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From the Editors

Just before the officers of this volume of the *Journal* relinquish their authority to the officers of volume 8, we would like to acknowledge the success of one of the Bureau's recent drafting projects. A modified version of the antiblockbusting legislation which was published in the March issue of this volume has been enacted into law for the City of New York by the New York state legislature. Unfortunately, the land sales fraud legislation which was prepared for the State of Vermont by the Bureau and which appears in this volume in a modified draft did not pass the Vermont legislature. However, the Bureau's efforts may yet reappear in regulations to be promulgated by the attorney general's office.

* * *

The most apparent characteristic of the subject matter of this last number of volume 7 is the concentration on issues in legislation and regulation at the federal level. Although most of the issues and arguments involved are readily transferable to similar problems on the state level, the only predominately state-oriented material is the land sales fraud legislation. The editors do not intend to establish a trend emphasizing federal developments in the *Journal.* There is a greater need for law review commentary on state legislation. We hope it is, however, convenient for our readers that we have published most of our commentary on federal topics in this volume in this last issue.

LABOR RELATIONS IN THE MUNICIPAL SERVICE

WILLIAM J. KILBERG*

Introduction

This article is limited to an examination of labor relations in the municipal services, although much of what is contained herein has applicability for all levels of government dealing with legal rights. The municipal service was chosen for analysis because that is "where the action is." Approximately two-thirds of all governmental employees are employed at the local level;[1] over one-half of these are employed in public education.[2] It is the cities which are feeling the brunt of social change and upheaval which comprises an increasingly significant aspect of public sector labor relations. Strong employee organizations have long existed on the state level but have generally confined their activities to those of a political lobbying nature. Municipal employers are more accessible to their employees and are more susceptible to political pressure than their state or federal counterparts. It is on the local level that we find militant trade unionism bearing some resemblance to the early union groups in the private sector.

Any member of the newspaper-reading public is already quite familiar with the rapid growth and impact of public sector unionism. What the reader may be less informed about is the lack of adequate preparation on the part of his state and municipal governments to insure labor peace in our cities. National labor law for the private sector was drafted in more trying times than these and under greater and more extended pressure. Yet the final product has been, or so it appears to me, far superior to anything yet drafted for the public service.

This article attempts to outline a proper approach to municipal labor relations. The first section deals with basic employee rights:

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1 BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES, Table 605 at 429 (89th ed. 1968).

2 *Id.*, Table 606.

the right to organize and join a union for the purpose of representation, and the right to bargain collectively with the public employer. The second section sets forth a "framework for analysis," the economic and political-social milieu within which municipal collective bargaining must take place. The final part of this study deals with some of the fundamental ingredients for successful collective bargaining: exclusive representation and adequate union security; proper determination of bargaining unit; and dispute-settlement mechanisms for collective bargaining impasses, notably, the question of the right to strike. This article does not discuss the proper scope of collective bargaining in the municipal service, *i.e.* what subjects are appropriate for bargaining.

I. Basic Rights

A. *The Right to Organize and Join a Union*

In 1953, Alabama enacted a statute[3] which effectively bars state employees from joining labor organizations. Employees who form or join a labor union are subject to forfeiture of all rights under the state merit system.[4] The statute does, however, exempt city and county employees and teachers from its provisions.[5] North Carolina prohibits government employees from joining labor organizations and specifies that contracts between government units and employee organizations are void and against government policy.[6] A South Carolina Attorney General Opinion[7] has held that a city may prohibit its employees from joining labor unions. Virginia law forbids public officials from recognizing or negotiating with a union, although employees are free to join employee organizations not affiliated with a labor union claiming the right to strike.[8] The right to organize or join a union is not, therefore, a universally accepted right in the public service.

3 Ala. Code, tit. 55, §§ 317(1)-(4) (1958).
4 *Id.*, § 317(2).
5 *Id.*, § 317(3).
6 N.C. Gen. Stats. §§ 95-97, 95-100 (1959).
7 S.C. Att'y. Gen. Op. No. 641. The Attorney General declared, in addition, that the state right-to-work law is not applicable to municipal employees.
8 Va. Jt. Sen. Res. no. 12, Laws of 1946, at 1006.

In contrast, it has long been national labor policy in the private sector to accord workers the "fundamental" right to organize into labor unions,[9] and aspects of union organizing involving rights of free speech and assembly have been held to be protected against state and local government interference.[10]

In the absence of statutory prohibition, the common law right to self-organization has been upheld in the public service.[11] The Supreme Court of Missouri, in dictum, recognized a constitutional right of public employees to join labor organizations in *City of Springfield v. Clouse*:[12] "All citizens have the right, preserved by the First Amendment . . . peaceably to assemble and organize for any proper purpose, to speak freely and to present their views and desires to any public officer or legislative body."[13]

The right to organize and join employee organizations in the face of statutory prohibition has given the courts more trouble. In *McAuliffe v. Mayor of New Bedford*,[14] a policeman was discharged for solicitation of funds for a political committee. Justice Holmes, in determining the constitutionality of this limitation on political conduct, said: "The petitioner may have a Constitutional right to talk politics, but he has no Constitutional right to be a policeman."[15] Holmes' theory that the officer waived his constitutional rights by accepting employment in public service gave ammunition to many courts. In *CIO v. Dallas*,[16] a "no union membership" ordinance was made applicable to all municipal employees. The validity of the regulation was attacked on constitutional grounds, alleging infringement of the rights of assembly, speech, press and petition in contravention of the first and fourteenth amendments, and denial of the equal protection of the laws. The constitutionality of the ordinance was upheld on the

9 NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1, 33, 34 (1936).

10 Staub v. City of Baxley, 355 U.S. 313 (1958).

11 Hagan v. Picard, 171 Misc. 475, 12 N.Y.S.2d 873 (1939), *aff'd* 258 App. Div. 771, 14 N.Y.S.2d 706 (1939); Norwalk Teachers Ass'n v. Bd. of Educ., 138 Conn. 269, 83 A.2d 482 (1951); Cleveland v. Association, 30 Ohio Op. 395, 413 (C.P. 1945); Mugford v. Mayor & City Council of Baltimore, 185 Md. 266, 44 A.2d 745 (1946).

12 356 Mo. 1239, 206 S.W.2d 539 (1947).

13 *Id.*, at 1246, 206 S.W.2d at 542.

14 155 Mass. 216, 29 N.E. 517 (1892).

15 *Id.* at 220, 29 N.E. at 517.

16 198 S.W.2d 143 (Tex. Civ. App. 1946).

reasoning of *McAuliffe*: "These rights and privileges are purely personal and may be *waived* . . . . While they have a right to these constitutional privileges and freedoms, they have no constitutional right to remain in the service of the city."[17]

An analysis of the constitutionality of state laws prohibiting public service unions must take as a starting point the proposition that prima facie, there is a *right of association* protected under the first amendment and applicable to the states by the fourteenth which, in the absence of other considerations, guarantees municipal employees the right to organize and join a union.[18] The state, however, has a countervailing interest in regulating the activities of its employees. To prevail, however, the interest of the state must be a strong one: it "must be justified by clear public interest, threatened not doubtfully or remotely, but by clear and present danger."[19] In *Shelton v. Tucker*,[20] the Supreme Court held that a state statute which required teachers to disclose the names of organizations to which they belong is unconstitutional under the fourteenth amendment because there are "less drastic means for achieving the same basic purpose,"[21] and the statute interfered with the constitutionally protected freedom of association.

The state has an interest in protecting the public health and safety against the threat of strikes in the public sector. It would not seem necessary, however, to prohibit union organization to achieve this proper end. An alternative mode of regulation which would not be as restrictive of the freedom of association, would be to prohibit the strike weapon, or to provide for injunctive relief against all public strikes. But the state need not go this far, if one accepts the proposition that not all strikes in municipal employment pose a danger to the public health and safety.

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17 *Id.* at 146; *accord,* Perez v. Bd. of Police Comm'rs, 78 Cal. App. 2d 638, 178 P.2d 537 (1947); King v. Priest, 357 Mo. 68, 206 S.W.2d 547 (1947); City of Jackson v. McLeod, 199 Miss. 161, 24 So. 2d 319 (1946), *cert. denied,* 328 U.S. 863 (1945) (police offices).

18 *Cf.* NAACP v. Alabama, 357 U.S. 449 (1958); NAACP v. Button, 371 U.S. 415 (1963); Bd. of Ry. Trainmen v. Virginia, *ex rel.* Virginia State Bar, 377 U.S. 1 (1964).

19 Thomas v. Collins, 323 U.S. 516, 530 (1945).

20 364 U.S. 479 (1960).

21 *Id.* at 488.

A recent decision, *American Federation of State, County, and Municipal Employees v. Woodward*,[22] has accepted this reasoning and declared that municipal employees have a constitutionally protected right to join a union. Two employees of the Street Department of North Platte, Nebraska, alleged that they had been discharged because of their union membership. The U.S. Court of Appeals for the Eighth Circuit reversed a District Court dismissal and found that union membership is protected by the right of association under the first amendment.[23] The court also held that if public employees are discharged from their jobs because they have joined a labor organization, they have a cause of action for deprivation of constitutional rights under the Civil Rights Act of 1871.[24] The court rejected the argument that civil servants have no federally protected right to be in the public employ. Citing *Wieman v. Updegraff*,[25] the court declared it unnecessary to decide "whether an abstract right to public employment exists. It is sufficient to say that constitutional protection does extend to the public servant whose exclusion . . . is patently arbitrary or discriminatory."[26]

It might also be argued that discrimination against public employees who organize or join labor organizations violates the equal protection clause of the Constitution. Unless a state or subdivision thereof has a rational reason for grouping public employees into a "class" to be treated differently than employees in the private sector, such distinction violates equal protection guarantees.[27] Assuming other means are available for deterring safety-endangering strikes, it is difficult to see what rational reason there is for distinguishing public employees as a "class" for purpose of the right to join a labor union, especially where a state makes a further distinction between state and city employees.[28]

Such "patently arbitrary or discriminatory" treatment might

22 406 F.2d 137 (8th Cir. 1969).

23 *Id.* at 139.

24 42 U.S.C. § 1983 (1964). For an excellent discussion of the proper application of Section 1983, *see* Note, *Limiting the Section 1983 Action in the Wake of Monroe v. Pape*, 82 HARV. L. REV. 1486 (1969).

25 344 U.S. 183 (1952).

26 *Id.* at 191-92.

27 *Cf.* Kotch v. Bd. of River Boat Pilot Comm'rs, 330 U.S. 552 (1947).

28 *E.g.*, ALA. CODE, tit. 55, §§ 317(1)-(4) (1958).

also be a violation of constitutional due process. There need not be "property" in public office for this to be so. In *McLaughlin v. Tilendis*,[29] the Seventh Circuit Court of Appeals granted relief under the Civil Rights Act of 1871[30] to a non-tenured teacher who was dismissed because of his membership in a union. The court stated:

> It is settled that teachers have the right of free association, and unjustified interference with teachers' associational freedom violates the Due Process clause of the Fourteenth Amendment . . . . Public employment may not be subjected to unreasonable conditions, and the assertion of First Amendment rights by teachers will usually not warrant their dismissal.[31]

And in *Keyishian v. Board of Regents of New York*,[32] the Supreme Court explicitly rejected the theory that public employment "may be conditioned upon surrender of constitutional rights which could not be abridged by direct government action."[33]

In summary, state statutes or actions of officials under color of law which penalize or prohibit public employee unionism are unconstitutional, and public employees may obtain an effective remedy for such discrimination directly from the federal courts.

B. *The Right to Bargain Collectively*

While municipal employees may hark to the clarion call of the union organizer, union organization by itself may be of little significance. Representation elections, grievance procedures, collective bargaining cannot take place in a vacuum. New institutions must be developed. Most national labor legislation has carefully excluded public sector employment from its coverage.[34] However, many states and localities have begun drafting recommenda-

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29 398 F.2d 287 (7th Cir. 1968).
30 Note 24 *supra*.
31 398 F.2d 287, 288-289 (7th Cir. 1968).
32 385 U.S. 589 (1967).
33 *Id.* at 605.
34 Labor-Management Relations Act (Taft-Hartley Act), 29 U.S.C. §§ 152(2), (3) (1964); Norris-LaGuardia Act, 29 U.S.C. § 101 (1964), *construed in* United States v. United Mine Workers, 330 U.S. 258 (1947), not to apply to employees of the federal government. *But see* Railway Labor Act, 45 U.S.C. § 151 (1964), *construed in* California v. Taylor, 353 U.S. 553 (1957), to apply to employees of a state-owned railroad.

tions for the formation of municipal labor relations statutes and for the improvement of existing legislation.[35] The year 1967 alone witnessed 17 new state statutes dealing with public sector labor relations.[36] With each state setting forth its own conception of the proper route for municipal labor relations to take, it is no wonder that municipal labor law is a hodge-podge of confusion and contradiction with the acceptability of collective bargaining varying with the jurisdiction.

Connecticut, Massachusetts, Michigan, Oregon, Wisconsin and New York have made collective bargaining mandatory for municipalities.[37] In Delaware collective bargaining is mandatory for state and county employers but municipalities may elect to come under its provisions.[38] In Minnesota, a city has an "obligation to endeavor in good faith to resolve grievances and differences relating to terms and conditions of employment," and an employee organization which has won formal recognition has the right to "meet and confer" with public officials.[39]

Special laws and provisions often exist for teachers and other certified public school personnel, as well as for policemen and firemen.[40] Because the Urban Mass Transit Act of 1964 makes "the continuation of collective bargaining rights" a condition for

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35 *See, e.g.*, CONN., REPORT OF THE INTERIM COMMISSION TO STUDY COLLECTIVE BARGAINING BY MUNICIPALITIES (1965); MINN., REPORT BY THE GOVERNOR'S COMMITTEE ON PUBLIC EMPLOYEE RELATIONS (1966); R.I., COMMISSION TO STUDY MEDIATION AND ARBITRATION (1966); N.Y. CITY, REPORT OF THE TRIPARTITE PANEL TO IMPROVE MUNICIPAL COLLECTIVE BARGAINING PROCEDURES (1966); MICH., REPORT OF THE GOVERNOR'S ADVISORY COMMITTEE ON PUBLIC EMPLOYEE RELATIONS (1967). An overall analysis of developments is contained in EXECUTIVE COMMITTEE, NATIONAL GOVERNORS CONFERENCE, REPORT OF THE TASK FORCE ON STATE AND LOCAL GOVERNMENT LABOR RELATIONS (1967).

36 RUBIN, A SUMMARY OF STATE COLLECTIVE BARGAINING LAW IN PUBLIC EMPLOYMENT: (New York State School of Industrial & Labor Relations at Cornell University, Public Employee Relations Reports, no. 3, 1968).

37 CONN. GEN. STATS. ANN. §§ 7-467-7-477 (1958); MASS. GEN. LAWS ch. 149, §§ 178G-N (1958); MICH. COMP. LAWS ANN. §§ 423.201-423.216 (1948); ORE. REV. STATS. §§ 243.720-243.760 (1967); N.Y. CIVIL SERVICE LAW, art. 14, §§ 200-212 (McKinney's Consolidated Laws 1959).

38 DEL. CODE ANN., tit. 19, §§ 1301-1313 (1965).

39 MINN. STATS. ANN. §§ 179.50-179.572 (Supp. 1965). *See also*, CAL. GOV'T CODE §§ 3500-3509 (West 1961); Fla. Laws ch. 59-223, S.B. 563 (1959).

40 *See, 2.9.*, CAL. EDUC. CODE §§ 13080-13088 (West 1959) (teacher groups may advise and confer); CONN. GEN. STATS. ANN. §§ 10-153b-f (Supp. 1967) (mandates collective bargaining). In Massachusetts, Michigan and Wisconsin, teachers are included in the mandatory collective bargaining law for municipal employees.

qualifying for a federal grant, the New Mexico legislature authorized municipalities to enter into collective bargaining with unions representing municipal transit workers.[41] New Mexico does not, however, have a comprehensive labor relations act for public employees.

Many courts have held that, even in the absence of express statutory prohibition, collective bargaining is not proper unless explicitly authorized by state legislation.[42] For example, a recent Florida decision[43] declared that a municipality, absent enabling state legislation, is not legally authorized to enter into a collective agreement with a union. Three states — North Carolina, Texas, and Virginia — statutorily prohibit collective bargaining in their government service.[44]

A landmark decision holding to the contrary is *Norwalk Teachers' Association v. Board of Education.*[45] The Supreme Court of Connecticut held that, without need of a permissive statute, but absent a prohibitory one, a board of education may bargain collectively with its teachers with regard to salary, grievances, procedures and working conditions within the Board's power to grant, provided that the agreement is limited to members of the Association and no strike threat is present.[46]

Most courts proscribing collective bargaining in the public service have grounded their rulings on the notion of sovereignty,[47] that public employee pressure on government as employer through the collective bargaining process would represent a derogation of the supreme legal authority and political power of the public authority.[48]

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41 N.M. STATS. ANN. ch. 274, §§ 14-53-14-14-53-16 (1965).

