loss-causing potential of various classes of vehicles. The "classes" could be defined in a rather wholesale fashion; for example, all commercial vehicles as compared to all other vehi-

cles, as the AIA now recommends.[40] On the other hand, the classification could distinguish between various classes of commercial vehicles if significant variations in risk exist.

The problem of how to relate the classes of risk to the percentage allocation is more difficult. One possibility presents itself if we distinguish between the average basic protection benefit[41] paid out in a collision between vehicles of the same risk class and the average benefit for collisions between vehicles in different risk classes. An example involving only two risk classes — private automobiles and long-haul trucks — is clearest for purposes of illustration. The appropriate calculations include: (1) the average benefits paid by the BPI of the automobile in a collision with another automobile, and (2) the average benefits paid by the BPI of the automobile in a collision with a long-haul truck. Both figures should be determinable with sufficient accuracy from data accumulated in claim cost studies under liability insurance and studies projecting costs for nonfault insurance.[42] These two figures will provide the average portion of the claim by the private auto BP which is attributable to the fact that he collided with a long-haul truck and not another auto. To effect a reallocation, this average portion, expressed as a percentage, will be paid by the BPI of the long-haul truck. Some hypothetical figures will illustrate the simplicity of this approach:

statewide average of benefits paid to auto BP in auto-auto accident	$ 500	
statewide average of benefits paid to auto BP in auto-truck accident[43]	$ 500	
portion of average benefits attributable to truck in auto-truck accident	$1000	2
	$1500	3

$$\frac{\$1000}{\$1500} = \frac{2}{3}$$

40 See note 50 *infra*. For further details on what might be relevant distinctions between classes of commercial vehicles, see INSURANCE DEPARTMENT, STATE OF NEW YORK, AUTOMOBILE INSURANCE . . . FOR WHOSE BENEFIT?, REPORT TO THE GOVERNOR 191, n.150 (1970) [hereinafter cited as NEW YORK REPORT].

41 The formula presented here would probably have to be calculated separately for vehicle protection insurance because the comparative risk between commercial vehicles and private passenger vehicles is likely to differ in bodily injury cases and property damage cases. Added protection reallocation would probably correspond to basic protection reallocation.

42 *E.g.*, AIA REPORT, *supra* note 10. The raw data rather than the published reports alone should supply the necessary information.

43 The average benefit paid out to the auto insured is meant to include claims

The reallocation percentage is 66⅔ percent. In all accidents between these two classes, the BPI of the truck will automatically reimburse the BPI of the auto for 66⅔ percent of benefits it paid out to its insured.

This case-by-case formula is mathematically simpler than the formula needed to operate the pooling approach because the frequency of auto-truck accidents is not a significant factor. A further advantage of this approach in contrast to the pooling approach is that it is not formulated on the assumption that premium rates have already been adjusted for loss-causing potential. Instead, premium rate adjustments should follow as a result of the operation of the formula. In this respect, the pooling formula above is incomplete in that it assumes away the most illusive aspect of the problem — the appropriate premium cost to commercial vehicles to account for loss-causing potential.

However, a case-by-case approach highlights problems of causation which are not starkly presented in a pooling approach. If physical contact is the sole criterion for involvement in a traffic accident and the consequent responsibility for reimbursement, some refinements in equity are lost because vehicles like long-haul trucks may increase costs by causing accidents in which they are not directly involved. A test of responsibility for reimbursement according to causation in fact, on the other hand, may introduce a potentially litigious issue, and the resulting costs to the reallocation process may not be justified by the marginal gains in equity. To avoid the issue of causation in most cases, responsibility for reimbursement might be assigned to the commercial vehicle only in cases of physical contact or where the operator is convicted of a traffic violation which was a contributing cause of the accident.[44] Any inequity still uncorrected would be of minor proportions.

Yet there may be a second more serious inequity in this approach. Again the auto-truck accident is a useful illustration. The formula reallocates the increased loss to the auto insured which is attributable to the collision with the truck. It does not, however,

brought on the policy by persons other than the automobile driver, *e.g.*, passengers. Thus the reallocation will reflect the fact that more persons are injured more severely in the automobile which collides with a truck. That truck-auto accidents involve more automobiles will be reflected in the number of reimbursement claims the truck insurer may have to pay.

44 One draft of the AIA nonfault proposal adopts this course. See note 50 *infra*.

make any provision for the fact that the truck's physical characteristics make it not only more likely to cause damage but less likely to suffer damage. Arguably truck operations are benefiting from the lower loss-causing potential of automobiles, and therefore, the savings from reduced loss to trucks should be allocated to automobile operation. On the other hand, once automobile operation is relieved of the increased loss caused by truck operation, as the formula provides, there may be little pressure to recognize this more questionable inequity. Determinations of what is "equitable" are rarely the necessary result of a parade of neatly articulated interests.

Reallocation According to Fault. A second alternative to the statutory case-by-case method is to reallocate the losses in accidents involving different classes of vehicles according to the distribution now current under the fault system. For example, the insurer of a truck in a truck-auto accident would reimburse the auto insurer for that percentage of the loss to the auto insured which is now paid, on the average, on tort claims brought by automobile drivers against truck operators. Data should be readily available, and the criticisms made against the fault system generally do not condemn it as an unfair principle for ultimate distribution of the loss.

However, even though an adoption of reallocation according to fault is relatively simple and, at the same time, not basically incompatible with nonfault compensation, such a formula for reallocation still has at least two distinct disadvantages. First, data would eventually become outdated. Second, the burden which commercial vehicles bear under the fault system is determined by many factors besides loss-causing potential, even assuming that jury verdicts tend to be awarded to that party most severely injured in accidents and thus tend to reflect loss-causing potential.

Reallocation According to Strict Liability. Finally, reallocation could operate on the principle that each class of vehicle should be responsible for the damage actually caused by its operation. In developing basic protection insurance, the drafters opted in general for a two-party contract structure of compensation rather than a three-party system under which the injured person would claim in strict liability against the insurer of the party which caused the injury. This choice was made for a variety of reasons, includ-

ing the advantages of a related insurer approach in claims administration.[45] This decision does not require that the ultimate burden of loss, as well as the burden of compensation in the first instance, remain with the basic protection insurer of the person injured. Tort principles of strict liability can still be employed in reallocating the loss. Thus, in any truck-auto accident, the truck insurer would reimburse the auto insurer for basic protection benefits paid out to the auto insured; similarly, the car insurer would reimburse the insurer of the truck for benefits paid out for damage to the truck insured.[46] Reallocation could likewise be established for all accidents involving vehicles of different classes of loss-causing risk. Reallocation would be unnecessary when the vehicles involved were in the same class.

How this reallocation would affect the relative burdens of commercial and private vehicle operation is best demonstrated by contrasting this reallocation with various AIA proposals. Under its nonfault insurance plan,[47] the AIA originally was willing to let "losses . . . remain where they fall."[48] Alternatively, if the argu-

45 BASIC PROTECTION, *supra* note 5, at 343-351.

46 The objection might be made that if the truck insurer is bound to pay for the claim of the auto insured, it is inadvisable to allow the auto insurer to handle the claim because the auto insurer has no self-interest in contesting excessive claims. Compare the 80 percent maximum in section I, B, 1 *supra*. This objection, however, is directed toward the original choice of a two-party system for basic protection insurance. See note 15 *supra* and accompanying text. Any solution which would turn the administration of the claim over to the truck insurer would create a three-party system for this class of claims. It would be difficult to justify this exception without accepting the arguments for a three-party system in general. Another solution would be to discourage the auto insurer from paying excessive claims by limiting reimbursement to, for example, 80 percent. Thus the AIA proposal referred to in note 50 *infra* does not encounter this problem. Yet this would distort reallocation premised on strict liability. Moreover, to some extent the problem is alleviated by the fact that the auto insurer must also pay the claim by the truck insurer and therefore, does not want to encourage the truck insurer to pay excessive claims. Thus the problem is less troublesome here than in allocation formulas where only the truck insurer is subject to a reimbursement obligation as in the AIA provision, note 50 *infra*, and in the basic reparation plan introduced in the Minnesota legislature by Senator Jack Davies. The basic reparation plan was introduced in the Senate in February of 1968, and will be reintroduced in 1971; the draft by Senator Davies is soon to be published in the Minnesota Law Review. It provides for the commercial vehicle to take over claims administration whenever reimbursement exceeds 75 percent. § 10 of unpublished draft, Feb., 1970.

47 See note 10 *supra*.

48 AIA REPORT, *supra* note 10, at 9. The AIA plan as originally submitted in the Massachusetts House of Representatives adopts this position by making no provision for the problem. Mass. H.B. 1928 (1970).

ments that this creates an "undesirable windfall" for commercial vehicles prevailed, the AIA proposed that insurance on commercial vehicles include mandatory coverage to pay primary benefits to occupants of automobiles injured in accidents with commercial vehicles.[49] Currently, one AIA draft provides that the commercial vehicle insurer would reimburse the private vehicle insurer for 75 percent of benefits paid out.[50] The 75 percent allocation represents a judgment as to what is a "reasonable" distribution of the loss.[51] The strict liability approach suggested here imposes a less severe burden on commercial vehicle operations than the original AIA alternative proposal. It imposes a more logically defensible

49 AIA REPORT, *supra* note 10, at 9. The Report of the New York Insurance Department advocates an allocation similar to this alternative AIA proposal. The Report argues that commercial vehicles should bear all the loss to the private vehicle because (1) commercial vehicles are better able to internalize the extraordinary costs of this class of accidents by increasing the costs of their services, and (2) commercial vehicles have more control over driving conduct and vehicle design and can thus reduce risks in the long run. NEW YORK REPORT, *supra* note 40, at 91-92, 115. The first argument does not consider that at least some of the costs in accidents between commercial vehicles and automobiles are attributable to automobile operation. This portion is probably not so insignificant that it can be ignored for practical reasons. The second argument makes a judgment which may not properly weigh the ability of insurers and manufacturers of automobiles to promote safety design in automobiles. Moreover, any additional incentive imposed by the New York proposal in contrast to the allocation advocated here would probably be insignificant in practical terms.

50 Mass. H.B. 1928 § 113K(c) (redraft dated Jan. 30, 1970). The text of the provision is as follows:

> (c) *Accidents involving commercial vehicles.* Any insurer, other than the insurer of a motor vehicle operated in the business of transporting passengers, which pays personal protection insurance benefits with respect to any person suffering accidental bodily injury in an accident involving a vehicle designed or primarily used to transport property or equipment over a public highway shall have a right of reimbursement from the personal protection insurer of such vehicle for seventy-five percent of the benefits paid; provided that the total reimbursement obligation of the insurer of such vehicle shall not exceed one million dollars with respect to all accidental bodily injury resulting from such accident. When two or more personal protection insurers have an obligation to make reimbursements under this paragraph with respect to the same accident, they shall share the obligation equally, but the limitation of the total reimbursement obligation stated above applies separately to each. For purposes of this paragraph, a vehicle shall be considered to be involved in an accident only if (i) there is physical contact of such vehicle with the person injured or the vehicle which he is occupying, or with another vehicle or object involved in the accident, or (ii) the operator of such vehicle is convicted of a traffic violation which contributed to the accident.

51 Interview with Robert Kein, Counsel to AIA, in Boston, Feb. 17, 1970.

allocation than the AIA's current suggestion of 75 percent distribution. In the end, results under this approach may not differ substantially from the current burden on commercial vehicles imposed under the fault system.[52]

III. Draft Regulations

As may have become apparent from the foregoing comments, the solutions which have been suggested here do not pretend to uncover and resolve all the problems associated with reallocation under nonfault insurance. Specific formulas have been used merely to demonstrate possible alternatives and to stimulate further development. Yet one of the proposed solutions to the first reallocation problem, the problem created by the tort waiver by the basic protection insured, is complete enough to warrant presentation in the form of draft regulations for adoption by the insurance commissioner. The following format includes regulations establishing the pooling system, outlined above,[53] which is designed to reallocate the savings created by the tort waiver. Also, selected sections of the Optional Basic Protection Act which are relevant to both of the reallocation problems which have been discussed are reproduced here for convenience.

SELECTED SECTIONS OF THE OPTIONAL BASIC PROTECTION ACT[54]

Section 30. *Ratemaking and Pooling or Redistribution.*

(*a*) *Allocation of savings from releases.* – In order to be non-discriminatory, premium charges for liability insurance and for basic, added, or vehicle protection insurance must take due account of the cost savings resulting from releases of basic, added, or vehicle protection insureds consistent with the terms of sections three, six, seven and eight of this chapter. Such savings shall be credited fairly and reasonably among only basic, added, or vehicle protection policyholders respectively

52 *Cf.* New York Report, *supra* note 40, at 142, which estimates that premium increases for commercial vehicles due to 100 percent allocation probably will be offset by decreases generated by the nonfault system as a whole.

53 See section I, B, 2 *infra.*

54 Mass. H.B. 610 (1970). See note 4 *supra.*

rather than being credited in any part to policyholders not electing such coverages.

(*b*) *Probability and magnitude of injuries.* — In order to be nondiscriminatory an insurer's premium charges for basic, added, or vehicle protection insurance must take due account of the probability and magnitude of injuries and losses that result from operation of a vehicle by a basic, added, or vehicle protection insured of the policy and are suffered by any basic, added, or vehicle protection insured of this or any other policy, even though the basic, added, or vehicle protection benefits to insureds of other policies are paid by other insurers.

(*c*) *Commissioner shall provide for redistribution among insurers.* — Since inequities might otherwise arise among insurers because of disproportionate allocation among them of the underwriting of various classes of risks, the commissioner of insurance shall ascertain that provision is made for redistributing among insurers (i) any disproportionate benefit of cost savings resulting from releases of basic, added, and vehicle protection insureds and (ii) any disproportionate burden of losses in relation to the premiums received for classes of risks based on probable injuries and losses to persons other than those to whom the insurer is required to pay basic, added, or vehicle protection benefits. The commissioner may approve or establish reasonable rules and regulations for a system of pooling or redistribution to accomplish such equitable allocation of cost savings and burdens among insurers.

(*d*) *Principles of redistribution.* — If no other arrangements for a system of pooling or redistribution have been approved or established by the commissioner of insurance or agreed upon between the insurers involved, such redistribution shall be effected by rights of equitable reimbursement in individual cases, among insurers of policies applicable to an accident, as provided in the following subparagraphs.

(1) *Redistributing savings from releases of basic protection insureds.* —To avoid any disproportionate benefit from releases of basic protection insureds, rights of reimbursement shall be recognized in favor of each basic protection insurer against each released liability-only insurer of any other policy applicable to the accident. A released liability-only insurer is one whose policy offered basic protection insurance (by reason of which the insurer and insureds are protected by the releases of basic protection insureds of other policies) but, by election of the policyholder, provided liability coverage without basic

protection coverage. As between two insurers of private passenger cars and as between two insurers of commercial vehicles of the same class, the right of reimbursement applies only to each tort claim that would have been released in full or in part if basic protection insurance had been elected, in such other policy, for the policyholder and all his relatives residing in the same household. Subject to the same limit as that of such a release, there is a right to reimbursement of any equitable percentage of the full cost of disposing of such tort claim, including defense and claims administrative costs. It shall be presumed that the equitable percentage is eighty percent. This presumption may be rebutted by proof that a different percentage of reimbursement is fair and equitable. However, in order to maintain fair and reasonable incentives for cost reduction and in recognition that in their absence the burden of costs upon liability-only insurers and their policyholders would be unfairly increased, in no event shall the percentage of reimbursement in any individual case exceed eighty percent. As between insurers of different classes of vehicles, it shall be presumed that these same rules of reimbursement apply, but this presumption may be rebutted by proof, and if essential to equitable distribution the right of reimbursement may be extended not only to as much as eighty percent of the cost of disposing of each such tort claim but also to an equitable percentage of the cost of disposing of each basic protection claim.

(2) *Redistributing cost of basic protection claims.* — To avoid any disproportionate risk of losses from injuries to persons other than those to whom the insurer is required to pay basic protection benefits, rights of equitable reimbursement shall be recognized. As between two basic protection insurers of private passenger cars and as between two such insurers of commercial vehicles of the same class, it shall be presumed that no reimbursement is required for equitable distribution. As between two basic protection insurers of different classes of vehicles it shall be presumed that an insurer against which a claim is made for basic protection benefits is entitled to partial reimbursement of the full cost of disposing of the claim, including defense and claims administrative costs, and that the rate of equitable reimbursement is the rate that effects a distribution of the loss between insurers proportionate to the premium rates charged for the applicable basic or added protection insurance. Either of these presumptions may be rebutted by proof that a different rate of reimbursement is fair and equitable.

(3) *Rules applying to added protection and vehicle protection in-*

surance. — The rules stated in subparagraphs (1) and (2) of this paragraph for application to basic protection insurance apply also to added protection and vehicle protection insurance.

REGULATIONS TO ALLOCATE COST SAVINGS RESULTING FROM RELEASES OF BASIC AND VEHICLE PROTECTION INSUREDS

Releases by Basic Protection Insureds

30(c).1 The commissioner shall establish a pooling system as described in 30(c).3-.5 to allocate the cost savings resulting from releases of basic protection insureds.

30(c).2 Each insurer subject to this chapter shall be required to participate in the pool.

30(c).3 For each calender year, each insurer whose number of liability-only policies is below the statewide average of liability-only policies receives from the pool an amount equal to that number of liability-only policies below the statewide average times average claim cost times claim frequency.

30(c).4 For each calendar year, each insurer whose number of liability-only policies is above the statewide average of liability-only policies shall pay into the pool an amount equal to that number of liability-only policies above the statewide average times average claim cost times claim frequency.

30(c).5 Definitions.

(1) Liability-only policies: insurance policies which insure against tort liability of the insured for bodily injury to another.