42 *E.g.*, Springfild v. Clouse, 356 Mo. 1239, 206 S.W.2d 539 (1947); Weakly Co. Mun. Elec. Sys. v. Vick, 43 Tenn. App. 524, 309 S.W.2d 792 (1957); Mugford v. Mayor & City Council of Baltimore, 185 Md. 266, 44 A.2d 745 (1946).

43 Dade County v. Amal. Ass'n of St. Elec. Ry. & Motor Coach Employees, 19 Fla. Supp. 69, 157 So. 2d 176, *cert. denied*, 379 U.S. 971 (1965).

44 MINN. STATS. ANN., §§ 179.50-179.572 (Supp. 1965).

45 138 Conn. 269, 83 A.2d 482 (1951); *see also* Christie v. Port of Olympia, 27 Wash. 2d 534, 170 P.2d 294 (1947); Local 611, Elec. Workers v. Town of Framingham, 75 N.M. 393, 405 P.2d 233 (1965).

46 *Id.*, 138 Conn. at 277-78, 83 A.2d at 486.

47 *E.g.*, Springfield v. Clouse, *supra* note 12.

48 *See* W. VOSLOO, COLLECTIVE BARGAINING IN THE U.S. FEDERAL CIVIL SERVICE 17 (1966).

The doctrine is firmly implanted in the English common law with the notion that "the King can do no wrong." As the concept was developed in the United States, it was rephrased to read the "states are sovereign."[49] American cities, as subdivisions of the states, have upheld the sovereignty doctrine as regards public sector collective bargaining on the ground that the executive and legislative branches of government cannot delegate to others what has been delegated to them by charter or constitution.[50] Since the government cannot be coerced into doing anything it chooses not to do, the doctrine is an "effective bar to any action on the part of government employees to *compel* the government to enter involuntarily into any type of collective bargaining relationship."[51] There is no reason, however, why the government cannot enter *voluntarily* into collective bargaining agreements. Analogizing from the decision in *Carter v. Carter Coal Co.*,[52] where the Supreme Court struck down the Bituminous Coal Conservation Act of 1935, one would have to deny validity to legislation which would give a complete delegation of rule-making power to private parties. A city administration, no less than that of the federal or state government, is guardian of all people's rights and must retain the legal authority to repudiate any of its commitments for the benefit and safety of the commonweal. Having this power and authority, however, does not mandate its exercise.

> Since the sovereign power in a society lies in the authority to make final public policy decisions, a policy decision by the government to establish collective bargaining procedures is in itself a sovereign act. This does not, *ipso facto*, constitute an abrogation of the sovereign will because it does not undermine the final authority of the government, as the ultimate law declaring agency, to impose unilateral solutions in instances of general public interest.[53]

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49 *Cf. The Federalist*, No. 81 (Hamilton).

50 *See, e.g.*, Springfield v. Clouse, 356 Mo. 1239, 206 S.W.2d 539 (1947).

51 W. HART, COLLECTIVE BARGAINING IN THE FEDERAL CIVIL SERVICE 44 (1961) (emphasis added).

52 298 U.S. 238 (1936).

53 W. VOSLOO, *supra* note 48, at 18; *cf.* A. HACKER, THE STUDY OF POLITICS: THE WESTERN TRADITION AND WESTERN ORIGINS 40 (1963), declaring that sovereignty is a *process*: "The process of sovereignty . . . is more concerned with *how* laws are passed than with *what* they say."

Furthermore, collective bargaining, properly viewed, is not a delegation of governmental power. Although parties may be required to bargain in good faith, they are not compelled to reach an agreement. Much of the argument based on sovereignty and improper delegation of power is a misconception of the collective bargaining process.[54] In addition, statutes which delegate to administrative agencies the power to legislate on prices, wages or hours, under proper standards set by the statute, notwithstanding the statutory stipulation that such administrative legislation may not take effect without the consent of certain private groups, have been upheld.[55] Since working conditions, promotions, and grievance procedures are within the discretion of administrative officials at all levels of the civil or municipal service and could be made the subject of negotiation without express statutory authorization, there is no valid legal reason why collective bargaining in the municipal service cannot take place.

Civil service rules and regulations codify the system of employer-employee rights and duties, but do not cover all government employees. Moreover, the "book" is inadequate in providing correction of unsatisfactory working conditions because those who administer the system often have no control over the vital aspects of the employment relation; and where administrators do have discretion, they may be in no way accountable to the employees who must work under their direction.[56] Thus, in the absence of collective bargaining rights, public employees often fare as poorly as their nonunion private sector brethren in terms of representation in and control over the environment of the work place. In the private sector, however, it is national and state labor policy to favor the imposition of collective bargaining where a majority of the employees in a given work unit desire it. A government which required private employers to bargain with their employees should not refuse to deal with its own employees on a reasonably similar basis.[57] There may well be public policy limita-

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54 See Anderson, *Labor Relations in the Public Service*, 1961 WIS. L. REV. 601, 619.

55 *Cf.* United States v. Rock Royal Co-op, 307 U.S. 533, 577-78 (1937).

56 Note, *Labor Relations in Public Employment*, 61 NW. U.L. REV. 105, 111-12 (1966), citing KAPLAN, THE LAW OF CIVIL SERVICE 318-19 (1958).

57 ABA, SECOND REPORT OF THE COMMITTEE OF LABOR RELATIONS OF GOVERNMENTAL EMPLOYEES 125 (1955).

tions on the collective bargaining process in the municipal service, but the process itself ought to be established.

Where public employees opt for the right to organize and join labor organizations, and a union is certified as a bargaining representative, city government has an opportunity to cut through its own bureaucratic complexity, better organize itself to serve the needs of the community, and improve means of communicating with its employees by carrying on a dialogue with its public servants through elected leadership. Other advantages to be gained by city management through collective bargaining may be summarized: (1) Improved employee morale; (2) More responsible attitudes and activities on the part of the employee organization and its leaders; (3) Recognition of management's rights; (4) Uniform application of administrative policies; (5) Promotion of better management by forcing the administration to train its own men in grievance procedures and employee relations; (6) Assistance in effecting needed policy changes.[58]

Having argued for the legality and advisability of collective bargaining in the public sector, and having set out its merit, I reach the question whether Congress can and should provide a national labor law for public employees in the face of some stern opposition from a number of states.

Were Congress to decide to regulate public sector labor relations, its authority would most likely be based on the commerce power, the constitutional grounding for the entire body of federal labor relations law.[59] Labor conditions in the municipal service "affect commerce." Work stoppages involving public employees would interrupt and burden the flow of goods across state lines. Local governments are large consumers of goods traveling through the states; and the commerce power does not distinguish between "nonprofit" and profit-making institutions.[60] Thus, there should be little doubt that a proper nexus exists between local government and interstate commerce to establish federal jurisdiction through the commerce power.

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58 MACY, *Employee-Management Cooperation in the Federal Service*, in MANAGEMENT RELATIONS WITH PUBLIC EMPLOYEES 208 (K. Warner ed. 1963).

59 NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1 (1937).

60 *See, e.g.*, Mitchell v. Pilgrim Holiness Church Corp., 210 F.2d 879 (7th Cir. 1953), *cert. denied*, 347 U.S. 1013 (1954).

The only stumbling block to congressional enactment of a national labor law for state and municipal employees is the "doctrine of intergovernmental relations," the purpose of which is to serve as a brake on federal encroachment of state governmental sovereignty. The cases discussing this doctrine portray a history of its withering impact,[61] and the Supreme Court now accords virtually dispositive weight to congressional determinations of its own legislative competence when those determinations have faced attack.[62] In *Maryland v. Wirtz*,[63] the Court affirmed a three-judge district court ruling[64] which upheld those portions of the 1966 amendments to the Fair Labor Standards Act which extended the minimum wage to nonadministrative, nonprofessional personnel in public schools, hospitals and nursing homes. Replying to appellants' contention that state sovereignty in the performance of governmental functions precluded application of the Act, Justice Harlan, speaking for the majority, dealt the doctrine of intergovernmental relations a severe blow: "If a State is engaging in economic activities that are validly regulated by the Federal Government when engaged in by private persons, the State too may be forced to conform its activities to federal regulation."[65]

An affirmative judgment as to the constitutionality of federal intervention does not necessarily lead to the conclusion that it is desirable. While it is to the advantage of many private sector enterprises which operate on a multistate or interstate basis to promulgate a uniform labor policy, a similar need for uniformity does not manifest itself in the municipal service. There is no compelling reason why the states should not differ in their approaches to public sector labor relations. Our knowledge of the various modes of achieving labor peace in the public sector is not yet so great as to warrant dismissal of the advantages to be gained from experimentation within the state and city services. If mis-

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61 *E.g.*, Parden v. Terminal Ry. of Ala. State Docks Dept., 377 U.S. 184 (1964); United States v. California, 297 U.S. 175 (1936); Bd. of Trustees of U. of Ill. v. United States, 289 U.S. 48 (1932); Oklahoma *ex rel.* Phillips v. Guy F. Atkinson Co., 313 U.S. 508 (1941).

62 *Cf.* Katzenbach v. McClung, 379 U.S. 294 (1964).

63 392 U.S. 183 (1968).

64 Maryland v. Wirtz, 269 F. Supp. 826 (D. Md. 1967).

65 392 U.S. 183, 197 (1968).

takes are to be made, perhaps it is better that they be made at the state and city levels than at the national level. Conditions of public employment also vary so greatly from state to state and city to city that it would be a considerable undertaking to draft a statute applicable to all. Congressional time and energy might be better spent in attempting to alleviate some of the root causes of labor unrest in major urban areas, *i.e.*, the financial and social crises of the city to which this discussion now turns.

II. The Framework for Analysis

A. *The Economic Context*

Collective bargaining in the municipal service takes place in a context economically dissimilar from that of the private sector. Increased costs are not as easily pushed on to the ultimate consumer; the strike is more of a political than an economic weapon; the city does not have certain economic alternatives open to it — such as, substantially reducing its work force, closing its plant down, or moving to a more favorable location;[66] wage and benefit agreements must be coordinated with statutorily set budget dates; and the cities face financial crisis. This does not preclude collective bargaining, but it may well emphasize the importance of good labor-management relations and the necessity for union-city cooperation in solving urban problems. In short, a municipality is a highly unsatisfactory environment for traditional labor-management warfare.

To begin with, there is no recognizable rational price structure or profit motive in the public sector for economic, political, and social reasons. Many municipal goods and services are not divisible into discrete units in production or distribution and are provided free or at nominal charges to consumers, while the great bulk of the actual cost is borne out of general tax revenues. Fire and police protection are classic examples of such "collective goods." On the other hand, rational market pricing is quite feasible in government-operated public utilities such as transit, water, highways, but are deliberately run on deficit bases for po-

66 The "contracting out" of certain services is, however, a plausible alternative, although not necessarily a viable one from a cost standpoint.

litical and social policy reasons. The New York City subways, water supply, and the Staten Island Ferry are the classic illustrations of this proposition.

The absence of a direct relationship between the cost of a city-supplied service and the price charged for it means that the public producer does not feel the same economic pinch that a private producer would in the event of a strike. The city does not give up vital income during a work stoppage because many services provided are, quite literally, "priceless." Any loss of tax revenue would be more than offset by the savings accrued from not having to operate a non-profitable service. The city can therefore sustain a longer strike than its private sector counterpart. However, if the service disrupted is a politically or socially sensitive one, a long work stoppage cannot be sustained. A strike or other work stoppage is less of an economic and more of a political struggle in the public sector than in the private.

Cities depend on tax revenue and the good graces of the state government for their income. The exodus of the middle class from strife-torn cities results in contraction of the local tax base. Attempts to increase taxation are, moreover, an exercise in futility. All cities face an elasticity in their tax revenue curve with respect to population: increased taxes yield further impetus for the harried middle class to reject urban for suburban living. Thus, there is no potential for a redistribution of income from consumers or management to workers as was envisioned by Congress for the private sector when the National Labor Relations Act was drafted. There can only be redistribution from one municipal employee to another or from one municipal service to another. It is the courageous political figure who will attempt to halt the flow of municipal services, and few politicians are known for their courage. Some of the more socially important municipal services, welfare payments in particular, comprise an enormous percentage of a city's annual budget.[67] City payrolls are another

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67 The current annual welfare budget in New York City is $1.4 billion, with approximately one million persons receiving regular welfare payments. "In 1965, the welfare population in New York City was increasing at a steady average rate of 4,956 a month. In 1966, the average began a rise of 8,311. In 1967, the increase leaped to 14,284 persons a month." It is still rising, and the data for other cities is not far different in percentage terms. Horwitz, "A Portrait of New York's Welfare Population," N.Y. Times (Magazine), January 26, 1969, at 22.

major source of yearly expenditure,[68] yet civil service regulations make it difficult, if not impossible, to shrink the size of the city workforce.[69] Unionization of these employees adds to this difficulty,[70] although the development of responsible unionism in the public service might help to decrease the amount and extent of featherbedding.

Unionization in the municipal service has taken its toll in wage increases as well because the strike and slowdown have proven to be effective weapons in public employment. Some of these increases, to be sure, are out of line and result from a labor stranglehold over vital municipal services. However, government pay scales generally run below those paid by private industry. In Detroit, for instance, the median private hourly wage was $2.04 in 1955 as compared to $1.79 for municipal employees. By 1967, the gap had widened — the average wage in the private sector was $3.49 but was only $3.09 for city workers.[71] Traditional civil service job security, moreover, has lost its appeal to workers in an inflationary economy where labor demand is at an all-time high.

B. *The Political-Social Environment*

In the private sector, the profit motive and a centralized decision-making structure impose unity and discipline over management's bargaining team. A united "management" front in the public sector is more often the exception rather than the rule. As a result, the choice of criteria by which to achieve an "optional" labor settlement is often a function of where one sits. The mayor and city council members, guided in great part by political considerations, tend to follow the ebbs and flows of opinion in their respective constituencies. The agency head is more likely to focus on administrative concerns such as cost and efficiency, but is also politically responsive to one of his major

68 Payroll costs take nearly 3.5 billion of New York City's $6 billion expense budget. Raskin, "Why New York is 'Strike City,'" N.Y. Times (Magazine), October 22, 1968, 7 at 30.

69 Dismissals in the New York City Civil Service run to less than 1.5 per cent a year. Blank, *The Battle of Bureaucracy*, THE NATION, December 12, 1966, 632 at 636.

70 This is not always the case, however. A contract between the City of New York and District Council 37 of AFSCME states that the City will not replace social service workers "who retire, resign or die in the next 18 months." AFL-CIO NEWS, February 15, 1969 at 2, col. 2.

71 TIME, March 1, 1968, at 34-5.

constituencies, his agency personnel. The relationship of a mayor to his bureau chiefs and commissioners has been compared to that of a "French Fourth Republic Premier facing an array of intransigent parties in the National Assembly."[72]

The big-city mayor is often caught between competing demands of unions on the one side and disadvantaged and minority groups on the other in a contest essentially between labor union concepts and civil rights concepts. In an attempt to satisfy one or the other of the groups, a mayor is likely to sow anger and distrust among one or both sides.

The municipal civil service as much as "government" is seen as an enemy of the ghetto resident. Services never seem to function as well in ghetto communities as they apparently do elsewhere; the ghetto resident is more apt to come into unfriendly contact with law enforcement officials than is his more fortunate suburban fellow-citizen; the demeaning nature of our welfare system, moreover, does not escape the mind of recipient and family. The schools are also a particularly sensitive area of contact between city employees and ghetto residents: parents are certain to blame the schools for the failure of their children, while school personnel, confident that they are doing the best they can within the confines of the system, are likely to be antagonistic toward the parents of their students.[73]

The civil service system is viewed by many in the ghetto as a repository of money and power from which the poor are unjustly excluded by a wall of rules and regulations designed to protect those already within the system. The concept of the "merit system" is not likely to be appreciated by a member of the unemployed or underemployed of the urban core. To him, the qualifications structure is part of a larger conspiracy of white society to keep him in perpetual subjugation. Being powerless to direct the course of the agencies which most affect him, the ghetto resident naturally views these agencies and their employees as "the

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72 Lowi, *Machine Politics — Old and New*, 9 THE PUBLIC INTEREST 87 (Fall 1967).

73 Mayer, *The Full and Sometimes Very Surprising Story of Ocean Hill, The Teachers' Union and the Teacher Strikes of 1968*, N.Y. Times (Magazine), February 2, 1969, at 18.

enemy." As union protectionism makes the job of the white civil service more secure, the resentment of ghetto community becomes more intense.