(2) Statewide average of liability-only policies: the percentage which the total number of liability-only policies written by insurers in the state bears to the total number of both liability-only and basic protection policies written by insurers in the state.

(3) Average claim cost: statewide average cost of disposing of a claim brought on a liability-only policy including settlement, recovery, defense and overhead costs, but the average shall not take into account (1) claims brought on a liability-only policy by a basic protection insured, and (2) any portion of a recovery or settlement above the limits which a basic protection insured waives under section 3(c)(1) of this chapter.

(4) Claim frequency: number of claims made per policy state-

wide on a liability-only policy by other than a basic protection insured and adjusted to take account of claims waived.

Releases by Vehicle Protection Insureds

30(c).6 The commissioner shall establish a pooling system as described in 30(c).7-.10 to allocate the cost savings resulting from releases of vehicle protection insureds.

30(c).7 Each insurer subject to this chapter shall be required to participate in the pool.

30(c).8 For each calendar year, each insurer whose number of liability-only policies is below the statewide average of liability-only policies shall receive from the pool an amount equal to that number of liability-only policies below the statewide average times average claim cost times claim frequency.

30(c).9 For each calendar year, each insurer whose number of liability-only policies is above the statewide average of liability-only policies shall pay into the pool an amount equal to that number of liability-only policies above the statewide average times average claim cost times claim frequency.

30c.10 Definitions.

(1) Liability-only policies: insurance policies which insure against tort liability of the insured for damage to another's vehicle.

(2) Statewide average of liability-only policies: the percentage which the total number of liability-only policies written by insurers in the state bears to the total number of both liability-only and vehicle protection policies written by insurers in the state.

(3) Average claim cost: statewide average cost of disposing of a claim brought on a liability-only policy including settlement, recovery, defense, and overhead costs.

(4) Claim frequency: number of claims made per policy statewide on a liability-only policy adjusted to take account of claims waived.

COMMENT: Reallocation for savings from waivers by vehicle protection insureds is similar to reallocation for basic protection waivers except that the definitions have been revised to take account of the fact that there are no limits on the vehicle protection waiver.[55] In all other respects the problems and the solutions are identical.

55 Optional BPI § 8(b).

Added protection insurance does not require reallocation because there is no disproportionate saving from waivers; a waiver by an added protection insured applies only to claims between added protection insureds and only to the lower of the two limits of the added protection policies.[56]

30(c).11 In administering the pooling formulas for basic and vehicle protection insurance, the commissioner shall approve calculations submitted to him by insurers of amounts to be received from or paid into the pools. If the insurers do not submit calculations, the commissioner shall calculate amounts to be received from or paid into the pools and may require insurers to submit to him all data reasonably necessary for these calculations.

COMMENT: Direct participation by the insurance companies should encourage innovative efficiencies in administration and further refinements in theory.

30(c).12 All receipts and disbursements from the pools for each calendar year shall be completed within — days following the end of each calendar year.

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56 *Id.* § 6(b).

NOTE

ELIGIBILITY AND REIMBURSEMENT UNDER THE NEW JERSEY PUBLIC DEFENDER STATUTE

Introduction

One of the dominant legacies of the Warren Court is the dramatic expansion of the right of the poor to counsel in criminal prosecutions.[1] The indigent defendant is now assured of the right to counsel not only at trial,[2] but also in pre-trial interrogation,[3] at critical stages in the police investigation,[4] in post-conviction appeals,[5] and in certain collateral attacks on imprisonment.[6] A landmark decision has extended the constitutional guarantee of counsel to juvenile proceedings,[7] and rumblings in the federal courts of appeals suggest that the right to counsel may apply in misdemeanor prosecutions also.[8]

This radical expansion of the right to defense counsel has raised serious questions as to the adequacy of existing institutions for providing legal services to the poor. The increased demand for legal manpower is staggering. An American Bar Foundation study[9] has estimated that at least 50 percent of all persons charged with felonies are unable to hire counsel for financial reasons. Using this figure, the President's Crime Commission has estimated that it would have required an expenditure of between $84 million and $158 million[10] to support the 4200 to 6300[11] lawyers

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1 For an excellent recent summary of the scope of the right to counsel see, Comment, *Reimbursement of Defense Costs as a Condition of Probation for Indigents*, 67 MICH. L. REV. 1404, 1405-7 (1969) [hereinafter cited as *Reimbursement of Defense Costs*].

2 Gideon v. Wainwright, 372 U.S. 335 (1963).

3 Miranda v. Arizona, 384 U.S. 436 (1966).

4 Hamilton v. Alabama, 368 U.S. 52 (1961).

5 Johnson v. Avery, 393 U.S. 483 (1969).

6 Griffin v. Illinois, 351 U.S. 12, 19 (1956).

7 In re Gault, 387 U.S. 1 (1967).

8 Harvey v. Mississippi, 340 F.2d 263 (5th Cir. 1968); Goslin v. Thomas, 400 F.2d. 594 (5th Cir. 1968); *see*, Junker, *The Right to Counsel in Misdeameanor Cases*, 43 WASH. L. REV. 685 (1968).

9 L. SILVERSTEIN, DEFENSE OF THE POOR IN CRIMINAL CASES IN AMERICAN STATE COURTS 7 (1965) [hereinafter cited as SILVERSTEIN].

10 PRESIDENT'S COMMISSION ON LAW ENFORCEMENT AND ADMINISTRATION OF JUSTICE, TASK FORCE REPORT: THE COURTS 57 (1967) [hereinafter cited as TASK FORCE REPORT].

necessary to defend all the indigent defendants in all phases of the criminal process nationwide in 1965. It is clear that the legal manpower needs estimated by the Crime Commission are not currently being met. Actual expenditures in the state systems for 1965 were roughly $17 million and in the federal courts were $3 million.[12] The majority of jurisdictions still rely on assigned counsel systems in which the lawyer either receives nominal remuneration for his work or no remuneration at all.[13]

The increasing demand for lawyers to defend the poor has led many states to turn from the traditional assigned counsel approach to some form of defender system. In this respect, the experience of New Jersey is typical. Prior to 1967, New Jersey used a conventional assignment system to provide lawyers for indigents.[14] The trial judge kept a master list of all practicing members of the bar and made assignments in all non-capital cases by alphabetical rotation.[15] Compensation was authorized only in capital cases. In 1966, the New Jersey Supreme Court declared that lawyers defending indigents in all cases must be compensated.[16] One year later, in the wake of the *Gideon* and *Escobedo* decisions, the state embarked on a complete reform of its indigent defense system by enacting a statewide public defender plan.[17]

The New Jersey defender statute raises a number of significant issues. For example, it does not provide legal services for indigents in misdemeanor prosecutions.[18] Moreover, it is questionable whether the right to counsel attaches early enough in the criminal process to meet current constitutional standards.[19] However, these

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11 *Id.*

12 Silverstein, *Manpower Requirements in the Administration of Criminal Justice*, in TASK FORCE REPORT, *supra* note 10, at 159.

13 *Id.* at 59.

14 *See*, Note, *Implementing the Right to Counsel in New Jersey — A Proposed Defender System*, 20 RUTGERS L. REV. 789, 808-13 (1965).

15 *Id.* at 809.

16 State v. Rush, 46 N.J. 399, 217 A.2d 441 (1966).

17 N.J. STAT. ANN. § 2A:158A-1 *et seq.* (Supp. 1969); for a history of the passage of the statute, see, Note, *The New Jersey Public Defender*, 5 COLUM. J.L. & SOC. PROB. 153, 153-4 (1969).

18 N.J. STAT. ANN. § 2A:158A-2 (Supp. 1969).

19 *Id.*; The right to counsel does not attach until the defendant is "formally charged" with an offense; *see*, White v. Maryland, 373 U.S. 59 (1963); Miranda v. Arizona, 384 U.S. 436 (1966).

issues have been discussed exhaustively elsewhere[20] and will not be treated here. This Note will instead examine two narrow aspects of the New Jersey defender plan. First, it will discuss the problems of defining and administering a standard of eligibility and the New Jersey approach to this problem. Secondly, the Note will examine a relatively unusual provision of the New Jersey Statute which requires that the defendant reimburse the state for the cost of his defense.

I. ELIGIBILITY

Some of the most perplexing problems in implementing a system of defense for indigents are raised by the question of who shall be eligible for the services of the program.[21] Historically, standards of eligibility for defender programs throughout the country have varied dramatically from state to state and even from county to county within states. Indeed, the confusion has prompted one commentator to conclude that "the strongest impression that emerges is that most counties have very little system [for determining eligibility] at all."[22]

The question of eligibility is inherently difficult because many factors must be weighed in each particular case. What are the resources of the accused? Does he have a job or own property? Can the property he owns be readily liquidated to pay for his defense? What are the resources of his family and friends? Should they be expected to contribute to his defense? Should his resources be used for his defense if he has a wife and children to support? How much will it cost to defend him? Is the crime a serious one? Will the costs of investigation or expert witnesses be high? What about the accused who has some resources but not enough to pay the fees charged by first rate lawyers? This list is not exhaustive.