When preparing for collective bargaining negotiations in the municipal service, the city's representatives must be prepared to meet militancy not only on the part of those who feel threatened by organized labor's power but by the municipal labor groups and their leaders as well. It is no secret that unions representing workers in the municipal service have become increasingly militant. For example, eighteen years ago the American Nurses Association adopted a no-strike policy, although it accepted in principle the idea of mass resignations as a last resort in order to achieve its "economic security program." In the last two years, mass resignations of nurses have occurred in city and state hospitals in at least five states, and several state organizations of the ANA have sanctioned the use of the strike weapon.[74] At the macro level, in 1967, there were 181 public employee strikes involving approximately 132,000 workers in the United States.[75] The number of strikes and striking employees is undoubtedly on the increase.

Public employees often suffer from a "breaking the dam" syndrome. Municipal workers find their working lives controlled by unseen and unknown forces contained within a bureaucracy of which they are a part. The Kafkaesque nature of the work place may be overwhelming, yielding a whole series of pent-up frustrations deriving from years of obsequiousness. These can erupt when a union leader appears on the scene. Professional employees, in particular, are apt to feel a high level of frustration, a feeling of lack of control over the conditions of the work place. The arbitrary attitudes of administrators is a common grievance. One school teacher, when asked why she joined the American Federation of Teachers, responded: "During a strike of teachers, the school principal, with arms waiving, shouted accusingly at the pickets: 'What are you doing to my school?' It isn't *his* school, you know."[76]

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74 71 AM. J. NURSING, IV (Sept., 1966).

75 Hall, *Work Stoppage in Government*, 1968 MO. LAB. REV. 53.

76 N.Y. Times, June 11, 1967, at 85.

As a consequence, many municipal employee organizations have developed a confrontation psychology. Feeling very much oppressed as a group, they have chosen to strike out at what they perceive to be their oppressors, the impersonal bureaucracy and the hierarchy of officials who represent it.

Collective bargaining can be an instrument which may be effectively used to lessen the antagonisms and fears which have produced this crisis in the cities. As an outgrowth of our concepts of representative democracy, collective bargaining has at its roots the belief that most differences among men can be resolved by peaceful means and that disparate interest groups can learn to "lower their voices" and reach accord on mutually acceptable terms. The remainder of this article will discuss and analyze some necessary institutional changes which are designed to enhance the opportunity for labor peace in America's cities.

III. Fundamental Ingredients for Successful Collective Bargaining

A. *Exclusive Representation and Adequate Union Security*

We have seen that collective bargaining is very far from being a "right" in the municipal service, although it has been argued here that public employees should have the right to bargain collectively with their employers through employee organizations. Assuming that municipal employees are entitled to representation of some sort in local government labor relations, the question then becomes what form that representation should take: whether majority rule is to be the criterion, so that one union shall be the bargaining representative for all the employees in a given unit, or whether multi-union representation and individual employee bargaining are preferable.

A number of states have specifically opted for exclusive employee representation.[77] On the other hand, the California leg-

77 Conn. Gen. Stats. Ann. §§ 7-467-7-477 (1958); Del. Code Ann., tit. 19, ch. 13 (1953); La. Rev. Stats. Ann. § 23:890 (1955) (public transit employees); Me. Rev. Stats. Ann., tit. 26, §§ 980-992 (1964) (firefighters); Mass. Gen. Laws Ann., ch. 149, §§ 178G-178N (1958); Mo. Ann. Stats. §§ 105.500-105.530 (Vernon 1953); R.I. Gen. Laws, tit. 28, §§ 28-9.1-1-28-9.4-19 (1956); Vt. Stats. Ann., tit. 21, §§ 1701-1705 (1957); Wash. Rev. Code Ann. §§ 41.56.010-41.56.900 (1951). *But see* N.Y. Civ. Serv.

islature in drafting the Winton Act, which set up collective bargaining for school teachers in that state, made it clear that it rejected the theory of majority rule. Under that act, organizations of certified employees advise and confer with school boards. If there is more than one organization, the employer confers with a negotiating council, whose five to nine members are apportioned to the employee organizations according to the size of their membership.[78]

In an early decision of the Circuit Court of Baltimore, an exclusive representation clause in a labor agreement between the city and a union of public works department employees was declared illegal on the ground that the "preferred position" conferred upon the union by the contract provision was "forbidden in the public service."[79] The potential disadvantages inherent in the possibility of continuing union rivalry and conflict might well develop if exclusive recognition were not a way of life in labor relations.[80] The private sector considerations which have favored exclusive recognition have great force in the public sector: majority rule leads to responsible union leadership,[81] and the existence of one representative provides a uniform and satisfactory grievance procedure.[82]

Exclusive representation as a fact of labor relations in the public service would mean that the employee representative would be forced to accept responsibility as a co-determiner of working conditions. This means that there would be a clearly defined individual or group of individuals to whom an aggrieved employee could turn for assistance and who could be held accountable were

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LAW, art. 14, §§ 200-212 (McKinney's Consolidated Laws 1959); WIS. STATS. ANN. §§ 111.80-111.94 (1957); COLO. ATT'Y GEN. OP. No. 61-3488 (Apr. 3, 1961).

78 K. WARNER AND M. HENNESSY, PUBLIC MANAGEMENT AT THE BARGAINING TABLE 18 (1967), *cf.* Nutter v. City of Santa Monica, 74 Cal. App. 2d 292, 168 P.2d 741 (1946).

79 Mugford v. Mayor & City Council of Baltimore, 185 Md. 266, 44 A.2d 745 (1946).

80 EXECUTIVE COMMITTEE, NATIONAL GOVERNOR'S CONFERENCE, REPORT OF THE TASK FORCE ON STATE AND LOCAL LABOR RELATIONS 12 (1967).

81 *See* Magruder. *A Half Century of Legal Influence Upon the Development of Collective Bargaining*, 50 HARV. L. REV. 1071, 1075 (1938).

82 *See* Civil Serv. Forum v. N.Y. City Transit Auth., 4 App. Div. 2d 117, 125, 163 N.Y.S.2d 476, 484 (1957), *aff'd.*, 4 N.Y.2d 866, 150 N.E.2d 705, 174 N.Y.S.2d 234 (1958).

that assistance not forthcoming.[83] Exclusive recognition has meaning for employer responsibility as well. The municipality would be required to meet with a single employee representative and would be unable to take advantage of dissension which would be likely to exist if more than one union were present. This focusing of responsibilities and accountabilities is important in a democratic process. Exclusive recognition goes far toward assuring stable representative democracy in municipal labor relations.

Unionism in the public sector, as noted earlier, operates in a context of strong emotional pressures due to its political nature and to contemporary urban social upheavals. In developing policy toward municipal service labor relations, therefore, proposals must be formulated which will temper the employer-employee confrontation. This is a major purpose of exclusive recognition. Many other union security devices serve this same purpose, and additionally assure the union that its very survival is not a subject of daily concern, thereby allowing it to concentrate on program implementation through collective bargaining.

The closed shop as a security device is a fruitless objective. It is outlawed in the private sector,[84] and would most certainly be held invalid as a discriminatory device in the public sector.[85] On the other hand, the union shop, where an employee must join the union after a stated period of time following employment; the agency shop, where an employee need not join the union but must pay it a service fee for its representational costs; and the maintenance of membership shop, where no union member may drop out of the union or cancel his dues deduction authorization except during a limited period each year, should find some degree of acceptance.

Philadelphia has a "modified union shop" agreement. The municipal service in that city is divided into three groups: (1) those positions whose incumbents are required to belong to the union; (2) those denied union membership; and (3) those where union membership is optional. Employees in the first and third

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83 CASE, PERSONNEL POLICY IN A PUBLIC AGENCY: THE TVA EXPERIENCE 57 (1955).

84 Labor Management Relations Act (Taft-Hartley Act) § 101 (1947) 29 U.S.C. § 158(a)(3) (1964).

85 *Cf.* Chapin v. Bd. of Educ. (Ill. Cir. Ct., Dec. 9, 1939), cited in 5 MUN. L.J. 72 (June 1940).

categories may resign from the union during a two week period each year.[86] Chicago, although not openly espousing the union shop, does not employ persons in certain occupations who are not union members; those occupations include: plumbers, carpenters, bus drivers, electrical workers, and subway-train and surface vehicle operators.[87] The agency shop was recently won by 12,000 hospital workers in New York City, represented by Hospital Local 420, District 37, American Federation of State, County, and Municipal Employees (AFSCME).[88] The Tennessee Valley Authority, while refusing to bargain over a union security clause, has provided in its contracts with white collar employees that membership and participation in an employee organization "are among the positive factors of merit and efficiency to be considered in selecting employees for promotion, transfer and retention."[89]

Many commentators have, however, opposed some or all union security devices in public employment. One writer has declared that, "Compulsory membership in a union as a prerequisite for entry or continuation in the public service would be as incompatible with the merit principle as discrimination based on political affiliation, religious belief, race or creed."[90] Some have taken the position that

> A union shop in a government agency violates the democratic concept that every citizen may have the privilege of aspiring to public service if he is qualified to assume such responsibility, and he may not be arbitrarily discriminated against in appointment, promotion, or retention in the service.[91]

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86 Terms of the agreement are set forth in Bill No. 656, adopted as an ordinance by the City Council and signed by the Mayor on April 4, 1961.

87 Strayhorn, *Municipal Employees and the Law*, 1961 U. ILL. L.F. 377, 390 (1961).

88 N.Y. Times, March 1, 1969 at 1. It was predicted that all unions who participate in the Office of Collective Bargaining will be granted the agency shop within the next year. This includes some 210,000 of the City's 300,000 employees — the transit workers and teachers being the only two groups not participating.

89 Thompson, *Collective Bargaining in the Public Service — The TVA Experience*, 17 LAB. L.J. 89 (1966).

90 W. VOSLOO, *supra* note 48, at 32; *see also* W. HEISEL and J. HALLIHAN, QUESTIONS AND ANSWERS ON PUBLIC EMPLOYEE NEGOTIATION 58-59 (1967); H. KAPLAN, THE LAW OF CIVIL SERVICE 331 (1958).

91 61 NW. U.L. REV., *supra* note 56, at 115.

Whether this be moral discrimination or not, it is doubtful that it is unconstitutional.[92] If a union bargains for all the employees in a unit, and represents them all without discrimination, as it should, then all should be required to bear the cost of that representation; this is the traditional "free rider" argument for union security.[93] The stability which a union shop, or other union security device would give to the labor-management relationship in the municipal service is reason enough for a city to accept the concept of union security, but the law need not make this a mandatory facet of public sector labor relations. As a subject of bargaining, it would give the city something to "trade off" for other union demands, and in that sense increase the scope of bargaining from management's point of view. A recent New Hampshire decision viewed the union shop as a proper subject of bargaining, so long as the ultimate power resided in the municipality and, in this case, the police commissioner to hire and fire personnel and to manage the police department.[94] This decision is a precedent to be followed.

B. *Proper Unit Determination*

A "bargaining unit" is a group of employees whose interests and relationships are such that they form an appropriate unit for the purposes of collective bargaining. It is "that constituency within which collective negotiations take place."[95]

There are a number of distinct problems associated with unit determination: craft severance, the inclusion or exclusion of supervisors and professional personnel, and the overall problem of unit size. It is the last-mentioned factor which will be discussed in this study, for it is the ultimate size of the unit which has the most ramification in light of the political-social and economic context discussed earlier.

There is no such thing as an "optimal" bargaining unit; unit

92 *Cf.* Ry. Employees Dept. v. Hanson, 351 U.S. 225 (1956).

93 *E.g.*, AFL-CIO, UNION SECURITY 13 (1958).

94 Tremblay v. Berlin Police Union, 108 N.H. 416, 237 A.2d 668 (1968); *but cf.* Benson v. School Dist. No. 1, 344 P.2d 117 (1959).

95 THOMPSON, UNIT DETERMINATION IN PUBLIC EMPLOYMENT 1 (New York State School of Industrial and Labor Relations at Cornell University, Public Employee Relations Reports, #1, 1968).

determination is a matter of judgment, and many factors enter into the determination of an appropriate unit for the purpose of collective bargaining.[96] Each of the parties affected by a unit determination has its own interest to serve. For the individual employee, the unit which best maximizes his power in the work place is the one favored; union and management will favor the unit which gives the one or the other the greatest tactical advantage in winning a representational election, and, thereafter, in dealing with the other party; the public has an interest in efficient administration of the work place and the continuance of labor peace. There is no assurance that the interests of any of the parties affected will collide or harmonize.

A city's production of services requires a work force composed of individuals with widely differing degrees of education and skill. There are few industries which employ so diverse a work force. Among those that do, for example, the railroad and newspaper industries, labor strife is not uncommon.[97] This diversity of work force leads naturally to a diversity of interest and identity with each group desiring its own bargaining unit. New York City, for example, bargains with 35 to 40 different unions in 900 bargaining certifications, many of which are based solely on job titles.

The pressure of market forces in the private sector is an impetus to narrowly-construed bargaining units. But employers and employees must consider the uniqueness of each proposed unit in terms of its own market constraints. This is not the case in the public sphere where the market plays little or no role and the only major economic consideration is the generating ability of government. The tactical considerations bearing on the ability of one party or the other to win a representation election ought not to have any influence in municipal employment. If anything, the election gerrymandering so common in the private sector should be eliminated.

A multiunion bargaining situation in municipal employment is detrimental for a number of reasons: it tends to increase the

96 *See, e.g.*, Mallinckrodt Chemical Works, 162 N.L.R.B. No. 48, 64 L.R.R.M. 1011 (1966).

97 For an excellent analysis of labor relations in the newspaper industry, *see* Paisner, Old Traditions and New Machines, an unpublished third-year paper at the Harvard Law School (1968).

cost of the bargaining process; it has within itself the seeds for a distortion of the civil service wage structure; and the opportunity for destructive wage escalation is greatly enhanced.

Multiunion bargaining adds to the cost of the bargaining process most directly by increasing the time spent in bargaining. The absolute number of agreements to be reached is high and the number of unions to negotiate with increases the likelihood of serious impasse. The city is apt, moreover, to become involved in the collective bargaining process on a continuous basis. Larger cities which are able to afford labor relations offices may be able to cope with this situation. Smaller cities, however, may find their chief executive neglecting other duties to satisfy his labor relations responsibilities. Even where a city is able to afford a permanent office of collective bargaining, it may be faced with a lack of qualified personnel to man the office adequately.[98] An attempt to avoid continuous collective bargaining by requiring a common expiration date for all contracts with the city would require increased manpower to deal with several unions at once and, in addition, raises the fear of a mass impasse in negotiations.

Multiunion bargaining tends to distort the municipal wage structure by fostering performance rivalry between different organized groups in the government work force.[99] Arthur Ross' "coercive orbits of comparison" has become an important standard in the determination of wages under collective bargaining, because a union is basically a political organization which must respond to both internal and external pressures.[100] The comparative successes of other public union leaders within the city places pressure on the municipal labor leader to secure for his membership an absolute wage increase at least as large as that obtained by other municipal employee groups. Absolute wage increases, however, result in resentment among normally higher-paid per-

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98 Weiford, *Organizing Management for Employee Relations*, DEVELOPMENTS IN PUBLIC EMPLOYEE RELATIONS 95, 105 (Warner ed. 1965).

99 *Cf.* the remarks of Mediator Theodore W. Kheel: "At the present time public unions make demands at the bargaining table which are sometimes motivated as much by competition with other employee groups as by their own particular interests." N.Y. Times, March 9, 1969 at 70.

100 A. ROSS, TRADE UNION WAGE POLICY 26 (1948); BURTT, LABOR MARKETS, UNIONS AND GOVERNMENT POLICIES 209 (1963).

sonnel, especially professional personnel, because percentage differentials between themselves and lesser-skilled groups tend to narrow. The city may also find it more difficult to attract such personnel because they would feel that their skill is insufficiently compensated for relative to the whole structure of rates in government employment. The strike threat increases the probability of a narrowing of the differentials because those with the most skill are not always those with the most bargaining power.[101]

The recent experience of the professional nurses in New York City illustrates the fact that municipal employees are very sensitive to any threat to their relative position in the wage structure. In their 1966 negotiations with the city, the nurses were careful to point out that the City's original offer would have left them far below city sanitation workers, swimming pool operators and hospital maintenance men.[102] Public health nurses, in turn, demanded that their incomes remain within a certain relationship to that of the professional nurses. As their attorney put it, "We can't accept any contract offer less than that given the hospital department nurses."[103]

The evil of wage structure distortion is only a part of a greater evil growing out of union leapfrogging — rapid wage escalation. The concept of "coercive orbits of comparison" is once again called into play, not merely to describe a distortion of relative wages but a continuous and never-ending series of wage increases propelled by the perpetual motion of inter-union rivalry at the bargaining table. And in the public sector, unlike the private, there is little chance that the threat of employer bankruptcy will force a union to break from its orbit.[104] John DeLury, President of the Uniformed Sanitationman's Association in New York,

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101 Wildman, *Conflict Issues in Negotiation*, 89 MO. LAB. REV. 617, 619 (1966).