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20 *E.g.*, Junker, *The Right to Counsel in Misdemeanor Cases*, 43 WASH. L. REV. 685 (1968); Note, *Right to Counsel at Pre-trial Lineup*, 63 NW U.L. REV. 251 (1968); Note, *Right to Counsel at Scene-of-the-Crime Identifications*, 117 U. PA. L. REV. 916 (1968).

21 *See generally*, Kamisar & Choper, *The Right to Counsel in Minnesota: Some Field Findings and Legal-Policy Observations*, 48 MINN. L. REV. 1 (1964) [hereinafter cited as Kamisar & Choper]; Stifler, *Determining the Financial Status of An Accused*, 54 ILL. B.J. 868 (1966); SILVERSTEIN, *supra* note 9, 105-23.

22 L. SILVERSTEIN, DEFENSE OF THE POOR IN CRIMINAL CASES IN AMERICAN STATE COURTS — A PRELIMINARY SURVEY 31 (1964).

The complexity of the task of defining eligibility often leads the legislature to avoid the issue entirely. Most state statutes on the subject simply fail to spell out a reasonably definite standard of eligibility. As a result, the duty to formulate standards usually devolves upon the trial judge, the committing magistrate, the defender agency or some other state official. But even where the statute does specify a workable standard of eligibility, problems in administering the statutory standard remain.

A. *The Standard of Eligibility*

1. Standards Historically

One potential approach to the problem of defining a statutory standard of eligibility is for the statute to specify some dollar amount of assets or income which, if exceeded, will disqualify the applicant from eligibility. This is perhaps the oldest statutory test of indigence. At common law, a prospective litigant could proceed *in forma pauperis* only if his assets did not exceed five pounds.[23] Vestiges of this approach are still extant in some states; for example, an Arkansas statute provides that poor persons may institute suits without payment of fees if the litigant "is not worth ten dollars . . . over and above his wearing apparel . . ."[24]

The principal advantage of the fixed dollar amount test is the ease with which it can be administered. The problem of the administrator becomes merely one of making an accurate factual inquiry. The tough, marginal cases are decided by an arbitrarily drawn statutory line. An associated advantage of this type of test is that it can be applied with at least apparent uniformity throughout a state. Thus the system will not be subject to the criticism that the practices of determining eligibility vary from locality to locality.

However, the fixed dollar amount standard raises serious problems in the criminal context. It has become generally accepted that any test of eligibility for defender services must be related

23 Note, *Aid for Indigent Defendants in the Federal Courts*, 58 COLUM. L. REV. 832, 839, note 54 (1958).

24 ARK. STATS. § 27-402 (1947).

to the costs of defense for the crime charged.[25] The costs of defense will obviously vary widely depending upon factors such as the complexity of the defense and the need for investigative work. Even where these factors are roughly equal, the costs of defense will vary radically from district to district due to variations in the prevailing rate of compensation for lawyers.[26] Thus any fixed money standard of eligibility will have the inevitable characteristic of discriminating unfairly against defendants in need of more expensive defense services and against defendants brought to trial in areas where lawyers' fees are quite high. Moreover, the fixed dollar standard tends to ignore the surrounding circumstances of the accused's financial status. Does the accused have dependents who also rely on his income? Can his assets be readily liquidated to pay a lawyer? These factors are extremely difficult to accommodate in any fixed money standard of eligibility.

Considerations such as these have led virtually all jurisdictions to turn to some type of verbal formulation of the standard of eligibility. The most pervasive type of verbal formula simply provides that counsel shall be appointed whenever the accused is "indigent and unable to employ counsel."[27] Almost without exception, state statutes make no effort to define indigence. The phrase "unable to procure counsel" does have a definite meaning, but unfortunately it suggests that eligibility should be denied whenever the accused has funds sufficient to interest even the most incompetent courthouse lawyer.

The American Bar Association Project on Minimum Standards

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25 AMERICAN BAR ASSOCIATION PROJECT ON MINIMUM STANDARDS FOR CRIMINAL JUSTICE, STANDARDS RELATING TO PROVIDING DEFENSE SERVICES 53 (1968) [hereinafter cited as ABA PROJECT].

26 *See, e.g.*, D. OAKS, THE CRIMINAL JUSTICE ACT IN THE FEDERAL DISTRICT COURTS, SENATE COMM. ON THE JUDICIARY, 90TH CONG., 2D SESS. 25 (Comm. Print. 1969) [hereinafter cited as OAKS] for data reflecting the variation in fees for defending a Dyer Act (auto theft) charge in different federal jurisdictions.

27 *E.g.*, IDAHO CODE ANN. § 19-1513 (1947) ("whenever it appears to the satisfaction of the court that the accused is poor and unable to procure the services of counsel"); IND. STAT. ANN. § 9-3501 (1956) ("any poor person . . . who does not have sufficient means to employ an attorney at law to defend himself."); IOWA CODE ANN. § 775.4 (1946) ("and if he [desires counsel] and is unable to employ any, the court must . . . assign him counsel."); KAN. GEN. STAT. § 62-1304 (1956) ("If he is not able to employ counsel . . . the court shall appoint counsel to represent him").

for Criminal Justice has taken the position that "counsel should be provided to any person who is financially unable to obtain adequate representation without substantial hardship to himself or his family."[28] This standard represents a significant advance over the typical state standard in two respects. By including the phrase "adequate representation" the ABA suggests that the proper measure of need is whether the accused can afford the fee of a *competent* defense lawyer in that locality as well as the other necessary expenses of representation. Additionally, this standard emphasizes that the accused should not be expected to exhaust all resources to obtain counsel if the result will be to deprive his family of the necessities of life.[29]

2. Standards in the New Jersey Act

The New Jersey approach to the problem of defining a statutory standard is a novel one. Rather than attempting to embody the test of eligibility in one simple phrase, the New Jersey act enumerates the factors which are relevant to an equitable determination of eligibility. The act defines "indigent defendant" as any "person . . . who does not have the present financial ability to secure competent legal representation and to provide all other necessary expenses of representation."[30] In a later section the act provides that

> Eligibility . . . shall be determined on the basis of the need of the defendant. Need shall be measured according to the financial ability of the defendant to engage and compensate competent private counsel to provide all other necessary expenses of representation. Such ability shall be recognized to be variable depending on the nature, extent and liquidity of assets and on the disposable net income of the defendant on the one hand, and on the nature of the charge, the effort and skill required to gather pertinent information, render advice, conduct trial or render other legal services, and probable expenses to be incurred, on the other hand.[31]

This standard makes it clear that the proper test of eligibility is

28 ABA PROJECT, *supra* note 26, at 10.
29 *Id.* at 54.
30 N.J. STAT. ANN. § 2A:158A-2 (Supp. 1969).
31 *Id.* § 2A:158A-14.

the ability to engage "competent" counsel. It directs the agency to consider the probable cost of defense, which will vary depending upon the complexity of the case. Further, it authorizes the agency to exercise discretion in determining which assets are available for the defense of the accused.

The act also includes a provision for partial eligibility[32] which represents a significant reform over prior state statutes. One criticism frequently made of statutory tests of eligibility is their tendency to place the defendant "squarely on one side or the other of the eligibility line."[33] Generally state statutes defining eligibility simply ignore the problem of the defendant who has some resources but not enough to finance an adequate defense.[34] The result is often that the extremes of wealth and poverty receive competent representation while the defendant of modest means is forced to resort to marginal courthouse lawyers for his defense.[35] The New Jersey act addresses this problem by providing that "where it appears that the defendant has . . . means to meet some part, though not all, of the cost [of his defense] . . . he shall be required to reimburse the office . . . in such amounts as he can reasonably be expected to pay."[36] This is a reform which has long been advocated by critics of defender sytems,[37] but New Jersey is one of the first states actually to enact such a provision.

Despite these advantages, the New Jersey standard of eligibility is subject to the criticism that it does not specify that eligibility should not be denied to a defendant who has some assets but who cannot apply those assets to his own defense without imposing substantial hardship upon himself and his family. It can be argued that the references to "the nature, extent, and liquidity of assets"[38] and to "disposable net income"[39] imply that these resources should be considered available for the defendant's defense only after deducting amounts necessary to supply his family with the neces-

32 *Id.* § 2A:158A-16.
33 OAKS, *supra* note 27, at 46.
34 SILVERSTEIN, *supra* note 9, at 110-13.
35 ABA PROJECT, *supra* note 26, at 56.
36 N.J. STAT. ANN. § 2A:158A-16 (Supp. 1969).
37 *See, e.g.*, OAKS, *supra* note 27, at 46; SILVERSTEIN, *supra* note 9, at 110-13; Kamisar & Choper, *supra* note 21, at 20-23.
38 N.J. STAT. ANN. § 2A:158A-14 (Supp. 1969).
39 *Id.*

sities of life. This is a possible interpretation of the act. A sounder approach would be to state this explicitly.