102 Lewis, *The New York City Hospital Story*, 66 AMER. J. NURSING 1526, 1529 (1966).

103 N.Y. Times, May 22, 1966, at 34.

104 Reder, *The Theory of Union Wage Policy*, 44-1 REV. OF ECON. & STAT. 34, 40 (1952). Reder argues that the union leadership must break from its orbit if the firm involved found itself unable at some point to meet the demands produced by equitable comparison or see the firm dissolve. This has not been the case in the newspaper industry, *see* Paisner, *supra* note 96, and is unlikely to be that in the municipal service. *Cf.* interview with Jerry Wurf, President of AFSCME, U.S. NEWS AND WORLD REPORT, September 26, 1966, at 98.

warned the city of a long siege with a simple expression of Professor Ross' theory: "The transit workers opened up another ceiling. The least we can expect is what they got."[105]

Leapfrogging will remain a troublesome fact of life in municipal labor relations so long as there is multiunit bargaining over wages and all terms and conditions of employment. City employees who are employed by different departments of the municipal government generally do not share the same work place. Teachers are in the schools, policemen walk a beat or serve in a stationhouse, sanitationmen man their trucks, white collar workers have separate office buildings depending on their department. Each service has its own impact on the public in the event of a work stoppage. A strike by one segment of the municipal service need not be respected by another segment; no one is forced to walk a picket line in defiance of another group's work stoppage. There is, therefore, little pressure brought to bear on any one group of employees by other groups to reach agreement on the city's terms on account of any economic sanction which the aggrieved union may employ against the city.

Philadelphia presents a fine example of "one big unit" for collective bargaining purposes. Philadelphia has bargained with a District Council of the American Federation of State, County, and Municipal Employees Union since 1939, which has had exclusive bargaining rights since 1959 and bargains for 20,000 employees (the union membership is 13,000, up from 4,500 in early 1952). In seventeen years, there have been only two brief work stoppages.[106] The Philadelphia bargaining scenario is an interesting one. Negotiations operate on an annual timetable with various steps scheduled during the year, beginning in April, with the mayor and the city council being consulted at important junctures. Monetary settlements are included in the mayor's budget message to the council and are subjected to council scrutiny and approval. Budget appropriations must be adopted by December 1, according to the city charter. Negotiated benefits appear in the form of civil service regulations, which are ap-

105 N.Y. Times, February 21, 1966, at 1.

106 Ross, *Those Newly Militant Government Workers*, FORTUNE, August 1968, 104, at 134.

proved by an administrative board consisting of the mayor, the managing director, and the finance director, all of whom have been consulted during the bargaining process.[107]

Professor George Hildebrand has summarized the success of the Philadelphia plan as follows: "The all-inclusive bargaining unit with exclusive representation permits effective bargaining while it reduces the possibility of leapfrogging by rival unions . . . The negotiated terms are simultaneously incorporated in civil service regulations, preventing any possible hiatus thereby allowing the city employees, through their union, to help shape the rules under which they work . . . most important, the practice of reaching a full "family understanding" on the management side, in regard to proposals, counterproposals and terms of settlement, greatly reduces the possibility of divide-and-conquer tactics, and back-door deals, which in turn protects the integrity of the bargaining process."[108]

As a matter of general policy, the all-inclusive bargaining unit would not necessarily bargain over all matters for all employees. Its function would be to set the basic wage and hour differentials and such other matters as pensions, sick leave and health benefits for all municipal employees, leaving smaller units bargaining over more functionally specific terms and conditions of employment. The individual employee's concern with his personal maximization of control over the work environment therefore would not be significantly threatened. Union reaction to the inclusive unit would, of course, depend on which union won the representation election. Policemen, firemen and teachers would not be included within the proposed all-inclusive unit, as they are not in Philadelphia, because of their historical affiliation with already-existing bargaining representatives and fraternal organizations and their unique importance to the city's health and well-being. It is also recognized that the scope of bargaining with these particular groups is likely to encompass a greater number of sensitive subject matter areas than it is with other groups of

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107 Rosen, *Collective Bargaining in Philadelphia*, MANAGEMENT RELATIONS WITH ORGANIZED PUBLIC EMPLOYEES 103 (Warner ed. 1963).

108 Hildebrand, *The Public Sector*, FRONTIERS OF COLLECTIVE BARGAINING 125 at 135 (Dunlop & Chamberlain ed. 1967).

municipal employees. It is important, therefore, that these employee classifications be bargained with separately, recognizing that many of the serious multinunion problems discussed above would still remain as a consequence.

The argument may be made that intergroup rivalry can be expected to erupt in the all-inclusive unit just as it has in the multiunit bargaining situation. In the all-inclusive unit proposal, there should be internal procedures provided which would be used to reconcile conflict before it would reach the bargaining table. Pressures toward militancy would diminish as the welfare of the whole and not of any individual part becomes the focal point. Furthermore, public labor's officialdom would for the first time view municipal employee wage and benefit demands as a whole, enhancing their awareness of the financial plight of the metropolis and hopefully leading to a greater degree of labor union responsibility. It would be advisable, nonetheless, to insure that in case of impasse, in those instances where a strike might be permitted, it would be impermissible for the entire unit to conduct a work stoppage; only that group of employees within the unit directly affected by the impasse should be permitted to stage a work stoppage or slowdown. In light of the lack of interdependency among municipal employee groups, this appears to be a feasible approach.

C. Settlement of Collective Bargaining Impasses: The Right to Strike

There has been all but unanimous condemnation of the strike weapon in the public sector.[109] Unlike the right to organize, it has been held that the right to strike is not a "fundamental" right guaranteed by the Constitution. Justice Brandeis took the opportunity in *Dorchy v. Kansas*,[110] which involved the constitutionality of a state statute prohibiting strikes to compel employers to pay disputed wage claims, to declare:

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109 *See, e.g.*, Railway Mail Ass'n v. Corsi, 326 U.S. 88 (1945); City of Los Angeles v. Bldg. & Constr. Trades Council, 94 Cal. App. 2d 36, 210 P.2d 305 (2d Dist. 1949); Norwalk Teachers Ass'n v. Bd. of Educ., 138 Conn. 269, 83 A.2d 482 (1951); Board of Educ. v. Redding, 32 Ill. 2d 567, 207 N.E.2d 427 (1965).

110 272 U.S. 306 (1926).

> To enforce payment by a strike is clearly coercion. The legislature . . . may subject to punishment him who uses the power or influence incident to his office to order the strike. Neither the common law, nor the Fourteenth Amendment, confers the absolute right to strike.[111]

Two grounds for upholding the validity of a strike in the public service have been advanced. The first lies in the judicial power of statutory construction. In *Los Angeles Metropolitan Transit Authority v. Brotherhood of Railroad Trainmen*,[112] the California Supreme Court held that a statute giving public transit workers the right to bargain collectively "and to engage in other concerted activities," impliedly gave the employees the right to strike. The Supreme Court of Minnesota, in refusing to enjoin a strike of public school janitors, used its power of statutory construction to hold that an anti-injunction statute which expressly excluded policemen and certain other municipal employees was meant to protect all government workers not so excluded in their concerted activities.[113]

A second ground which courts have used in refusing to enjoin work stoppages in the public sector is that type of operation in which the public employees are engaged is "proprietary" and not "governmental" in nature.[114] The distinction, although an appealing one, has little validity especially when one considers that the public perhaps has more of a stake in the uninterrupted service of some proprietary services such as transportation than in some strictly governmental functions such as city parks.

The most common bases for the denial of the right to strike in public employment have been the doctrine of sovereignty,[115] and the possible danger to health and safety which a strike might

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111 *Id.* at 311.

112 54 Cal. 2d 684, 355 P.2d 905 (1960), *interpreting* CAL. PUBL. UTIL. CODE, App. I, §§ 3-6 (Supp. 1960).

113 Board of Educ. v. Local 63, Pub. School Employees, 233 Minn. 144, 45 N.W.2d 797 (1951), *overturned* by the Minnesota legislature in the year of decision, MINN. STAT. ANN. § 179.58 (Supp. 1964).

114 Los Angeles v. Los Angeles Bldg. & Constr. Trades Council, 94 Cal. App. 2d 36, 210 P.2d 305 (2d Dist. 1949); Int'l Bhd. of Elec. Workers v. Grand River Dam Authority, 292 P.2d 1018 (Okla. 1956); Weakly County Municipal Elec. Sys. v. Vick, 43 Tenn. App. 524, 309 S.W.2d 792 (1957).

115 *E.g.*, City of Cleveland v. Division 268, Amal. Ass'n of St. Employees, 85 Ohio App. 153, 90 N.E.2d 711 (1949).

cause.[116] A lesser-used theory for denial of the strike weapon is the argument that public employees have a higher obligation of service than do employees in the private sector.[117] This third argument has little practical validity. A man driving a bus for the XYZ Bus Company does not suddenly become crowned with the mantle of public service when his employer changes to the city of Oshkosh, Wisconsin. This concept, if it is to make any sense, must be subsumed under the belief that work stoppages in the public sector endanger the health and safety of the community.

The sovereignty doctrine discussed earlier in relation to the right to bargain collectively holds that the sovereign cannot be compelled to do that which it chooses not to do. The sovereign may, of course, permit itself to be coerced. It may be argued that, just as the doctrine of sovereign immunity from tort claims has been abrogated in some jurisdictions,[118] the total prohibition of the right of employees to withdraw their labor ought also to be eroded by a contemporary re-thinking of the problem, except in those cases where the municipality can establish that substantial harm would flow from a work stoppage. It has been argued that where the public interest is not adversely affected, the city ought to be willing to accept the nationally proclaimed labor policy and enter into collective negotiations with majority-elected employee representatives. Going one step further, it is suggested that where the public interest is not endangered, the city ought also to permit its employees to withdraw their labor in order to compel acceptance of the union's position in a collective bargaining impasse. The central question with which we have to deal, then, is whether and in what ways, the public interest will be substantially harmed by public employee work stoppages.

Many writers dealing with the question of the right to strike in public employment have recommended a "functional" ap-

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116 *Cf.* City of Manchester v. Manchester Teachers' Guild, 100 N.H. 507, 131 A.2d 59 (1957); Port of Seattle v. Int'l Longshoremen's Union, 52 Wash. 2d 317, 324 P.2d 1099 (1958).

117 *Cf.* McAuliffe v. New Bedford, 155 Mass. 216, 220, 29 N.E. 517, 517-18 (1892) (J. Holmes); ABA SECTION OF LABOR RELATIONS LAW, REPORT OF COMMITTEE ON LAW OF GOVERNMENT EMPLOYEE RELATIONS 99 (1961); 1961 NEW YORK LEGISLATIVE ANNUAL 353.

118 ARIZ. REV. STATS. § 12-821 (1955).

proach to strike prohibition which calls for lifting the ban for those employees who perform "nonessential" services.[119] "Essentiality" has been defined in at least two ways: a situation where an interruption of the service would (a) threaten the health and safety of the public;[120] or (b) cause a high degree of public inconvenience.[121] This second definition, however, is of little value in determining the essential qualities of a public service, because all strikes in the public sector have as their aim to cause a certain amount of general public inconvenience; failing that, a strike threat would be an ineffectual weapon. As indicated earlier, the economic threat, except in services which directly affect the earning capacity of the citizenry, is not a great one in the public sector; indeed, a municipality actually saves money during a strike. It is only the threat of public inconvenience — a political threat — that has any force in public labor relations. To use this as a criterion for banning strikes would almost be tantamount to an absolute prohibition.

Vermont, for example, has accepted the first definition in determining the legality of municipal employee work stoppages. Its statute reads: "No public employee may strike or recognize a picket line of the labor organization while performing his official duties, *if the strike will endanger the health, safety, or welfare of the public.*"[122] This conforms with the argument that the right to strike ought to be permitted unless a municipality can show threatened substantial harm in the event of a work stoppage. We must now ask whether municipal employee work stoppages are, per se, threats of substantial harm in the sense that they endanger the health, safety or welfare of the public.

A city provides essential services, but it also provides some

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119 *See, e.g.*, White, *Strikes in the Public Service*, 10 PUB. PERS. REV. 6 (January 1949); Rains, *Collective Bargaining in Public Employment*, 8 LAB. L.J. 548 (1957); Note, *Labor Relations in the Public Service*, 75 HARV. L. REV. 391, 408 (1961); 59 MICH. L. REV. 1260 (1961); Steiber, *Collective Bargaining in the Public Sector*, in American Assembly, CHALLENGES TO COLLECTIVE BARGAINING 65, 81 (1967). *But see* Wollett, *The Public Employee at the Bargaining Table: Promise or Illusion?*, 15 LAB. L.J. 8, 12 (1964); Taylor, *Public Employment: Strikes or Procedures?*, 20 ILR REV. 617 (1967); Hildebrand, note 107 *supra*.

120 Note, *Union Activity in Public Employment*, 55 COLUM. L. REV. 343, 362 (1955).

121 47 VA. L. REV. 338, 342 (1961).

122 VT. STATS. ANN., tit. 21, § 1704 (Supp. 1969) (emphasis added).

rather unessential ones. It is peculiar logic that refuses to let the man who cleans the mayor's desk at night go out on strike but allows the drivers of a private bus company to have that right, simply because the city does not own the bus line. There are a host of equally glaring contradictions. In Manhattan, drivers on the buses operated by the public Transit Authority are covered by the no-strike law, while those driving for the privately owned Avenue B and East Broadway Transit Company are under no such restriction. Fired by the Washington Suburban Sanitation Commission after a 1966 strike, garbage men in suburban Washington savored the immense satisfaction of going back to work — at the higher wages they had demanded — for the private contractor to whom the commission had let the new refuse collection contract.[123]

Yet, given these inconsistencies, how does one distinguish between health-and-safety endangering strikes and those that are not? The contradiction between public and private ownership of the means of transportation, for example, may best be alleviated by prohibiting the strike weapon among *all* transit systems. It would be difficult to argue that the twelve-day New York transit strike of 1966 did not have serious repercussions for the health and safety of the citizens of that city: the strike prevented one half of the New York work force from reaching their jobs;[124] many hospital clinics were forced to close;[125] the transit authority lost an estimated $243,500 per day;[126] retail sales in the city were off 41%;[127] and the strike was estimated to have cost the city $100 million per day in revenues.[128]

But wholesale prohibitions on the right to strike among transit systems would not be an answer either; one can imagine instances where transit strikes would not endanger public health, safety or welfare, *e.g.*, a strike of one day's duration. Furthermore, a blanket prohibition conflicts with the national labor laws. In the private sector, we provide an injunction remedy. Because of

123 TIME, March 1, 1968, at 34.
124 N.Y. Times, Jan. 4, 1966, at 1.
125 N.Y. Times, Jan. 7, 1966, at 17.
126 N.Y. Times, Jan. 5, 1966, at 16.
127 N.Y. Times, Jan. 14, 1966, at 29.
128 N.Y. Times, Jan. 5, 1966, at 1.

the peculiar characteristics of the public sector discussed earlier — the political process, the economic and psychological milieu and the nature of the services produced — an injunction remedy alone may not be enough. The framework in which public sector collective bargaining takes place requires new approaches to the problems of impasse in negotiations.

As part of the new approach to labor relations in the municipal service, *the total ban on strikes ought to be eliminated. It is an unworkable device.* Psychologically, municipal employee unions are geared to strike. Their members have felt harassed for too long and are anxious to redress past grievances in one fell swoop. Moreover, they see what a strike can bring; the 1967 teachers strike in New York netted an average increase of well over 20 per cent in pay and benefits in a 26-month contract, a settlement three times larger than anything granted before.[129] Unions in most major cities are a potent political force, and the newly organized public employee organizations are willing to share in the power without having to taste the responsibility. Public unions have a strategic and tactical need to strike. The municipal political process is a slow one. The institutional and procedural differences between the public and the private sectors prevent a government from acting with the speed and efficacy with which a corporation may act. A strike may be what is required to stir lethargic elected and administrative officials into action. A ban on strikes is, in itself, an inducement to strike. The pressure of the strike mechanism is reintroduced by the threat of unions to violate it.

Mediator Theodore W. Kheel has asked: "Is it socially desirable to create a circumstance in which the wish of the union to bargain collectively is achieved through the violation of the law rather than the prospect of a legal strike?"[130] This total strike ban, Kheel argues, "eliminates collective bargaining, which implies the right of the buyer or seller to refuse to buy or sell by a strike or a lockout."[131]

The formulation of sanctions in the public strike area is a deli-

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129 Kilberg, *Limiting Public Strikes*, RIPON FORUM 5 (March, 1968).
130 N.Y. Times, Jan. 7, 1969, at 1.
131 *Id.*

cate proposition. If sanctions are imposed too harshly on a striking union, they become ineffective. One cannot throw an entire employee organization into prison and still expect the city's vital services to continue functioning. On the other hand, if sanctions are too mild, they will simply have no deterrent value. The solution is not to forbid all strikes but to give a public employee union a way to demonstrate its grievance without endangering the entire fabric of a metropolitan community.

Aids to contract settlement have slowly been evolving in the private sector. Fact finding, mediation and voluntary arbitration are all common mechanisms for labor peace in the industrial world. In the public sector, however, only a handful of states have seen fit to authorize their state and local officials to use these devices. Most states simply forbid strikes by public employees and are then powerless when they occur. Any collective bargaining scenario envisioned in the public sector must provide for adequate procedures to aid the parties in reaching agreement. The one procedure which ought not to be on the agenda is compulsory arbitration. There are serious questions as to the legality of a procedure which purports to impose a binding settlement upon a city government.[132] A procedure which allows collective bargaining participants to forego good faith bargaining in the expectation that a third party will settle their disputes for them should be avoided.

Mechanisms for the resolution of collective bargaining impasses, however, are not enough. As we have seen, employers in the public sector lack the discipline which the profit motive supplies to employers bargaining process in the private sphere.[133] Means must be developed to unify the municipal bureaucracy

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132 *Cf.* Everett Fire Fighters Assoc. v. Johnson, 46 Wash. 2d 114, 278 P.2d 662 (1955) (compulsory arbitration held invalid as an illegal delegation of governmental authority); see Taylor, note 118 *supra*, at 632.

133 *But cf.* Letter to the author from Professor Eric Polisar, Nov. 8, 1967: "What, for example, are the market pressures on utilities? What are the market pressures on private hospitals as distinct from publicly owned hospitals? In practical, as distinct from theoretical or philosophical terms, what is the difference between aerospace production in Huntsville, Alabama and the production of similar and occasionally identical items by North American Aviation on the West Coast? The illustrations could be extended almost indefinitely." Professor Polisar was, up until the time of his death in July, 1968, Associate Professor of Industrial and Labor Relations at Cornell University.

into a bargaining force which can approach the union's demands with acceptable counter-offers. Municipal unions must be given a legal weapon which will impress all city officials with the importance of reaching a settlement. There is a need for political confrontation in the public sector, moreover, which is absent in the private. The voting public is a more potent force in municipal bargaining than it is in corporate labor relations. Any weapon which the union is given must allow it to bring its case to the public.

The danger, of course, is that of a crippling confrontation. Too much power in the hands of a striking union may endanger the health and safety of the city and lead to repressive countermeasures by the municipality, such as the jailing of union officials or the calling out of the National Guard. In vital employment areas to be determined by each city individually through the use of a committee made up of representatives of government, labor and the public, no strike should be permitted. Two such areas would be the police and fire departments. Only one "bright line" would, therefore, have to be drawn, between essential and unessential community services. In all other sectors of the municipal service, a restricted strike schedule should be devised. This schedule would set a number of hours that a union would be allowed to strike once a contract deadline has been reached without agreement and all mediation, factfinding and conciliation procedures are exhausted. The independent committee might, for example, settle on four hours a week as allowable strike time, to be used when and how the union sees fit. Transit workers might then choose to go out on Friday evening from 3 to 7 p.m. This would produce a great public inconvenience and would give the union the attention it needs to put pressure on a political entity like a city government. But it would not paralyze the community. The problem of defining an "essential" service would thus be greatly minimized; only those services which a city could not forego for the briefest moment would be deemed "essential" and not subject to a work stoppage.

If a four-hour strike would not be enough to impress the city's negotiators with the union's legitimate claims, the independent commission might allow a longer work stoppage period. How-

ever, this probably would not be necessary. The point of the restricted strike schedule is one of inconvenience — to inconvenience the public enough so that a union will feel that its claims will be heard. The news media tend to detail the issues of a collective bargaining dispute only when there is confrontation between the parties, no matter how brief. The necessary inconvenience of even a short work stoppage would have its desirable impact. Inconveniencing the public is the only way the necessary confrontation may take place in the public sector. The cab drivers in New York City made this plain when they staged a one-day work stoppage and successfully influenced the city's decision to permit an increase in taxicab fares. Collective bargaining on the municipal level is basically a political struggle involving the use of power. But it is not the use of power, per se, that should be objected to; it is wanton destructiveness that ought to be deplored. The restricted strike schedule is a means of halting that destructiveness.

A restricted strike schedule is a weapon that can be accepted by cities because it would allow normal negotiations to continue without a major disruption of the life of the city. For the union it presents a step forward, a legal means for bringing grievances to the public without facing fines, jail sentences or worse. Were the union to take undue advantage of the restricted strike, strong sanctions would be appropriate including suspension of the union's certification as a representative of its members. Yet one would expect public employee unions, once their right to strike is accepted, to obey limitations on this right, much as unions in the private sector obey artificially contrived limitations on picketing and boycott procedures. The supreme art in the field of labor relations is to develop rules that both permit struggle and control it. A restricted strike schedule may be such a rule.

SECTION 531: OPERATING-CYCLE ANALYSIS OF WORKING CAPITAL NEEDS

LOUIS H. HAMEL, JR.*

Introduction

The income tax imposed upon corporations under the Internal Revenue Code of 1954 is at a maximum rate of less than 50% of taxable income,[1] while the tax imposed upon individuals graduates to a top rate of 70%.[2] Because of this difference, shareholders with substantial taxable income have an incentive to use corporations as reservoirs of their growing wealth, assuming they can avoid double taxation by causing the corporations to refrain from paying dividends. Shares of such corporations will acquire a new basis at the death of the shareholder[3] and, therefore, the wealth they represent can be passed on relatively cheaply. Also, such shares can be used in a tax-free reorganization to acquire marketable securities.[4]

Since the first federal income tax statute, there have existed provisions for penalizing the use of corporations for the personal tax advantage of shareholders by causing them to unreasonably accumulate earnings.[5] Presently, such provisions are found in sections 531-537 of the Internal Revenue Code of 1954.[6] A penalty

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1 INT. REV. CODE OF 1954, § 11.

2 *Id.*, § 1(a)(2).

3 *Id.*, § 1014(a).

4 B. BITTKER AND J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS (2d ed., 1966) § 6.01, at 211.

5 For the history of the penalty tax see United States v. Donruss Company, 393 U.S. 297 (1969), and W. Cary, *Accumulations Beyond the Reasonable Needs of the Business*, 60 HARV. L. REV. 1282 (1947).

6 For summaries of the penalty tax provisions see T. NESS AND E. VOGEL, TAXATION OF THE CLOSELY-HELD CORPORATION (1967) Ch. 5; B. BITTKER AND J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATION AND SHAREHOLDERS (2d ed., 1966) Ch. 6A; and *Symposium . . . New Emphasis on Section 531*, 17 W. RES. L. REV. 704 (1966).

tax[7] is imposed upon the corporation[8] if, in order to avoid the tax which shareholders would pay on a dividend,[9] earnings and profits are retained by a corporation beyond its reasonable needs.[10]

The key issue in section 531 cases is whether the corporation's earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, because, if so, there arises a presumption of abuse which cannot be overcome except through showing, by a preponderance of the evidence, that a tax-avoidance motive was altogether lacking.[11] On the other hand, no penalty will be imposed if accumulations are reasonable, whatever the motive.[12] Thus, if an asserted section 531 deficiency is contested, it is necessary to litigate the question whether earnings and profits have been permitted to accumulate beyond the reasonable needs of the business. The sections particularly giving rise to this issue are 533(a), which creates a presumption of tax-avoidance motive, and 535(c), which grants a credit against the penalty for the reasonable needs of the business.

Courts face a hard task under sections 533(a) and 535(c) because they must review what is, in the first instance, a matter of

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7 INT. REV. CODE OF 1954, § 531. The tax is upon "accumulated taxable income" of the year, as defined in section 535. The rates is 27½% of the first $100,000 and 38½% of the balance of "accumulated taxable income."

8 Despite early misgivings, the tax probably could be imposed on shareholders instead of the corporation. Helvering v. National Grocery Co., 304 U.S. 282 (1937) (dicta).

9 Tax avoidance purpose is a condition prerequisite to imposition of the tax under section 532(a). Under section 533(a) and section 533(b) there are provided evidentiary rules in aid of judgment on the purpose issue. INT. REV. CODE OF 1954, §§ 532, 533.

10 Section 535(c) provides a credit against the penalty tax for amounts retained for the reasonable needs of a business other than a mere holding or investment company (defined in Treas. Regs. 1.533-1(c)). *Id.* § 535.

11 The presumption is created by section 533(a). *Id.* § 533(a). The Supreme Court in *Donruss,* 393 U.S. 297 (1969) held that the presumption can be overcome only by proof, by a preponderance of the evidence, that tax avoidance was not "one of the purposes" for the accumulation. As was noted in the opinion of Mr. Justice Harlan (concurring in part and dissenting in part), the *Donruss* rule gives taxpayer little chance of overcoming the 533(a) presumption.

Section 533(b) makes mere holding or investment company status prima facie evidence of tax-avoidance purpose. INT. REV. CODE OF 1954 § 533.

For a discussion of the evidentiary provisions of the statute see NESS AND VOGEL *supra* note 6, 5.3-5.4.

12 INT. REV. CODE OF 1954, § 535(c). J. P. Scripps Newspapers v. Commissioner, 44 T.C. 453 (1965). *Contra,* D. HERWITZ, BUSINESS PLANNING (1966) 579.

business judgment. Such a review not only creates a risk of unfairness to the taxpayer, but also may interfere with government policies favoring the growth of small business.[13] In enacting the 1954 Revenue Code, Congress was mindful of complaints that the penalty provisions are a threat to small business principally because of the lack of adequate standards for determining business needs.[14] One of its responses to such complaints was the enactment of section 534 whereby taxpayer may shift the burden of proof to the Commissioner. This section, however, has been ineffective in practice, at least until recently,[15] although in the absence of reliable standards on the substantive issue, burden of proof is crucial.[16]

While the penalty tax has been upheld against a due process challenge,[17] courts have been conscious of the danger of unfairness in its application. The strongest judicial expression of this consciousness is that of Justice Learned Hand, concurring, in *Casey v. Commissioner of Internal Revenue*[18]:

> I believe that the statute meant to set up as a test of "reasonable needs" only the corporation's honest belief that the existing accumulation was no greater than was reasonably necessary. Section 532(a) was a penal statute, designed to defeat any plan to evade the shareholders' taxes, and there can be no doubt that it presupposes some deliberate purpose to

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13 W. Cary, *Accumulations Beyond the Reasonable Needs of the Business*, 60 HARV. L. REV. 1282 (1947); S. Ziegler, *The 'New' Accumulated Earnings Tax*, 22 TAX L. REV. 77 (1966-67).

Except for Trico Products Co. v. McGowan, 169 F.2d 343 (2d Cir., 1948), there are no reported cases of imposition of the penalty upon widely-held corporations, and in *Trico* most of the stock was in the hands of a few shareholders.

14 H.R. REP. No. 1337, 83d Cong., 2d Sess. (1954); SEN. REP. No. 1622, 83d Cong., 2d Sess. (1954).

A portion of the House Report (at 52-53) follows: "One of the principal reasons for confusion as to application of the section 102 [predecessor to 531] tax has been the lack of adequate standards as to what constitutes the reasonable needs of the business. Some of the standards informally employed in the past, such as the distribution of 70 percent of earnings, have been erroneous or irrelevant. More often, in the absence of adequate guidance, revenue agents in examining cases have applied their individual concepts as to business needs."

15 P. Babin, *The Procedural Aspects of the Accumulated Earnings Tax*, 21 TAX EXECUTIVE 8 (1968). Magic Mart, Inc. v. Commissioner, 51 T.C. — (CCH Dec. 29,456) (1969) (pre-trial order on burden of proof).

16 Gsell & Co., Inc. v. Commissioner, 294 F.2d 321 (2d Cir., 1961) (dicta).

17 Helvering v. National Grocery Co., 304 U.S. 282 (1937).

18 267 F.2d 26 (2d Cir., 1959).

> do so and is not satisfied by proving that the corporation was mistaken in its estimate of its future needs.[19]

Courts have been aware that they must not only avoid unfairness, but also must not interfere with managerial discretion.[20]

Commentators have stressed the essentially factual nature of a section 531 inquiry,[21] the presence of a subjective element in business "needs,"[22] and the acute possibility of abuse of the power the penalty tax gives the Internal Revenue Service.[23] Since decided cases represent but a tiny portion of those in which a 531 deficiency is threatened or asserted,[24] it appears there is serious danger that taxpayers may capitulate rather than face the risks and costs of litigation.[25] Therefore, tax writers have welcomed efforts to downgrade the subjective elements of decision in these cases.[26]

Since 1965, with the case of *Bardahl Manufacturing Corporation v. Commissioner*,[27] there has developed a method whereby

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19 In the light of *Donruss*, 393 U.S. 297 (1969), the final three lines of the quotation are probably an inaccurate statement of the law.

20 Halby Chemical Company, Inc. v. United States, 67-2 USTC ¶ 9500, 180 Ct. Cls. 584 (1967) (management belief that any new operation it took on should be at least as large as existing operations); Carolina Rubber Hose Co. v. Commissioner, 24 T.C.M. 1159 (1965), *gov't appeal dismissed by stipulation*, April 8, 1966 (conservative management, having once faced insolvency, resolved to build a new plant without using borrowed funds); J. P. Scripps Newspapers v. Commissioner, 44 T.C. 453 (1965) (managerial discretion will not be upset unless facts clearly warrant doing so); Electric Regulator Corporation v. Commissioner, 336 F.2d 339 (2d Cir., 1964) (section 531 not intended to give government a veto over directors' decisions).

21 BITTKER AND EUSTICE, *supra* note 4, at 211.

22 NESS AND VOGEL, *supra* note 6, at 5.12.

23 D. Nelson, "Recent Trends Regarding Unreasonable Accumulation of Surplus," 43 TAXES 857 (1965).

24 J. Cuddihy, *Accumulated Earnings and Personal Holding Company Taxes*, 21 N.Y.U. INST. ON FED. TAX'N. 401 (1963) (2%).

25 H.R. REP. NO. 1337, *supra* note 14, at 52: "The poor record of the Government in the litigated cases in this area indicates that deficiencies have been asserted in many cases which were not adequately screened or analyzed. At the same time taxpayers were put to substantial expense and effort in proving that the accumulation was for the reasonable needs of the business. Moreover, the complaints of taxpayers that the tax is used as a threat by revenue agents to induce settlement on other issues appear to have a connection with the burden of proof which the taxpayer is required to assume. It also appears probable that many small taxpayers may have yielded to a proposed deficiency because of the expense and difficulty of litigating their case under the present rules [on burden of proof]."

26 *E.g.*, S. Ziegler, *supra* note 13.

27 24 T.C.M. 1030 (1965) (hereinafter referred to as *"Bardahl"* or *"Bardahl Manufacturing"*).

it is thought that relatively easy, predictable, and conceptually justifiable judgments can be made with respect to the reasonable needs issue as to those needs which derive from current activity, as distinguished from anticipated changes. This is the "operating-cycle" method, and this article is devoted mainly to an exposition of the method with a critical evaluation of its usefulness as a standard. Throughout the article, and in its concluding section particularly, attention will be given to the question whether this purported standard successfully reduces the need for case-by-case review of managerial discretion.

I. Background to *Bardahl*

A. *"Earnings and Profits" in Section 533(a)*[28]

The application of section 533(a) involves not only a quantification of "reasonable needs" but also construction of the expression "earnings and profits" in its context there. This expression is one which has currency in the language of federal income taxation rather than in the language of general accounting.[29] But the content of the expression in a given situation is at least partially derived from the accounting method of the taxpayer. The taxpayer's accounting method, providing it clearly and consistently reflects income, governs tax reporting generally.[30] Not only is the determination of taxable income governed by the taxpayer's accounting method, but so also is the determination of accumulated earnings and profits, the tax counterpart of a Balance Sheet category.[31]

Under conventional accounting systems, results of operations will be closed periodically to the Balance Sheet. Unless the closing entry has such an effect upon the Balance Sheet that an "accumulation of earnings and profits" has occurred, one of the

28 Section 533(a) is as follows: "For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary." Int. Rev. Code of 1954, § 533(a).

29 H. Pomeroy, *Accumulations and Distributions of Earnings and Profits*, 17 Western Reserve L. Rev. 717 (1966).

30 Treas. Regs. 1.446-1(a)(2).

31 Treas. Regs. 1.312-6(a).

essential conditions for the imposition of the tax is lacking.[32] It would appear that if the closing effects an increase in such a Balance Sheet account as "Retained Earnings" or "Surplus" there has occurred an "accumulation of earnings and profits,"[33] whereas if no such increase occurs, either because of loss from operations of intervening distributions to shareholders,[34] there has been no "accumulation." From the premise that the expressions "accumulation of earnings and profits" and "accumulated earnings and profits" refer to bookkeeping processes and a bookkeeping balance, it would appear to follow that the phrase in section 533(a), "The fact that the earnings and profits . . . are permitted to accumulate . . . ," denotes a bookkeeping fact. However, it is unclear whether the fact denoted is the bookkeeping balance, "accumulated earnings and profits," or the process of causing an increase therein. If the former is denoted, then the judicial task under section 533(a) is to make a quantitative comparison between the bookkeeping balance of accumulated earnings and profits, on the one hand, and the dollar equivalent of the reasonable needs of the business, on the other. Some cases have followed such a course.[35] That this is the correct interpretation of section 533(a) may be suggested by the fact that the provision for the minimum credit for the reasonable needs of the business, in section 535(c)(2), involves a comparison between the minimum dollar amount of the credit and the bookkeeping balance.