B. *Administration of the Eligibility Standard*

1. Who Makes the Eligibility Determination?

Nationwide, there is significant variation among the states as to which official is responsible for determining eligibility. Usually the trial judge makes the decision. In many jurisdictions, however, this function is performed by "a committing magistrate, prosecutor, defender, assigned counsel, probation officer or other official."[40] New Jersey has chosen to place responsibility for the determination in the defender agency.[41]

Systems which grant this authority to the defender agency have been criticized on the theory that the defender, because of heavy case load pressures, may be tempted to apply an overly strict standard of eligibility.[42] The fact that most of the New Jersey defender offices do have a very heavy case load lends credence to this argument as applied to New Jersey. During fiscal year 1969, it was estimated that approximately 12,000 new cases were assigned to the approximately 65 attorneys in the New Jersey public defender organization at that time.[43] During that same period 6,800 cases were closed by the agency.[44] By any measure, this is a heavy case load.[45] However, since the New Jersey statute authorizes the defender to assign cases to private attorneys,[46] case load pressures

40 L. SILVERSTEIN, DEFENSE OF THE POOR IN CRIMINAL CASES IN AMERICAN STATE COURTS — A PRELIMINARY SUMMARY 31 (1964).

41 N.J. STAT. ANN. § 2A:158A-15 (Supp. 1969).

42 ABA PROJECT, *supra* note 26, at 57.

43 OFFICE OF THE PUBLIC DEFENDER, REPORT TO SPECIAL COMMITTEE OF THE NEW JERSEY LEGISLATURE, 2 (Feb. 6, 1969) [hereinafter cited as REPORT TO SPECIAL COMMITTEE].

44 *Id.*

45 The New Jersey Public Defender has stated that no staff attorney should be expected to handle more than 125 cases per year although the field offices quite frequently exceed this figure, *see Id.* at 4. The President's Crime Commission has estimated that a full-time defender attorney with the support of adequate investigative services could effectively represent between 150 and 200 felony defendants per year, *see* TASK FORCE REPORT *supra* note 10, at 55.

46 N.J. STAT. ANN. § 2A:158A-7(c) (Supp. 1969) authorizes the Public Defender to "Maintain . . . trial pools of lawyers who shall be available to serve as counsel on a case basis as needed." In most regions, approximately 10 percent of the cases are farmed out to the trial pool, *see*, REPORT TO SPECIAL COMMITTEE, *supra* note 43, at 4.

may be less significant in determining eligibility to the extent that the agency is not subject to budgetary restrictions limiting its ability to turn to the "trial pool" lawyers.

A strong argument in favor of the New Jersey plan is that the defender agency has the resources to investigate the financial status of the applicant. The traditional arbiter of eligibility — the trial court judge — has neither the time nor the staff to conduct an extensive investigation of the applicant. The defender agency, on the other hand, will customarily have professional investigators on its staff[47] who could investigate the financial status of the accused.

On balance, the New Jersey approach is a sound one. The assumption that the trial judge will be more solicitous of the rights of indigents than the defender agency is probably unjustified.[48] Since one of the major criticisms of defender programs is that the defendant's claim of indigence is rarely challenged,[49] the capability to conduct such an investigation may be the crucial factor in considering this question.

2. Investigation and the Problem of Abuse

The criticism most frequently leveled at defender systems by the bar (and occasionally by the bench[50]) is that defendants too frequently succeed in misrepresenting their assets to secure undeserved free legal services. One study of the assignment system in the federal district courts has noted that "the most widely felt abuse of the assignment system is the false claim of indigency."[51] This skepticism is also reflected in the results of a questionnaire conducted in ten sample federal districts among lawyers who had defended indigents under the Criminal Justice Act of 1964. Thirty-eight percent of the lawyers responding indicated a belief that the act was being abused by defendants who were financially able to retain counsel.[52] In the Northern District

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47 *Id.* § 2A:158A-7(a). This section empowers the Public Defender to hire investigators.

48 *See, e.g.*, Connally, *Problems in the Determination of Indigency*, 1 GA. S.B.J. 11 (1964).

49 See footnotes 49-52, *infra*, and the accompanying text.

50 *See* Connally, *supra* note 47.

51 Note, *The Representation of Indigent Criminal Defendants in the Federal District Courts*, 76 HARV. L. REV. 579, 585 (1963).

52 OAKS, *supra* note 27, at 33.

of Illinois (Chicago), 62 percent of the responding lawyers believed that defendants were abusing the act.[53]

One approach to this problem is for the defender agency to conduct an independent investigation of the defendant's financial status to verify his claim of indigence. Sanctions can be imposed whenever false representations are discovered.[54] Yet it is frequently argued that the cost of such investigations is likely to exceed the cost to the agency of defending those few applicants who have misrepresented their resources.[55] This argument, however, assumes that the only alternatives are either to investigate the status of *every* applicant or to accept every application at face value. This assumption ignores the deterrent value of well-publicized, selective investigations, which could serve as a significant check on abuse without incurring prohibitive costs.[56]

Moreover, as has been pointed out elsewhere, the cost of the investigation is not the only relevant consideration: "Since . . . the representations to the court [are] about an essential item of judicial business, their falsification should be a matter of serious concern to society."[57] One ancillary benefit of a systematic program of selective investigation is that it will serve to disarm critics of defender systems and perhaps make them "more receptive to both the present system and forthcoming proposals for extending further aid."[58]

The New Jersey defender statute directs the public defender to make such investigations of the financial status of applicants as he may deem necessary.[59] The current practice in New Jersey is that such investigations are made only infrequently. Questionnaires to the field offices of the New Jersey defender organization indicate that investigations are made only where the organization has some positive reason for being suspicious of the applicant's

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53 *Id.* at 36.

54 *See, e.g.*, 18 U.S.C. § 3001A (1963) which imposes criminal penalties for false swearing or submission of false claims in order to receive free legal services in the federal courts.

55 Note, *supra* note 51, at 586.

56 For an elaboration of this argument, see OAKS, *supra* note 27, 39-43; *see also*, Kamisar & Choper, *supra* note 21, at 22.

57 OAKS, *supra* note 27, at 42.

58 Kamisar & Choper, *supra* note 21, at 22.

59 N.J. STAT. ANN. § 2A:158A-15 (Supp. 1969).

claim of indigence — as where, for example, the defendant has posted a large cash bond.[60]

One reason for the apparent lack of investigation is the widespread belief among the defender staff that the act is not being abused by defendants. No responding attorney indicated that he felt that abuse was a significant problem at this time.[61] Secondly, the respondents largely felt that any policy of investigation would be more costly than defending the few pretenders who attempt to abuse the system.[62] Lastly, investigations are difficult to make because of lack of manpower.[63]

The obvious danger presented by this lack of investigations is that it may become known among the defendant population and result in an increasing number of falsified claims of indigence. The administrators of the New Jersey defender organization have recognized this problem. The agency's budget request for fiscal year 1970 included a request for an investigator for each regional office who would devote his time to investigating claims of indigence.[64] But to date, the legislature has failed to appropriate sufficient funds for any systematic investigative procedure.[65]

II. The Obligation to Reimburse the State

Certainly the most controversial aspect of the New Jersey Statute is the requirement that the indigent ultimately reimburse

60 Questionnaire on file with the Harvard Student Legislative Research Bureau. Of the twelve regional public defender offices, five responded to the questionnaire. Of the five respondents, four indicated that the applications are usually taken at face value with little investigation unless there is some specific reason for suspecting that the applicant is misrepresenting his resources. Richard A. Walsh, Deputy Public Defender, also noted that this was the prevailing practice. Interview, February 16, 1970.

61 *Id.*

62 *Id.* One field office director commented: "My own opinion is that about 10 percent of our clients could afford counsel. Our clients do not, however, have the type of assets that would be easily discoverable. I can think of no method to screen out that 10 percent that wouldn't cost much more to initiate than the cost of providing representation."

63 *Id.* One respondent commented: "There are only three investigators in this office. Caseload for this region is about 1200 to 1500 cases a year. If the investigators spent their time on credit checks, there would be no time to investigate facts pertaining to the client's defense."

64 Report to Special Committee, *supra* note 43, at 9.

65 Interview with Richard A. Walsh, Deputy Public Defender, February 16, 1970.

the state for the cost of his defense.[66] New Jersey is not the first state to enact such a provision. The Florida public defender statute, enacted four years prior to the New Jersey statute, contains virtually an identical provision.[67] Furthermore, some state[68] and federal[69] courts follow a practice of requiring reimbursement from defendants as a condition of probation, although recent commentary indicates that the practice is of dubious constitutionality.[70] However, only a minority of jurisdictions require any form of reimbursement from the indigent if he meets the eligibility requirements of the system.