On the other hand, if the 533(a) "fact" is the act of permitting an increase in the bookkeeping balance, then what is to be compared with needs is not the balance itself but the whole collection of considerations underlying the act. The leading case of *Smoot*

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32 INT. REV. CODE OF 1954 § 532(a). H. Pomeroy, *supra* note 29, at 721.

33 *Cf.* Commissioner v. W. S. Farish and Co., 104 F.2d 833 (5th Cir., 1939) (penalty cannot be imposed if prior deficit in earnings and profits is not exceeded by current accumulation).

Also see Koch Co. v. Vinal, 228 F. Supp. 782 (D. Neb., 1964), Nonacq. Rev. Rul. 65-68, 1965-1 C.B. 246 (Service maintains that a bookkeeping transfer does not reduce "earnings and profits" for 531 purposes, notwithstanding the fact that corporation's liberty to make distributions is thereby limited, under State law).

34 *See* INT. REV. CODE OF 1954, § 535(a).

35 *E.g.*, World Publishing Co. v. United States, 169 F.2d 186 (10th Cir., 1948), *cert. denied*, 355 U.S. 911 (1958), *reh. denied*, 336 U.S. 915 (1949); Ted Bates & Company, Inc. v. Commissioner, 24 T.C.M. 1346 (1965).

Sand & Gravel Corporation v. Commissioner[36] takes the position that a comparison between needs and Assets is called for, and courts and commentators following this decision have emphasized liquid Assets, reasoning that dividend capacity is largely a question of the availability of liquid assets.[37]

The word "accumulation" may lead one to think of an activity done with respect to non-mathematical objects. Assuming that section 533(a) requires a comparison between the reasonably expected cost of goods and services and whatever it is that a corporation has "accumulated," the tendency is to think of the accumulated objects as real. As a result, one is likely to either think of earnings and profits as if they were real resources or ignore earnings and profits and concentrate on real resources. In effect, the tendency is to either misunderstand the accounting significance of the "earnings and profits" terminology, or disregard it. Perhaps the better view would be that 533(a) does not call for any such comparison, but rather for a review of the decision to accumulate, in the light of need; but the cases assume that a quantitative comparison of some kind is required, and substitute Assets for "earnings and profits."

Payment by a corporation for the goods and services represented by the expression, "reasonable needs," will not, under conventional accounting systems, result in a charge against a Surplus account. An Asset or Liability account will be credited. Business needs are simply not commensurable with Surplus. It seems unnatural to courts and commentators[38] alike to make a comparison between earnings and profits, on the one hand, and needs, on the other, when, if a comparison of balances is called for at all, Assets or net Assets could be used.

If a corporation has wealth not derived from earnings, such as securities with unrealized appreciation, it is pretty clear that while such wealth will not fall within the expression, "earnings and profits," it will be deemed a source for the satisfaction of the corporation's business needs and will be influential in a 533(a)

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36 274 F.2d 495 (4th Cir., 1960), *cert. denied,* 363 U.S. 832 (1960).

37 Electric Regulator Corporation, 336 F.2d 339 (2d Cir., 1964).

38 S. Ziegler, *supra* note 13; D. Nelson, *supra* note 23.

determination.[39] Not only will such wealth be considered, but it may be valued in terms of its market value, and not as an "Asset," stricting speaking (*i.e.*, at book value).[40] In such an event there must be a departure both from a mechanical comparison of needs with earnings and profits and also from any other strictly bookkeeping comparison.

The purpose of the statute can be satisfied without any provision requiring the trier of fact to compare the bookkeeping balance of earnings and profits, or any other bookkeeping balances, with reasonable needs. Section 532(a) makes it plain that the purpose of the statute is to deter taxpayers from adopting a dividend policy aimed at the avoidance of double taxation, a *sine qua non* of abuse of the difference between corporate and individual income tax rates.[41] The evidentiary rule of section 533(a) serves this purpose only when a corporation with wealth in excess of its business needs is in a position such that a distribution to shareholders would be a dividend. This would be the case, under section 316, only if the corporation has current or previously accumulated earnings and profits. Therefore the purpose of the statute is satisfied if section 533(a) is construed to require: (1) presence of the conditions necessary for a section 316 dividend, and (2) an excess of real purchasing power over the need therefor. It is admitted that section 535(c)(2)[42] carries some weight in favor of a different construction, but its wording can readily be explained in terms of a desire for administrative convenience, and it seems unlikely that it was intended by Congress to define the nature of a 533(a) inquiry.

B. *Privileged Asset Categories*

Not only did *Smoot Sand & Gravel*[43] shift the emphasis from earnings and profits to Assets, but it also suggested that certain

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39 *See* National Grocery Co., 304 U.S. 382 (1937).

40 Vuono-Lione, Incorporated v. Commissioner, 24 T.C.M. 506 (1965). *Cf.* Koch Co. v. Vinal, 228 F. Supp. 783 (D. Neb., 1964), Nonacq. Rev. Rul. 65-68, 1965-1 C.B. 246 (securities kept on hand in the ordinary course of an insurance brokerage business taken at book value).

41 *Donruss*, 393 U.S. 297 (1969) (dicta).

42 Which provides the minimum credit for reasonable needs.

43 274 F.2d 495 (4th Cir., 1960), *cert. denied*, 363 U.S. 832 (1960).

kinds of Assets, like inventories, can be accumulated "with impunity." In *Smoot*, and the cases which follow it, there appear to be three strands of reasoning underlying the notion of privileged Assets. First, it is felt that some sorts of Assets are inherently likely to be reasonably related to business needs, such as inventories.[44] Second, it is not considered feasible for a corporation to pay dividends in kind out of inventories or fixed assets.[45] Third, it is felt that liquid Assets can be traced to earnings and profits, but that other Assets cannot, and that such tracing is appropriate.[46] Each of the first two premises is subject to criticism or qualification, and it is submitted that the third is simply without merit. As to the first two, little argument is needed in support of the proposition that a calculated scheme to accumulate wealth in the form of non-liquid assets should fail. However, the supposition that non-liquid assets are reasonable in amount is not made explicit in the *Bardahl* series of cases.

The idea that assets need to be traced to earnings and profits in a section 533(a) inquiry is related to the assumption that courts are expected to make a comparison between some bookkeeping balance and needs, an assumption already discussed. Courts following *Smoot* have sometimes tried to subtract from Assets generally those which were not purchased with business revenues.[47]

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44 Treas. Regs. 1.535-2(b)(4); Smoot Sand & Gravel, 274 F.2d 495 (4th Cir., 1960), *cert. denied*, 363 U.S. 832 (1960) is cited for the following proposition: "To the extent the surplus has been translated into plant expansion, increased receivables, enlarged inventories or other assets related to its business, the corporation may accumulate surplus with impunity."

Later on, however, in Sears Oil Co., Inc. v. Commissioner, 359 F.2d 191 (2d Cir., 1966), the *Smoot* dictum was called "somewhat of an oversimplification," and it was held that only reasonably necessary inventories can be accumulated with impunity.

45 Electric Regulator Corporation, 336 F.2d 339 (2d Cir. 1964). *See* J. P. Scripps Newspapers, 44 T.C. 453 (1965); Bremerton Sun Publishing Co. v. Commissioner, 44 T.C. 566 (1965), *gov't appl. dismissed by stipulation* 1/28/66; Sandy Estate Company v. Commissioner, 43 T.C. 361 (1964); Faber Cement Block Co., Inc. v. Commissioner, 50 T.C. 317 (1968), Acq. I.R.B. 1968-43.

46 See cases cited at note 44; Electric Regulator Corporation, 336 F.2d 339 (2d Cir., 1964) (the "nature" of the accumulated surplus must be considered); and Schenuit Rubber Co. v. United States, 293 F. Supp. 280 (D. Md. 1968). Also W. C. Farish and Co., 104 F.2d 833 (5th Cir. 1939) (*semble*). Battlestein Investment Co. v. United States, 69-1 USTC ¶ 9219 (S.D. Tex. 1969) at 83,993 ("The authorities hold that a taxpayer is not entitled to duplicate the depreciation allowance with accumulated earnings for the purpose of replacing assets.").

47 Schenuit Rubber Co., 293 F. Supp. 280 (D. Md. 1968).

Reflection on the accounting processes involved, however, suggests that tracing of Assets to earnings and profits is unlikely to be either successful or illuminating. During the course of an accounting period there occur receipts and accruals causally related to bargains made by the business, and such bargains will have been made for profit.[48] Typically, the accounting entries will be a debit to an Asset account and a credit to an Income account. Charges to Expense accounts are coordinated in time to the Income entry only to the extent required by the principle of matching, which requires merely that they be made with respect to the same accounting period as the relevant Income entry.[49] Typically, there is no causal coordination of record between particular items of expense and particular Income entries. While Net Income is determined only at the end of the accounting period, the Assets generated by business bargains, both profitable and unprofitable ones, are recorded throughout the period and immediately begin undergoing continuous transformation. Ordinary accounting permits an overall comparison of Assets with "sources" (Liabilities, Surplus, and Common Stock, for example), but does not provide for a tracing of fixed Assets to one kind of "source" and liquid Assets to another. A more fundamental criticism of the tracing suggestion, however, is that section 533(a) need not be interpreted as requiring that the Assets available to satisfy business needs be derived from earnings and profits. Rather, as has been suggested, the statute may be viewed as calling for an evaluation of the business needs in the light of all the resources of the business, so that if an accumulation not warranted by the reasonable needs of the business is permitted at a time when a distribution would be a section 316 dividend, the section 533(a) presumption is operative.[50]

48 But some bargains made for the remote purpose of profit may be made without immediate expectation of profit.

49 See 1 APB ACCOUNTING PRINCIPLES 4091.13(c) (CCH, 1968), APB Opinion No. 11, Par. 14(d) (American Institute of Certified Public Accountants, 1967).

50 Treas. Regs. 1.537-1(a) contains the following: "An accumulation of the earnings and profits (including the undistributed earnings and profits of prior years) is in excess of the reasonable needs of the business if it exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business." This statement inconsistently suggests both that earnings and profits must be considered in relation to needs and that needs must be considered in relation to what a prudent businessman looks to to pay for them (presumably not Retained Earnings).

C. *Working Capital Needs*

One of the recognized categories of business needs relevant to a section 531 case is the category of working capital needs.[51] The expression "working capital" is in common use, and has various nuances of meaning.[52] In general it involves the usual assumption that a business is inherently continuous. While business behavior can, indeed, be engaged in without repetition and be completed in a finite time interval, the expression "a business" ordinarily denotes a combination of businesslike behavior with circumstances indicative of a disposition to make the activity continuous and relatively independent. One of the purposes of incorporation is to provide a substratum for continuous self-sustaining business activity, although, to be sure, the corporate form can be used for a single short-lived venture. Working capital analysis is relevant to a 531 case when the taxpayer is the typical on-going business.

In accounting usage, working capital is represented by the excess of Current Assets over Current Liabilities.[53] One use of the working capital concept is in determining the credit-worthiness of a business entity. Another use is less specific and has to do with financial analysis. Its underlying premise seems to be that certain resources of a business are "working" by circulating, so that some part of them is always in readiness to undertake new work and insure the continuity of operations. "Working capital" has a significantly different meaning in the credit context from what it has in the circulating-capital context. For while in the latter context the currentness of assets is associated with their circulating function, in the credit context and in common parlance the currentness test is relative liquidity. Resources which "work," as opposed to relatively static ones, tend to be readily convertible into cash. By association, the working or current quality of resources comes to be tested by their convertibility into cash, their liquidity. However, in using the working capital concept to describe the resources needed to maintain continuity of

51 Treas. Regs. 1.537-2(b)(4).

52 J. BOGEN (ed.), FINANCIAL HANDBOOK (1964) 16.1.

53 1 APB ACCOUNTING PRINCIPLES 2031.03 (CCH, 1968), ARB 43, Ch. 3A, Par. 2 (American Institute of Certified Public Accountants, 1953). In Magic Mart, Inc., 51 T.C. — (CCH Dec. 29,456) (1969) at 2355 n.4, the Tax Court said, "The term 'working capital' is synonymous with such terms as 'net quick assets' and 'net liquid assets' found in the decided cases."

business operations, to quantify circulating capital, liquidity is not the proper test.[54] Net liquid Assets may, for example, exceed working (circulating) capital. In addition, liquid Assets may be necessary in a business even though there is no working capital requirement for them.[55]

Failure to appreciate the difference between net liquid Assets and circulating Assets can undermine an analysis of the working capital needs of a business. One of the serious ambiguities involved arises from the fact that in ordinary usage Current Liabilities enter into the calculation of working capital. Liabilities are commonly classified as Current on the basis of their liquidity,[56] and not because of any special relationship to circulating Assets. Therefore, in one application of the working capital concept, liquid Liabilities, as such, are irrelevant. On the other hand, from the point of view of the credit analyst, it is axiomatic that a business must have at least enough "Current Assets" to discharge those Liabilities falling due in the near future.[57]

When working capital needs are to be determined from the point of view of the ability of the business to engage continuously in its normal activities, the elements which should enter the working capital analysis are those which are associated with an "operating cycle"[58] instead of the accounting period. These are

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54 APB ACCOUNTING PRINCIPLES 2031.12 (CCH, 1968), ARB 43, Ch. 3A, Par. 2 (American Institute of Certified Public Accountants, 1953): "The committee believes that, in the past, definitions of current assets have tended to be overly concerned with whether the assets may be immediately realizable. * * * It should be emphasized that financial statements of a going concern are prepared on the assumption that the company will continue in business. Accordingly, the views expressed in this section represent a departure from any narrow definition or strict *one year* interpretation of either current assets or current liabilities; the objective is to relate the criteria developed to the operating cycle of a business."

C. PARK AND J. GLADSON, WORKING CAPITAL (1963), develop (32-36) the distinction between operating-cycle and accounting-period concepts of currentness, and point out (64-65) the difference between liquid Assets and Liabilities and "Current" Assets and Liabilities under an operating-cycle view of currentness.

55 Lion Clothing Co. v. Commissioner, 8 T.C. 1181 (1947) (plan to increase inventories if and when supplies became available).

56 *I.e.*, the requirement that they be paid off within a relatively short time. See Bremerton Sun Publishing Co., 44 T.C. 566 (1965) (working capital calculation involved current portion of long-term mortgages).

57 In Vuono-Lione, 24 T.C.M. 506 (1965), the Tax Court distinguished between those working capital requirements bearing on taxpayer's credit standing and those arising out of operations.

58 1 APB ACCOUNTING PRINCIPLES 2031.05 (CCH, 1968), ARB 43, Ch. 3A, Par. 5

Current Assets and Current Liabilities, to be sure, but since in the context the test of currentness is circulation rather than liquidity one can neither include all liquid items nor exclude all nonliquid items when speaking of "Current" items.

To the extent that operating-cycle analysis of working capital needs involves a departure from everyday accounting terms, it is doubtful that such analysis is really useful to courts in section 531 cases. However, as shall be seen below, *Bardahl* and other cases purport to analyze the working capital needs of a business without adverting to the latent dissymmetry between the operating cycle concept, on the one hand, and conventional routines for sorting out Current Assets and Liabilities from non-current, on the other hand.

D. *The One-Year Rule*

The 1948 case of *J. L. Goodman Furniture Co. v. Commissioner*[59] involved a finding that taxpayer needed sufficient working capital to meet operating expenses for one year. In *Goodman* it appears that the court used the excess of current Assets over Liabilities as "working capital." The so-called one-year rule became, in later cases, a "rule of administrative convenience."[60] But it became apparent, in certain cases, that where taxpayer's inventories and accounts receivable turned over several times in one accounting period the one-year rule provided too generous a measure of working capital requirements.[61] The seminal concept

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(American Institute of Certified Public Accountants, 1953): "The ordinary operations of a business involve a circulation of capital within the current asset group. Cash is expended for materials, finished parts, operating supplies, labor, and other factory services, and such expenditures are accumulated as inventory cost. Inventory costs, upon sale of the products to which such costs attach, are converted into trade receivables and ultimately into cash again. The average time intervening between the acquisition of materials or services entering this process and the final cash realization constitutes an *operating cycle*."

59 11 T.C. 530 (1948).

60 The Dixie, Inc. v. Commissioner, 277 F.2d 526 (2d Cir., 1960), *cert. denied,* 364 U.S. 827 (1960); Bremerton Sun Publishing Co., 44 T.C. 566 (1965), *gov't appl. dismissed by stipulation* 1/28/66; H. Van Hummell, Inc. v. Commissioner, 364 F.2d 746 (10th Cir., 1966), *cert. denied,* 386 U.S. 956. Magic Mart, Inc., 51 T.C. — (CCH Dec. 29,456) (1969).