The mechanics of the New Jersey plan are relatively simple. The statute provides that "the reasonable value of the services rendered . . . may in all cases be a lien" on all property which the defendant owns or later acquires.[71] The defender agency is directed to "effectuate the lien" whenever the reasonable value of the services rendered exceeds $150.[72] The agency may, at its discretion, effectuate the lien even when the reasonable value of the services is less than $150.[73] Effectuation is accomplished by the filing of a notice with the Clerk of the Superior Court.[74] The lien attaches from the date of filing for a period of ten years[75] and is given the "force and effect" of a judgment at law.[76]

The statute directs the agency to do "all things necessary and proper to collect all moneys due . . . for services rendered."[77] The agency is empowered to "institute and maintain any action or

66 N.J. STAT. ANN. § 2A:158A-17 (Supp. 1969). The term reimbursement is used herein to refer to payments made by the defendant for the cost of his defense after his case is disposed of by the courts. The New Jersey act also includes provisions for requiring reimbursement at the time the services are rendered from those who are partially eligible for the services of the agency. See footnotes 33-37 and the accompanying text.

67 FLA. STAT. ANN. § 27.56 (Supp. 1969); *see also*, N.C. GEN. STAT. §§ 15-4.1 to 6 (1965) requiring reimbursement of fees paid to private attorneys under the state's assigned counsel system.

68 SILVERSTEIN, *supra* note 9, at 113.

69 OAKS, *supra* note 27, at 58-59.

70 *Reimbursement of Defense Costs, supra* note 1, at 1420.

71 N.J. STAT. ANN. § 2A:158A-17 (Supp. 1969).

72 *Id.*

73 *Id.*

74 *Id.*

75 *Id.*

76 *Id.*

77 *Id.* § 2A:158A-19.

proceeding in the courts" necessary for collection.[78] However, in any such action the defendant may "contest the value of the service rendered."[79]

A. *Standards in Compelling Reimbursement*

One substantial criticism to be made against the New Jersey reimbursement plan is that it fails to specify a proper standard for determining when reimbursement should be required and when it should not. Presumably, not all defendants will be able to reimburse the state for the cost of their defense. Some will be incarcerated and will never acquire any assets with which to do so within the ten year period. Others will be out of prison and working, but receiving an income which barely provides them and their families with the necessities of life. In this case, few would argue that the former defendant should be compelled to reimburse the state for the cost of his defense, yet the New Jersey Act gives little guidance on the question.

The act provides that the "Public Defender . . . shall do all things necessary and proper to collect all moneys due to the state . . . for services rendered pursuant to this act."[80] The agency is authorized to "compromise and make settlement" of any claim whenever "the financial circumstances of said person are such that in the judgment of the Public Defender the best interest of the State will be served by such . . . settlement."[81] The impropriety of the best-interest-of-the-state standard for enforcing reimbursement is patent. The agency might well conclude that the best interests of the state are served by always seeking to maximize the general revenue. The standard should focus on the subsequent ability of the defendant to pay the fees without unreasonable hardship to himself and his family.

By way of contrast, the Model Defense of Needy Persons Act allows the county to bring an action for the value of legal services received only if the defendant subsequently becomes able to pay as measured by the same standard used in determining eligi-

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78 *Id.*
79 *Id.*
80 *Id.*
81 *Id.* § 2A:158A-20.

bility in the first instance.[82] Thus the defendant is never expected to reimburse the state unless his assets or income exceed a certain minimum standard specified by the act.

B. *Constitutional Objections*

In *United States v. Jackson*,[83] the Supreme Court declared that governmental objectives "cannot be pursued by means that needlessly chill the exercise of basic constitutional rights."[84] That case dealt with certain portions of the federal kidnapping act which provided that the death penalty could be imposed if the defendant elected to try his case before a jury whereas the maximum sentence was life imprisonment if the case were tried without jury or if the accused pleaded guilty. The court invalidated the provision stating that "The . . . effect . . . of such a provision is . . . to deter exercise of the Sixth Amendment right to demand a jury trial."[85] The court failed to find any sufficient governmental interest which justified the chilling effect exerted on the right to jury trial.

By analogy, it might be argued that creating liens against all property the accused might acquire in the future places an impermissible burden on the exercise of the constitutional right to counsel.[86] There is little doubt that the requirement that the individual reimburse the state for the cost of his defense has at least a potential chilling effect on the exercise of that right. However, the state could argue that this problematic deterrence of the exercise of the right to counsel is justified by the legitimate state objectives that are furthered by the reimbursement requirement. The state could argue that reimbursement is necessary to support the cost of the program and to deter abuse of the system, and that reimbursement is basically equitable in that the fortuity of temporary indigence should not relieve the defendant of his

82 Dickerson, *Model Defense of Needy Persons Act* 4 HAR. J. LEGIS. 14 (1966). [hereinafter cited as Model Act].

83 390 U.S. 570 (1968).

84 *Id.* at 582.

85 *Id.* at 581.

86 This argument is similar to one made previously against the practice followed in some jurisdictions of requiring reimbursement of defense costs as a condition of probation; see *Reimbursement of Defense Costs, supra* note 1, at 1413-16.

obligation to pay for his own defense.[87] The opponents of the reimbursement plan could point to the small amounts which have actually been collected in relation to the total cost of the defender program in attempting to minimize the state interest at stake. With regard to the deterrence-of-abuse rationale it could be argued that alternative means exist for accomplishing this objective which do not have the same chilling effect.[88]

When presented with these competing interests, the court's resolution of the issue would probably turn on the persuasiveness of the factual argument that the reimbursement obligation is a significant factor in causing defendants to decline representation. A similar constitutional argument might be that waiver of the right to counsel in a jurisdiction requiring reimbursement could not be considered voluntary if the defendant were influenced by the fear of being saddled with future debts of some indeterminate amount.[89] There is, however, nothing in past decisions which would compel this conclusion.

C. *Policy Evaluation*

Apart from the constitutional objections, there remains the question of whether the reimbursement requirement is a sound exercise of legislative power. The ABA Project on Minimum Standards for Criminal Justice has taken the position that there should be no obligation to reimburse the state except on the ground of fraud in obtaining the determination of eligibility.[90] In contrast, the Model Defense of Needy Persons Act includes a limited reimbursement requirement,[91] providing that the gov-

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87 See the text accompanying footnotes 90-96, *infra*, for an elaboration of these arguments.

88 *Id.*

89 Johnson v. Zerbst, 304 U.S. 458, 465 (1938), held that it is the duty of the trial judge in the federal courts to determine whether "there is an intelligent and competent waiver by the accused"; subsequent decisions established that there is a presumption against the waiver of constitutional rights, and that such a waiver must be clearly voluntary. *See* Von Moltke v. Gillies 332 U.S. 708 (1948); Aetna Ins. Co. v. Kennedy, 301 U.S. 389 (1937); Miranda v. Arizona 384 U.S. 436 (1966).

90 ABA PROJECT, *supra* note 26, at 58; The ABA based this recommendation on the ground that such a requirement might deter the exercise of the right to counsel and that this danger is not justified by the negligible amounts which are likely to be collected.

91 Model Act, *supra* note 82, at 14.

ernmental unit may, within three years, bring suit to recover payment for legal services rendered if the defendant has subsequently become able to pay.[92]

The principal argument in favor of introducing a reimbursement requirement into the defender plan is that it provides a wider financial base for the defender program. The funds derived from reimbursements can be used by the state to improve the quality of the program. More lawyers could be employed and the case load per lawyer reduced, and the scope of representation could be extended. Alternatively the funds derived could be used to reduce the cost of the program to the state. However, it should be noted that in the first two years of operation revenue from reimbursements amounted to less than one percent of the defender organization's total budget.[93] This percentage is, however, deceptively low. Those who do repay the state customarily do so in installments, and consequently, a lag is to be expected between the rendering of services and the receipt of reimbursements.[94] Also, the administrative difficulties associated with launching any new program undoubtably have contributed to the loss of reimbursement revenue. These factors can be expected to level off during the third and fourth years of operation and a more accurate evaluation of reimbursements as a revenue source should emerge.

A second argument in favor of the reimbursement requirement is that such a requirement serves to discourage defendants from abusing the system by making false claims of indigence. Undoubtably, a requirement that the defendant reimburse the state for the cost of his defense will make the defender system less attractive to defendants, and thereby reduce the temptation to conceal assets in order to gain program benefits. Yet, even with

92 *Id.*

93 Interview with Richard A. Walsh, Deputy Public Defender, February 16, 1970. Reimbursement collections during the first two years of the program were approximately $35,000. This figure includes payments made by those defendants who were found to be partially eligible as well as collections from the lien provisions of the statute. The budget of the agency for the first two fiscal years was approximately $3.4 million.

94 *Id.*

the reimbursement requirement, there may still be considerable incentive to prefer the defender program over a private attorney. First, payment to the defender will be deferred and can be made in installments. This usually will not be possible with a private attorney. Secondly, the rate charged by the public defender agency is likely to be far less than would be charged by a private attorney of comparable skill. These factors may tempt a defendant of modest means who nonetheless could employ a private attorney to misrepresent his resources even though the defender program is not free. This becomes more likely as the knowledge becomes widespread that the public defenders are as competent as most private members of the criminal bar. Moreover, other methods are available for accomplishing the same objective which do not have the effect of distorting the system as a whole.[95] The defender statute can include a provision authorizing the defender to recover costs from defendants who are found to have misrepresented their assets.[96] Thus, the deterrence-of-abuse rationale, standing alone, would not seem to justify the reimbursement requirement.

A third argument to be made in support of the reimbursement requirement is that temporary indigence at the time of the criminal prosecution should not affect one's obligation to pay for the cost of his defense. According to this rationale, it is basically equitable that a defendant who is without funds at the time of his trial be liable for the cost of his defense if he subsequently experiences a substantial increase in resources.

The principle argument against the reimbursement requirement is that it may deter some individuals from exercising their constitutional right to counsel, which is an undesirable burden even if it is constitutionally permissible. Insofar as the reimbursement requirement is applied to those recipients of legal services who are on probation or parole, the reimbursement requirement may be undesirable as a matter of sound rehabilitative policy. There is a strong social interest in favor of creating conditions in which those individuals who have been drawn into

95 See the text accompanying footnotes 54-58, *supra.*

96 *See, e.g.,* Model Act, *supra* note 82, at 14.

the criminal process can make a fresh start.[97] One commentator has concluded that the financial pressure generated by the obligation to repay the state might well be "disruptive to a man who is trying desperately to build a solid emotional and financial foundation for rehabilitation."[98] There have been no empirical studies in this area, but there seem to be grounds for fearing that the impact of the reimbursement requirement on the parolee and the probationer is not beneficial.

On balance, there is little to commend the reimbursement requirement as a matter of policy. In establishing a public defender system, New Jersey has made a substantial commitment towards solving the "age-old problem . . . [of] providing equal justice to rich and poor . . . alike."[99] While the reimbursement requirement may reduce the cost of this commitment to the state, the marginal monetary gains would not seem to justify its undesirable consequences.

*Philip C. Cook**

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97 *See generally*, J. RUMNEY & J. MURPHY, PROBATION AND SOCIAL ADJUSTMENT (1952).

98 OAKS, *supra* note 27, at 58; *see also Reimbursement of Defense Costs, supra* note 1, at 1419-20.

99 Griffin v. Illinois, 351 U.S. 12, 16 (1956).

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BOOK REVIEW

BLACK CAPITALISM, STRATEGY FOR BUSINESS IN THE GHETTO, By *Theodore L. Cross.* New York: Atheneum, 1969, pp. 209, index, appendices, $8.95.

Black Capitalism means different things to different people. It means social or community ownership to those who are not interested in creating a few black capitalists. They want black industrialism, based on community ownership and management.[1] To Mr. Cross, author of *Black Capitalism,* it represents individual entrepreneurship. Cross is in step with President Nixon in approach. The President gave a national focus as well as his personal commitment to his brand of black capitalism, beginning with his campaign address, "Bridges to Human Dignity," where he announced:

> For a long time, we . . . have been talking about . . . enlisting private enterprise in the solution of our great social problems, about profits as the great material power of our fantastically productive economy. What many of the black militants now are saying in effect, is this: "We believe you, and now we want a chance to apply those same principles in our own communities."
>
> Our reply should not be to reject this request, but to seize upon it . . . and to respond to it.
>
> The ghettos of our cities will be lastingly remade . . . when the people in them have the will, the power, the resources, and the skills to remake them.[2]

At a recent conference of minority enterprise, sponsored by the U.S. Chamber of Commerce, James M. Roche, chairman of Gen-

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1 Roy Innis, National Director of CORE has stated: "By black capitalism . . . we mean the acquisition of the instruments of black capitalism, the community-owned means of operating shops, factories, stores and industry. We're not just interested in creating 10 or 15 black capitalists. . . . What we want is a broad black industrialism, based on community action, ownership and management, in the hands of blacks, all the blacks in the community." Quoted in Milton Moskowitz, *Where It's At: Black Capitalism,* BUSINESS AND SOCIETY, Dec. 17, 1968, at 3.

2 On March 5, 1969, by Executive Order 11458, the President proceeded to implement his campaign statements by setting up the Office of Minority Business Enterprise under the Secretary of Commerce as a focal point for efforts to develop minority enterprise.

eral Motors, warned that minority-owned businesses were not a panacea for the country's social problems: "Those who advocate it expect too much from it; and those who belittle it fail to see how essential it is . . . ."[3] At the same conference, Commerce Secretary Stans, who coordinates the Nixon Administration's effort in this regard through his Office of Minority Business Enterprise (OMBE), admitted their efforts were suffering from a credibility gap.[4] The Administration's emphasis has included continuation of the Small Business Administration's "Project Own." It was originally started under the last administration by Howard Samuels, the SBA Director. Now, it has been repackaged under a new name, "Operation Business Mainstream." Present indications are that minority loan activity under this program has continued to increase.[5] Other OMBE activities have involved pledges of increased government involvement of minority-owned firms in government procurement and encouragement of franchisors to set up operations in minority communities.[6] To date, however, there has been no over-all strategy nor indications of any efforts to systematically examine and develop new proposals, such as tax incentives for business involvement in the ghettos.

It is to this end — to suggest a new strategy — that Cross' book is directed. The book is organized to present a logical argument for his proposals. After describing existing conditions in the ghetto, the impediments to business involvement, why business "ducks" such involvement, and why it should become involved, Cross describes a variety of tax credit proposals. These tax credit proposals are consistent with his basic premise for bringing wealth to our ghetto residents: the need for developing credit and equity capital, front-end risk money, and entrepreneurial skills.[7] Cross' underlying philosophy can be tersely summarized. In the ghettos, he declares, "Let us sponsor the 'sickness of riches' that now exists in the mainstream economy."[8] He seems to feel moved to pros-

3 The Washington Post, Jan. 22, 1970, Section C, at 1.

4 *Id.*

5 See *Hearings before the House Select Committee on Small Business*, 91st Cong., 1st Sess., 138, 141, 153 (1969).

6 The Los Angeles Times, Feb. 17, 1970, Part II, at 8.

7 T. Cross, Black Capitalism, Strategy for Business in the Ghetto (1969).

8 *Id.* at x.

elytize on behalf of our capitalistic system of commerce. He urges that if necessary there must be a "*forced* injection of credit, risk capital, and entrepreneurial skills into the ghetto economy."[9]

A very basic concept, integral to establishing the need for tax credits, is espoused in the first part of the book. His argument is that business efforts to bring the ghetto resident into the mainstream economy will not succeed until such business involvement fulfills "essential corporate needs." It is this critical judgment, that business does not and should not be expected to act other than in its own essential interests, that makes his book an important contribution to an understanding of the business role in solving our urban problems. Cross argues that such corporate "needs" will be generated only if the racial schism and violence in America reach crisis proportions *or* if the stakes become high enough from government subsidies, either directly or through tax credits, to make the risks of involvement attractive.

There are several propositions contained in this argument. First, Cross tries to show that existing efforts, spurred by concern over urban unrest, have not been particularly successful. The response of the business community to ghetto problems was developed following the riots of 1968. As a voluntary effort it has been praiseworthy, but to date it has been limited. Three highly publicized large business endeavors have been Aerojet-General's Watts Manufacturing Co., E.G. & G.'s Roxbury plant, and IBM's plant in Bedford-Stuyvesant. These have been manufacturing operations and have operated essentially as subsidiaries of their parents. As yet, none has reflected much potential for high profits. They have provided a new but limited source of employment for the ghetto areas in which they are located. That such business efforts have not been triumphal successes is attributed by Mr. Cross to the fact that the job will not be done "by philanthropy alone." An integral element of that statement is that the cost of doing "business" in the ghetto, because of costs peculiar to those areas, prevents the creation of competitive, profitable operations. Thus, such efforts by business, he contends, must be characterized basically as philanthropy. Furthermore, Cross examines the motiva-

9 *Id.* at 69.

tions behind these efforts. Were these anti-riot holding actions or did they get to the core of the problem: lack of credit, risk capital, and skills? It may be too soon to judge if business will adequately respond to the need voluntarily since these efforts have been on an experimental basis. It is clear, however, that we do not have the time to move slowly.

The next proposition of Cross' argument for additional financial incentives for involvement by the business sector is that direct governmental efforts are not and will not be effective. This proposition presents a dilemma, however. To chastise direct government action, and yet rely on reallocation of government revenues to finance a system of "categorical corrective incentives" is not altogether consistent. For instance, Cross contends that government may be able to decree equal job opportunity, but it cannot "force or create this kind of capital or savings." Nevertheless, government action is indeed involved here in the form of excused taxes which would otherwise be collected in order to "pay" business to move into ghetto areas.