61 Kirlin Company v. Commissioner, 23 T.C.M. 1580 (1964), *aff'd,* 361 F.2d 818 (6th Cir., 1966); United States v. McNally Pittsburg Mfg. Corp., et al., 342 F.2d 198 (10th Cir., 1965).

in *Goodman* was that a business ought to be able to accumulate enough resources to get it through one period of operations, from the commencement of operations to the point at which they begin to be repeated. This period, however, the "operating cycle," may be longer or shorter than a single accounting period.

E. *Summary*

In the discussion which follows, there should be kept in view the matters which have been discussed in this section, namely: (1) the question whether section 533(a) calls for a comparison between needs and "earnings and profits," or any other bookkeeping balance; (2) the tendency to assume that any accumulation of relatively nonliquid assets is reasonable; (3) the ambiguity of the "working capital" concept depending upon whether liquidity or circulation is the test of currency of Assets and Liabilities; and (4) the existence of precedent for determining working capital needs in terms of the time elapsed before activities are repeated.

II. *Bardahl* AND OTHER CASES

A. *The Authority and General Characteristics of Operating-Cycle Analysis in 531 Cases*

The Tax Court in *Bardahl Manufacturing Corporation v. Commissioner*[62] cited Regs. 1.537-2(b)(4) to the effect that earnings retained to provide for working capital requirements are accumulated for the reasonable needs of the business, and adopted the view of the parties that "the most appropriate basis for determining petitioner's need . . . is to compute the amount of cash reasonably expected as being sufficient to cover its operating costs for a single operating cycle."[63] The Court excluded from such "costs" charges for depreciation and federal income taxes. It defined an operating cycle as "the period of time required to convert cash into raw materials, raw materials into an inventory of marketable Bardahl products, and inventory into sales and ac-

62 24 T.C.M. 1030 (1965).

63 The Court evidently referred to all liquid Assets in using the word, "cash." Citation was made to Smoot Sand & Gravel, 274 F.2d 495 (4th Cir., 1960), *cert. denied*, 363 U.S. 832 (1960) and other cases discussed in Section I, A of this paper.

counts receivable, and the period required to collect the outstanding accounts." The Court's interpretation of section 533(a) is suggested by its comparison of net Current Assets with reasonable needs. It makes such a comparison by substracting from net Current Assets the sum of ordinary operating expenses of one business cycle and anticipated extraordinary expenses. There is no discussion of the reasonableness of nonliquid Assets, and no effort is made to distinguish between liquid Assets and circulating Assets in determining the amount of net Current Assets. By subtracting from net Current Assets not only the requirements of a single operating cycle but also anticipated extraordinary expenses, the Court to some extent offsets any difficulties that might arise by reason of an excess of liquid capital over circulating capital.

The sister corporation of Bardahl Manufacturing was the petitioner in *Bardahl International Corporation v. Commissioner*[64] and it was again at the suggestion of the parties that an operating-cycle analysis of needs was applied to liquid Assets. In this case, the Tax Court, noting that the operating-cycle approach had been used in a First Circuit case heard after *Bardahl Manufacturing*,[65] had occasion to be more explicit in its evaluation of the approach than in the earlier case. It said the method is (1) a yardstick to measure managerial judgment so as to shed light on motive, and (2) "as good as any other" approach for determining the 535(c) accumulated earnings credit.[66] This seems a decidedly moderate appraisal in comparison with the enthusiastic reception which *"Bardahl"* has received in some quarters.[67]

Appellate Court "approval"[68] of *Bardahl Manufacturing* came from the First Circuit in *Apollo Industries, Inc. v. Commissioner*[69] in the form of a remand. The Tax Court had made a

64 25 T.C.M. 935 (1966).

65 Apollo Industries, Inc. v. Commissioner, 358 F.2d 867 (1st Cir., 1966).

66 25 T.C.M. 935 (1966) at 944.

67 *E.g.*, an undated release of Research Institute of America, Inc., *Using Formula to Defend Against Accumulations Penalty Tax*. A portion follows: "In at least this area [current operating requirements], the [Tax Court] decisions have approved a mathematical method of computing the corporation's needs which largely eliminates any conflicting opinions an examining agent may have about the amount needed for a particular corporation's current operating expenses. This way the subjective arguments can at least be limited to the area of future plans."

68 Bardahl International, 25 T.C.M. 935 (1966) at 944.

69 358 F.2d 867 (1st Cir., 1966).

finding that taxpayer had unreasonably accumulated its earnings but failed to support these findings to the satisfaction of the appellate court. The First Circuit applied an operating-cycle analysis to the case and, unable thereby to confirm the lower court's conclusions, remanded. The case was settled without further proceedings in the Tax Court.[70] It is significant that the First Circuit seemed to feel that operating-cycle analysis is powerful enough to overcome the remoteness of a reviewing court from the facts, and that it would have affirmed, apparently, in spite of the inadequacy of the trial court's findings, if its operating-cycle analysis had come out differently. While the *Apollo* Court did not intend to "sanctify" the *Bardahl Manufacturing* approach,[71] its selection by the Court as a test of the reasonableness of the Tax Court's findings gave it at least the aroma of sanctity.

Operating-cycle analysis has been used with some consistency in recent Tax Court cases,[72] and, with mixed feelings, in other courts.[73]

B. *The Specific Components of the* Bardahl *and* Apollo *"Formulas"*

A considerable amount has been written[74] and more writing will appear[75] concerning the proper elements of a *Bardahl*-type

70 A. Grossman, *Section 531 Problems Including the Bardahl Formula*, 45 TAXES 913 (1967).

71 Apollo Industries, 358 F.2d 867 (1st Cir., 1966), at 872.

72 *E.g.*, Faber Cement Block Co., Inc. v. Commissioner, 50 T.C. 317 (1968), Acq. I.R.B. 1968-43 (Tax Court directed a *Bardahl* analysis on its own motion); Adolph Coors Co. et al. v. Commissioner, 27 T.C.M. 1351 (1968) (IRS unsuccessfully urged a complicated "multiple-cycle" working capital analysis). Magic Mart, Inc., 51 T.C. — (CCH Dec. 29,456) (1969) (method used over taxpayer's objection.

73 Schenuit Rubber Co., 293 F. Supp. 280 (D. Md. 1968) (Court apparently averaged the proffered findings of two opposing expert witnesses); R. C. Tway Company v. United States, F. Supp. (W.D. Ky., 1968) ("a reasonable method" not determinative but corroborative; New England Wooden Ware v. United States, 289 F. Supp. 111 (D. Mass., 1968) (Wyzanski, J., evidently contemplating the fate of the Tax Court in *Apollo*, made an operating-cycle finding as a gesture of largesse, saying it was neither determinative nor corroborative of his conclusions).

74 *E.g.*, R. Livsey, *A Proposed Operating Cycle Test for Section 531 Working Capital Accumulations*, 46 TAXES 648 (1968); N. Luria, *Comment: The Accumulated Earnings Tax*, 76 YALE L.J. 793 (1967); A. Grossman, "Section 531 Problems Including the *Bardahl* Formula," 45 TAXES 913 (1967); S. Ziegler, "The 'New' Accumulated Earnings Tax," 22 TAX L. REV. 77 (1966-67); R. Skinner, *Reasonable Needs of the Business*, 17 WESTERN RESERVE L. REV. 737 (1966).

75 Professor Victor L. Andrews of Georgia State College, the government's expert

"formula." For the purpose of considering how effective *Bardahl* has been, or might be, in the judicial context as a standard of judgment, a brief exposition of the details of the *Bardahl* approach will be given here.

In *Bardahl Manufacturing Corporation*[76] the Tax Court took the following steps:

(1). Current Liabilities were subtracted from Current Assets to derive "Net liquid assets available to meet anticipated business needs";

(2). Total needs of the business for liquid assets were found by adding:

> (a) Ordinary operating expenses for one business cycle, viz., the product of:
>
> (i) the total of Cost of Goods Sold and other operating expenses, exclusive of Depreciation and Federal Income Taxes, multiplied by
>
> (ii) a decimal representing the portion of one accounting period occupied by one average operating cycle, and
>
> (b) Anticipated extraordinary expenses, as found by the Court;

(3). The total found under paragraph (2) was subtracted from the balance found under paragraph (1), and the difference was called excess or shortage of working capital;

(4). Unrelated investments and loans were added to the excess or shortage found paragraph (3), and the sum (if a positive number) was found to be an amount "accumulated beyond the reasonable needs of the business."

The method of determining the portion of one accounting period occupied by a single average operating cycle was not explained in *Bardahl Manufacturing*, but in *Bardahl International*[77] the following method was used:

(1). Cost of Goods Sold was divided by average Inventory to derive the number of times Inventory "turns over" annually.[78]

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in Schenuit Rubber Co., 293 F. Supp. 280 (D. Md., 1968), is preparing an article for FORDHAM L. REV. Letter to the author, January 31, 1969.

76 24 T.C.M. 1030 (1965).

77 25 T.C.M. 935 (1966).

78 J. BOGEN (ed.), FINANCIAL HANDBOOK (1964), has a brief study of ratio analysis,

Inventory turnover was converted into a number of days by dividing into 365.

(2). Net Sales were divided by average Receivables to derive the number of times Accounts Receivable "turn over" annually.[79] Accounts Receivable turnover was converted into a number of days by dividing into 365.

(3). The numbers of days found in paragraphs (1) and (2), above, were added together and the sum was called the length of a single operating cycle.[80]

In *Bardahl International,* however, the Tax Court did not use average operating cycle. The Court adopted the taxpayer's view that a prudent manager would be ready to meet not just the average demands but rather the peak demands of the business year. While the opinion is less than clear, it appears that the Court found the number of days in one peak operating cycle by using, instead of average Inventory and Receivables, the Inventory and Receivables of the month in which the sum of these two was the highest of any month in the year.[81]

Another factor in *Bardahl International* which was absent from *Bardahl Manufacturing* was the subtraction from the number of days in the operating cycle otherwise established of the number of days in the average period for which credit was extended to the taxpayer, principally by its sister company which supplied its inventories. *Bardahl International* was a sales company, and had agreed to take all of Manufacturing's production for sale at prices established by Manufacturing. By an established practice which appeared likely to continue, International did not pay Manufacturing until after having paid all its other creditors.

The Court in *Bardahl International* stated its view that "the taxpayer should have sufficient liquid assets on hand to pay all

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including turnover ratios, at 8.31-8.40, and discusses Inventory and Accounts Receivable turnover in connection with working capital needs, at 16.9-16.12.

79 *Id.*

80 The decimal representing the portion of one accounting period occupied by one average operating cycle is, of course, the quotient of 365 divided into the operating cycle expressed as a number of days.

81 R. Skinner, *supra* note 74, approves of this modification and enlarges upon it at 743-747. Peak cycle was used by the Court in Magic Mart, Inc., 51 T.C. — (CCH Dec. 29,456) (1969). Also, in that case the inventory cycle alone was taken to represent the operating cycle, taxpayer having no trade accounts receivable.

of its current liabilities and any extraordinary expenses reasonably anticipated, plus enough to operate the business during one operating cycle."[82] In an earlier section of this article it has already been pointed out that the concentration on liquid Assets involves assumptions about the reasonableness of nonliquid Assets, and that there is a distinction between the operating-cycle and credit-analysis concepts of "Current" Assets. One will observe that the Tax Court mingles the operating-cycle and credit-analysis approaches. Some of the criticism of *Bardahl* appears to be related to this mingling. Treating Current Liabilities as a working capital requirement, specifically, has been the subject of unfavorable comment.[83] Yet the subtlety of the criticism, and the complexity of the suggested remedy,[84] give rise to questions whether a truly sophisticated operating-cycle analysis would be a useful judicial standard. And even if out of scholarly discussion there emerges a refinement of the *Bardahl* approach which is faithful to the operating-cycle concept of working capital, there will still be need to take into account innumerable considerations affecting managerial judgment concerning current operating requirements, such as the need to maintain a certain credit standing. The use of current or quick ratios in section 531 cases, for example, has been criticized because they do not provide a measure of working capital needs.[85] But whether they do so is, in part, a question of whose point of view is considered. The difficulty involved in trial of a 531 case comes partly from aversion to the unfairness and bad sense of upsetting managerial judgment which is supported by looking at the facts from any reasonable point of view.

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82 25 T.C.M. 935 (1966) at 944.

83 N. Luria, *supra* note 74; Schenuit Rubber Co., 293 F. Supp. 280 (D. Md. 1968) (testimony of government's expert witness). *Schenuit* is illustrative of the metamorphic quality of the so-called "*Bardahl* formula."

84 See Adolph Coors Co., 27 T.C.M. 1351 (1968) (Tax Court disapproved of IRS effort to refine the operating-cycle approach, it appears).

The method suggested by N. Luria, *supra* note 74, is, by his own admission, likely to make courts "shy away."

For an example of the subtlety and unconventional quality of sophisticated operating-cycle theory see C. Park and G. Gladson, *Working Capital* (1963), cited by S. Ziegler, *supra* note 74.

85 N. Luria, *supra* note 74, at 803.

In *Apollo Industries, Inc.*,[86] the First Circuit "followed" *Bardahl Manufacturing* but in doing so restructured the approach significantly without commenting on the fact that it was doing so. Instead of multiplying annual operating costs (including Cost of Goods Sold) by a decimal representing one whole operating cycle, as in *Bardahl*, the *Apollo* Court separately found the inventory cost of an Inventory cycle, and added to it the other operating costs of an Accounts Receivable cycle. It used the following steps:

(1). Current Liabilities were subtracted from Current Assets to derive "Net Liquid Assets";

(2). Working capital needs for one operating cycle were found by adding:

> (a) Costs of materials tied up in inventories, viz., the product of:
>
> (i) Inventory turnover expressed in a number of days, multiplied by
>
> (ii) average daily Inventory expense (Cost of Goods Sold divided by 365), and
>
> (b) Operating costs incurred before Accounts Receivable are turned into cash, viz., the product of:
>
> (i) Accounts Receivable turnover expressed in a number of days, multiplied by
>
> (ii) average daily operating expense (Direct and Indirect Cost, exclusive of Depreciation and Income Taxes, divided by 365);

(3). The total found under paragraph (2) was subtracted from the balance found under paragraph (1), and the excess, if any, was applied to the anticipated cost of special projects.

The specific approaches of *Bardahl* and *Apollo* have vastly different results when applied to the same facts, the *Bardahl* approach being more favorable to the taxpayer.[87] There is disagreement among commentators generally over the issue on which the Tax Court and the First Circuit silently diverged. The *Bardahl* assumption that the number of days in an operating cycle is the sum of the numbers of days in an Inventory turnover period and an Accounts Receivable turnover period, implying that the whole Inventory cycle is completed before the Accounts Receiv-

86 358, F.2d 867 (1st Cir., 1966).

87 Appendix A, *infra*.

able cycle begins, seems unsound. But, again, the price of an analytically correct method of determining the length of an operating cycle may be loss of usefulness as a standard of judicial decision.[88]

Bardahl and *Apollo* are alike in using Inventory and Accounts Receivable turnover, which is obtained by dividing Cost of Goods Sold by average Inventory or Net Sales by average Accounts Receivable. Involved in this process is yet another unspoken assumption. If a corporation increases its average Inventory or average Receivables the turnover will be lower, the number of days in a turnover period greater. When cost is multiplied by the number of days in the turnover period, therefore, the product will be a larger working capital requirement. As to Inventories, a corporation which is in a position to accumulate wealth is likely to be able to increase its average Inventories, at least if it deals in a relatively stable market. With respect to Receivables, there is, of course, a built-in risk in the relaxation of collection policies, although it is conceivable that circumstances — such as the relationship between *Bardahl Manufacturing* and *Bardahl International* — might warrant lengthening the collection period.

Not only is the length of the cycle subject to some manipulation, but also the operating costs can, in some measure, be controlled. Salaries, for example, may be inflated for the purpose of inflating operating cycle costs.[89]

Even practices not intended to manipulate the operating cycle may have the effect of strongly distorting it. A manufacturer whose raw materials are commodities in a volatile market, for example, may maintain inventories far in excess of near-term production requirements as a hedge, and may on occasion sell such inventories unprocessed in the same market in which he bought them.

Not only is it unclear how best to determine the length of one operating cycle, but it is also unclear whether one operating cycle — instead of two or three — is really significant. In Section I, C, of this article the rationale of the operating-cycle is discussed,

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88 *See* S. Ziegler, *supra* note 74, at 98.