This rhetoric actually disguises his underlying assertion: that government administration is generally ineffective. His illustrations support this interpretation. Singled out for particular denegration are the two government bureaucracies which have gained a reputation for slow-moving, overly-regulated operations: the Federal Housing Administration, now part of the Department of Housing and Urban Development, and the Small Business Administration. Several operational restrictions in these agencies are criticized as practices evidencing, in his view, the inability of such entities to attract private capital to and build affluence in the black community. One is FHA statutes which discourage speculative ventures. These provisions require that housing development be left to inexperienced nonprofit sponsors or limited dividend developers rather than to real estate entrepreneurs.[10] Cross claims this requirement is more severe than necessary to protect against corruption while at the same time it inhibits participation by legitimate wealth-makers. That these restrictions have caused ineffective programs is subject to challenge. Although governmental

10 *Id.* at 16, 107.

efforts have not been efficient, the primary reason for failure to accomplish desired objectives has been arguably the lack of congressional appropriations. Cross' tax incentives, moreover, are just another means to augment, indirectly, the funds for these efforts.

In sum, his discussion of the role of government suffers from lack of depth. Some people may be misled by the use of tax credits rather than direct government subsidies, but sophistication is growing.[11] Tax incentives or credits are but another form of federal expenditures.[12] The suggested use of tax credits essentially substitutes general tax revenues, paid by all, for voluntary industry contributions while lessening the 50 percent tax "bite" usually taken from corporations.

That is not to say that valid arguments cannot be made in favor of the approach. There are pronounced public objectives involved. One must recognize, however, the true impact of Cross' proposals. His basic plan is for a combination of tax credits. He somewhat simplistically notes "that there are good tax-incentive credits and there are bad ones. The object of an oil-depletion credit is bad; the object of a ghetto development tax credit is good. Some tax credits are broad and wasteful; others are carefully honed and effective."[13] Yet his appeal for focused subsidies is important. His specific proposals are consistent with this objective. He contends that the proposed Community Self-Determination Act,[14] which would give credits to newly established firms, would be ineffective because credits should go to the "creators of profits." Thus, his proposals would include tax credits to the lender who opens up credit to the ghetto. He would avoid incentives for fixed assets in favor of tying credits to actual operating costs. He would promote liquidity by giving credits for secondary purchasers of ghetto installment loans. Tax credits would also be given to major depositors in ghetto banks, to lending institutions based on the amount of resident savings, to non-residents making deposits in order to build risk funds, to franchisors for ghetto firms. Train-

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11 *See* Surrey, *Tax Incentives as a Device for Implementing Government Policy*, 83 HARV. L. REV. 705 (1970).

12 *Id.* at 706.

13 CROSS, *supra* note 7, at 148.

14 S. 33, 91st Cong., 1st Sess. (1969); introduced earlier as S. 3875, 90th Cong., 2d Sess. (1968).

ing efforts and loans of personnel would qualify for tax credits also; and credits would be allowed for new plants or businesses located in ghettos and slated for turnover to local residents through employee stock options and time-phased sales.

One question that should occur to the reader is for whom was this book written? Since Cross is an editor of a banking publication, one would suspect that he addressed his book primarily to the business sector. To some extent it is also a manifesto directed to government decision-makers to explain what business demands from the government in exchange for business cooperation. But in style and in coverage, the book is an attempt to rouse the lethargic businessman to action. If that is its primary purpose, however, it has made the job quite difficult.

His extensive description of the impediments to economic activity in the ghetto establishes the point too well. As portrayed, the ghetto is an anarchy. It has erected tariff walls that increase the cost of its goods and services; these cost factors obstruct any attempt to make profits; savings, credit, and risk capital are nonexistent; there is no indigenous class of entrepreneurs; and, finally, the ghetto will attack most well-meaning efforts because of current feelings for black nationalism.

It is hard to imagine that the normal businessman who reads this parade of horrors would proceed far enough to consider the proposals set forth later in the book. Moreover, this forty-page description is followed by a fairly complete absolution for noninvolvement. It is rich with old dogma. The businessman's "work ethic" makes him balk at helping the needy and unemployed; "[i]f a healthy man is out of work, it is because he is lazy." Also included is a quote from a businessman that "a corporation's officers . . . should . . . not be free to indulge in their own ideas of social engineering."[15]

There is a lesson here for those who would prompt business to involve itself in solving ghetto problems. They should listen carefully to what Cross recites for he is accurately describing the reactions of the business community. Business interests are not

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15 CROSS, *supra* note 7, at 74, 75-76.

designed to play much of a benevolent role in our society because we have decreed certain rules of profitability for them. That which has brought us wealth and material success does not countenance squandering corporate profits on social goals for long. Of course, not everyone would agree with his description (or justification) of resistance by business. There are good practical reasons for this position, however, for without greater profit incentives, Cross recognizes the general reluctance of businessmen to abandon their ethic. There are many powerful forces which discourage or forbid such activities. The need for a positive corporate profit picture and the desire for promotion, to name but two of many, often preclude and certainly inhibit middle-management response; it is always safer to hedge even where top management would proceed.

This discussion of the businessman's perspective, however, suffers somewhat from a too fervent emulation of that view. The superficial and anecdotal discussion detracts from the examination of the complex nature of the barriers to overcoming ghetto poverty. For instance, when describing the ghetto condition, he notes the failure of blacks to take proffered jobs; having been burnt too often, blacks naturally assume all jobs they are offered are dead-end employment. Moreover, he comments, they dislike the feeling of accepting white handouts. That is fair enough. But later in describing the businessman's perspective, he notes (without additional comment) that credit is unavailable since the banker assumes that the "ghetto borrower is risky, unpredictable and unreliable."[16] The conscientious businessman who reads these descriptions will find his reluctance to act reinforced. In fact, Cross admits his proposals are designed "to accommodate . . . existing business attitudes . . . ."[17] Thus, the concern one has is for what is missing — the commentary upon the validity of these beliefs of the business community. Or maybe one is disturbed by the fact that there is no "call to arms" — no attempt to describe the problems and then follow with at least some optimism. Perhaps there are no grounds for optimism, but that is not the message of this book. Without some encouragement, few will have the

16 *Id.* at 48.
17 *Id.* at 80.

appetite to face these obstacles unless the government makes the price right. And that price, after reading this, is likely to be quite high.

At times Cross does make a somewhat convincing case for industry responsibility in solving urban problems. For instance, he shows that corporate involvement fosters a good corporate image, aids in recruiting new, more idealistic graduates, and may substitute for enlarged federal programs which would centralize governmental power. Yet he continually returns to his emphasis on broader public responsibility as a prerequesite to action by private business. He accepts the argument that business has aggravated unemployment problems by increasing automation, but he denies that business has a corresponding obligation to correct this condition: "Ultimately, it serves little purpose to argue that private enterprise should have a vital interest in solving our urban problems because it bears a major responsibility for creating them."[18] His argument is that society by its demand for goods is responsible for these problems because industry merely responds to the consumer's choices by operating on the profit principle, a principle which has long been considered legitimate. As a result, he says, all society should bear the costs of solving these problems, especially since individual businesses cannot act unless their competitors do likewise. Mr. Cross also decries the use of economic boycotts to bring about social action, citing Father Groppi's business boycott for fair housing.[19] Rather than reinforcing his point, however, the examples reflect the inherent power of business interests which, if sufficiently threatened, will respond positively, if begrudgingly, as they did in Wisconsin. The political power of our economic institutions is obvious. Moreover, when these institutions respond only to pressure, not voluntarily, they encourage renewed pressure. This argument could have appropriately been made to support voluntary action programs by business.

A final criticism might be that the Community Self-Determination Act is not given much attention, even though it received strong initial congressional backing when introduced in 1968.[20]

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18 *Id.* at 89.
19 *Id.*
20 S. 33, 91st Cong., 1st Sess. (1969).

To a degree this meager treatment is justified since few commentators have given it any support.[21] It is unfortunate, however, that at least some of the community control alternatives for Black Capitalism do not receive more consideration since the concept of community self-determination has become extremely important to ghetto residents. Moreover, organizations such as community development corporations afford the most effective means for channeling outside involvement into the ghetto in a form most palatable to its residents.

Although some discussion of community control would have been preferable, Mr. Cross has advanced a considerable number of potential avenues for increased efforts, primarily through tax incentives. No price tag is estimated nor are the proposals fully examined, but that which has been done is quite useful. It is one of the few books that deals with this subject.[22] It is an important beginning and an excellent exposition of the businessman's perspective. It sets forth the incentive approach necessary for business to take action if real and substantial progress is to be made. From that standpoint, Cross is only stating a simple truth: if you want business to take a major role in this undertaking, you have to make it worth its while.

*Otto J. Hetzel**

21 *See, e.g.*, Sturdivant, *The Limits of Black Capitalism*, 47 HARV. BUS. REV. 122 (1969); Miller, *Community Capitalism and the Community Self-Determination Act*, 6 HARV. J. LEGIS. 412 (1969).

22 An American Assembly publication, BLACK ECONOMIC DEVELOPMENT, edited by William F. Haddad and G. Douglas Pugh, published by Prentice Hall, 1969, is the only other comprehensive book on this subject area. It is a collection of separate articles. A particularly useful portion of Cross' book provides a lexicon of terms and an overview of then existing "black entrepreneurship and company programs in the ghetto" in two appendices covering 43 pages. There are also four pages of suggested bibliography.

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