89 J. Sullivan, *Planning to Avoid the Section 531 Tax*, 17 WESTERN RESERVE L. REV. 763 (1966).

and it is evident from that discussion that if the objective of working capital analysis is to determine what it takes for business activity to be continuous, then the single cycle — the time it takes to being repeating an activity — is the appropriate time measure. But this is an analytical notion. It does not respond to the question how much a prudent manager would consider reasonable to have available in the light of his ordinary volume of business, and undoubtedly is not intended to do so. Assuming one can accurately determine the length and cost of a single operating cycle, one knows how much capital is absorbed by circulating business activity. Given such knowledge, does it follow that one should decide to distribute to shareholders (absent expansion plans) any excess resources? It is not only difficult to answer the preceding question, but it is also difficult to decide whether it should be answered on the basis of financial analysis or on the basis of an empirical consensus. Some propose that the Internal Revenue Service publish a rule whereby 120% of the requirements of one operating cycle plus an amount equal to current liabilities would be a standard,[90] possibly only as a "safe harbor." Such a rule might well be serviceable in that expectations could be formed by it. But would it have any greater conceptual justification than the one-year rule of *Goodman*?[91]

C. *Ted Bates*

In *Ted Bates & Company, Inc. v. Commissioner*,[92] decided the same year as *Bardahl Manufacturing*, the parties did not urge an operating-cycle analysis on the Tax Court. But the case contains working-capital issues which deserve comparison with the operating-cycle cases. Citing *Smoot*[93] and *J. P. Scripps Newspapers*[94] for the proposition that section 533(a) calls for a comparison[95] between liquid Assets and business needs, the Court proceeded to

90 S. Ziegler, *supra* note 74, at 102, cited with apparent approval in A. Grossman *supra* note 74, at 917.
91 11 T.C. 530 (1948).
92 24 T.C.M. 1346 (1965).
93 274 F.2d 495 (4th Cir., 1960), *cert. denied*, 363 U.S. 832.
94 44 T.C. 453 (1965) (see note 20, *supra*).
95 See Section II, A of this article.

attempt to quantify taxpayer's operating and other requirements. Among the operating needs found by the Court was the amount the Ted Bates organization paid its principal and others before collecting from clients. The organization was an advertising agency which earned commissions from the media with which it placed advertising for clients. The agency's bills to its clients included not only the media's charges (out of which came its commissions, apparently) but also the cost of art and talent for which, by industry custom, the agency was obligated to make prompt payment. The length of time in which the agency liquidated its Accounts Receivable was greater than the length of time in which it liquidated its Accounts Payable. The need generated by the difference is pretty clearly an example of a working capital requirement in the circulating-capital sense.

Another operating requirement found was the risk that in the event the Bates agency lost a large account it would, nevertheless, be reasonably unwilling to lay off high-salaried personnel. To provide for this risk, the taxpayer was warranted in maintaining a fund of liquid Assets. Here is an example of the divergence between circulating-capital and conventional notions of working capital, for such a "reserve" should not be included in the computation of working capital in the circulating-capital sense.

On a third operating requirement the *Ted Bates* Court found against the taxpayer and involved itself in what appears to be a serious misconception. Taxpayer contended that it was entitled to a "reserve" for such operating costs as client solicitation and preparation of advertising copy. This would appear to be another clear example of a working capital requirement, even in the circulating-capital sense. The Court, however, rejected the contention on the ground that such costs are deductible from gross income in determining taxable income. It relied, mistakenly, on *Smoot Sand & Gravel*[96] which had refused to consider Bad Debts and Depreciation as needs to be subtracted from available liquid Assets, since Balance Sheet reserves out of Assets had already been made for these items.

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96 274 F.2d 495 (4th Cir., 1960).

Having found to its satisfaction the reasonable needs of the business, the Tax Court then engaged in a curious procedure. Before comparing the quantified needs of the business with Assets, the Court compared them with the balance of taxpayer's Retained Earnings account. Only with respect to those years in which Retained Earnings exceeded reasonable needs of the business did the Court go on to make a comparison with net liquid Assets.[97] This is consistent with the Court's statement that, "Generally, in an 'accumulated earnings' case, under existing law, two factors must be present before the 'accumulated earnings' tax will be applicable. Thus, the taxpayer must have retained earnings in excess of the reasonable needs of its business. In addition, the taxpayer, during the years in question, must have been in a sufficiently liquid position to allow the distribution of a dividend (or a larger dividend than was distributed)."[98] The Court's two-factor test is clearly wrong if it is meant to be an interpretation of section 532(a), which makes the fact of accumulation and tax-avoidance purpose the conditions of applicability of section 531. If the test is taken as enunciating the combined effect of sections 532(a) and 535(c)(1) it is again wrong because 535(c)(1) provides only a credit, against accumulated taxable income for the year in question, equal to the part thereof retained for the reasonable needs of the business. It neither permits retention of an amount equal to the excess of reasonable needs over Retained Earnings nor requires a distribution when Retained Earnings exceed the reasonable needs of the business. Is the test, then, an interpretation of section 533(a)? If it is, then the *Ted Bates* Court must read section 533(a) as requiring a comparison of needs with balances, and must read "earnings and profits" literally in some situations and substitute net liquid Assets for that expression in others. The restriction thereby imposed upon the scope of a section 533(a) inquiry does not have any evidentiary utility with respect to the purpose issue and is commended only by a reading of 533(a) which is either literalistic, and countermanded by *Smoot*

97 Ted Bates, 24 T.C.M. 1346 (1965) at 1366. See text accompanying note 35, *supra.*

98 24 T.C.M. 1346 (1965) at 1357.

Sand & Gravel[99] on which the court purports to rely, or is simply wrong as was suggested in Section I, A, of this article. In any event, since *Ted Bates* itself departs from a literal comparison between the balance of earnings and profits and needs, in the case of years in which taxpayer's earnings and profits exceed reasonable business needs, it is not authority supporting any literal reading of "earnings and profits," after the fashion of World Publishing.[100] In short, the two-factor test of the *Ted Bates* case seems ill-conceived.

D. *Summary*

The *Bardahl* series of cases is innovative with respect to the one-year rule, but otherwise does not significantly refine working capital analysis under section 531. The cases continue to evidence uncertainty about the kind of inquiry contemplated by section 533(a), they tend to disregard the possibility of unreasonable wealth not represented as liquid Assets, and they do not look behind the conventional concept of working capital.

The operating-cycle technique, originally suggested by litigants apparently as the product of pre-trial formation of the issues, may be invoked even where neither before nor during trial has a determination been made that the assumptions implicit in such analysis are satisfied by the facts. At least, it was once so invoked by an appellate court.

The precise elements of the operating-cycle approach are not agreed upon generally, and it appears from the literature that an approach which is satisfactory from the point of view of financial analysis will be considerably more complicated than those used in the cases.

To the extent that the cases have been consistent in their application of an operating-cycle approach, they have given rise to a new set of implied assumptions. They assume that certain financial statement relationships are not distorted, intentionally or

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99 274 F.2d 495 (4th Cir., 1960).

100 World Publishing Co., 169 F.2d 186 (10th Cir., 1948), *cert. denied,* 355 U.S. 911 (1949), *reh. denied,* 336 U.S. 915. See text accompanying note 35, *supra.*

otherwise. They also assume that certain premises of analysis are premises of managerial decision.

IV. Conclusion

The provisions for a penalty tax upon undistributed personal holding company income[101] carve a relatively well-defined subclass out of the class of potential abuses of the difference between individual and corporate tax rates by means of earnings retention. In the personal holding company provisions the legislature chose such characteristics as stock ownership by a special kind of group[102] and the presence of a certain relative quantity of income from special classes of sources[103] and made them characteristic of this subclass, thereby preempting, to a large extent, the process of making connections between a general prohibition of abuse and particular instances thereof.

The general class of earnings retention abuses was further subdivided, but with less definition, within the section 531 context by special provisions appertaining to any "mere holding or investment company."[104]

Sections 533(a) and 535(c)(1) govern the residue, in effect, of what the legislature conceived to be potential abuses by means of earnings retention. It is not surprising that the process of judgment as to cases falling within the residual class has to be made without the aid of Congress, that is, without the help of vote-identified criteria of discrimination other than those of the most general kind.

According to the interpretation of section 533(a) set out previously in this paper, a Court is thereby required to decide whether a corporation has more money than it needs.[105]

One may indeed wonder whether such an issue lends itself to

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101 Int. Rev. Code of 1954, §§ 541-547. Section 532(b)(1) makes the accumulated earnings and personal holding company tax provisions mutually exclusive.

102 Int. Rev. Code of 1954, §§ 542(a)(2) and 544.

103 Int. Rev. Code of 1954, §§ 542(a)(1) and 543.

104 Int. Rev. Code of 1954, §§ 533(b) and 535(a)(3).

105 With qualifications (*e.g.*, section 316 dividend capacity and section 532(a) purpose) which do not significantly narrow the scope of the question.

reasoned judicial decision.[106] One may also question whether the social cost of requiring such decision is warranted when the issue is compared, for example, with those of anti-trust law. Nevertheless, it would appear that so long as the disparity between corporate and individual taxation is maintained there will be some point, however small, at which only individualized judgment can prevent corrosive leakage in the system.

This is not to say, however, that the policy favoring judgment according to generalizable principle is inapplicable at the point where judgment is highly individuated. In the 531 area there is surely a strong interest in the formation of reliable expectations, limitation on agency discretion, and motivating voluntary compliance with law. This is especially so because the 531 tax is a penalty, which should not be imposed without fair warning, and because an *in terrorem* impact of the penalty would conflict with government policy favoring small businesses.

Bardahl represents a praiseworthy effort in the direction of generalization. However, as the preceding sections of this article are meant to demonstrate, it both relies upon a great many implicit presuppositions and has within it a number of conceptual impurities. One response to the defects of *Bardahl* is to develop a style of operating-cycle analysis which will suit the experts. Another is to let the experts testify.[107] But as one follows out these responses, going in the direction of greater abstraction and generalization, one may find them less and less fitted to the task of reviewing managerial decision. While one disapproves of the many infirmities of the cases discussed in this paper, and approves the effort to work out a better operating-cycle formula, at the same time it is important to discourage the development of a concept of reasonableness not suited to the purpose of section 531. The success of *Bardahl* as a standard can be impaired not only because of any analytic defects within it, but also because of therapeutic responses which make it appear that the ultimately volitional activity of management must conform to purely analytic principles. The policies favoring private management of

106 H. Hart, Jr., and A. Sacks, *The Legal Process* (Harvard Law School: Tent. Ed., 1958) (mimeographed materials), 699.

107 As in Schenuit Rubber Co., 293 F. Supp. 280 (D. Md. 1968).

business, particularly of small informally managed businesses, give rise to a countergeneralization. That is, the policy favoring generalization must be tempered by a policy favoring reasonable decision on the basis of considerations of limited applicability. At the present time, the techniques of operating-cycle analysis found in the cases and commentaries are useful and should be particularly suggestive in the pre-trial stage of a 531 case. They are in a crude state and both permit and demand adaptation and refinement. If in the future, however, there is evolved a settled technique of analysis it will need to be accompanied by a caveat against its use as a means of upsetting a managerial decision which might be reasonable from some other perspective than that embodied in operating-cycle analysis.

APPENDIX

(Comparison of the results of the *Bardahl* and *Apollo* methods when applied to the same assumed facts.)

Assumptions:

Current Assets 1,600,000.
Current Liabilities 280,000.
Annual Net Sales 2,800,000.
Accounts Receivable 216,000.
Cost of Goods Sold (COGS) 1,035,000.
Other Operating Expenses, excluding Depreciation and Income Taxes, 1,470,000.
Average Inventories 580,000.
Average Receivables 216,000.

Applied to the above assumptions, there follows the method of *Bardahl Mfg.* and *Bardahl International:*

(1)	Current Assets	1,600,000	
(2)	Current Liabilities	—280,000	
(3)	Line 1 less line 2		1,320,000
(4)	Cost of Goods Sold	1,035,000	
(5)	Average Inventories	÷ 580,000	
(6)	Line 4 divided by line 5	1.78	
(7)	365 divided by line 6		205.05
(8)	Net Sales	2,800,000	
(9)	Average Receivables	÷ 216,000	
(10)	Line 8 divided by line 9	12.96	
(11)	365 divided by line 10		28.16
(12)	Line 7 plus line 11 (days in 1 cycle)		233.21
(13)	Line 12 divided by 365 (cycle as % of 1 year)		.639
(14)	Other Operating Expenses	1,470,000	
(15)	Cost of Goods Sold (line 4)	+ 1,035,000	
(16)	Total of lines 14 and 15		2,505,000
(17)	Line 16 times line 13		1,600,000
(18)	Line 3 less line 17 (excess of needs over Net Liquid Assets)		(280,695)

Applied to the same assumptions, there follows the method of *Apollo Industries:*

(1) Current Assets	1,600,000	
(2) Current Liabilities	— 280,000	
(3) Line 1 less line 2		1,320,000
(4) Cost of Goods Sold	1,035,000	
(5) Average Inventories	÷ 580,000	
(6) Line 4 divided by line 5	1.78	
(7) 365 divided by line 6		205.05
(8) Line 4 divided by 365		× 2,835.62
(9) Line 7 times line 8		581,444.00
(10) Accounts Receivable	216,000	
(11) Net Sales (2,800,000) divided by 365	÷ 7,671.23	
(12) Line 10 divided by line 11		28.16
(13) Other Operating expenses (1,470,000) divided by 365		× 4,027.40
(14) Line 12 times line 13		113,412.00
(15) Total of lines 9 and 14		694,856
(16) Line 3 less line 15		625,144

Summary: The *Bardahl* method results in total requirements for one operating cycle of $1,600,000; the *Apollo* method results in total requirements for one operating cycle of $694,856. The application of the *Bardhal* method indicates a shortage of net liquid Assets with respect to the needs of one operating cycle of $280,695; the *Apollo* method indicates a surplus of net liquid Assets with respect to the needs of one operating cycle of $625,144.

HOME OWNERSHIP FOR TENANTS: A PROGRAM TO USE TAX-FORECLOSED PROPERTIES

SHELDON L. SCHREIBERG*

Introduction

There has been much speculation recently about the desirability of home ownership for low-income persons.[1] Home ownership, it is claimed, offers an opportunity for personal dignity and self-respect, self-reliance, and stability. It provides the owner with a long term interest in both his building and his community.[2] Few studies have been made in this area. Nonetheless, undocumented observations indicate that, regardless of the character of a particular landlord, the slum market shares certain characteristics, including: a general feeling of alienation from property on the part of tenants, ineffective management, minimal maintenance, vandalism, general neighborhood deterioration and substantial landlord-tenant antagonism.[3]

Though the evidence is scanty, the desire for home ownership appears strong among low-income families. A poll run for the Boston Model Cities program indicated that 67% to 75% of the residents of the area earning less than $7,000 favored home owner-

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1 *See generally*, Butler, *Approach to Law and Moderate Income Home Ownership*, 22 RUTGERS L. REV. 67 (1967); Sengstock & Sengstock, *Homeownership: A Goal for All Americans*, 46 J. URBAN LAW 317 (1968); Comment, *Government Programs to Encourage Private Investment in Low Income Housing*, 81 HARV. L. REV. 1295 (1968); REPORT OF NATIONAL COMMISSION ON CIVIL DISORDERS 477 (1968); *Home Ownership*, 26 J. HOUSING 278-294 (1969); Davis, *Cooperative Self-Help Housing*, 32 LAW & CONTEMP. PROB. 409 (1967).

2 Quirk, Wein and Gomberg, *A Draft Program of Housing Reform—The Tenant Condominium*, 53 CORNELL L. REV. 361, 364 (1968) [hereinafter cited as Quirk]. Traditional formulations of this idea are also found in C. ABRAMS, MAN'S STRUGGLE FOR SHELTER IN AN URBANIZING WORLD 221 (1964) and in an address by President Herbert Hoover delivered at Constitution Hall, Washington, D.C., December 2, 1931, cited in C. ABRAMS, THE CITY IS THE FRONTIER 254 (1967).

3 U.S. OFFICE OF ECONOMIC OPPORTUNITY, COMMUNITY ACTION AND URBAN HOUSING 42 (1967) [hereinafter cited as OEO].

ship.[4] Moreover, comparison of the relationship between ownership and maintenance by an independent consulting firm disclosed that living conditions in a government housing project sharply improved after the project was converted to a low and middle-income cooperative.[5] In addition, George Sternlieb reports that his investigations revealed an inverse relationship between maintenance and the number of properties owned by a landlord.[6] Senator Percy, testifying on behalf of his home ownership proposal, stated that when he walked through the Bedford-Stuyvesant area in New York he found one block littered with junk and garbage; the next block was neat and attractive. He later learned that the first block was composed entirely of tenants while the second had 70% home ownership.[7] No more substantial evidence was offered at the hearings on the Percy Home Ownership Bill.

However, some workers on cooperative projects feel other factors must be considered in evaluating the effect of ownership on responsibility and maintenance. Nancy LeBlanc, a lawyer for Mobilization for Youth Legal Services, Inc. in New York, believes that a substantial sacrifice must be made by low-income persons before they have a "sense of ownership."[8] Krasnowiecki has noted that "ownership with its built-in complications of title, costs, credit references, foreclosures and so forth, is not designed to cater to those who are scourged by instability in income and family structure."[9] The New York City officials interviewed in

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4 2 HOUSING INNOVATIONS, INC., HOME OWNERSHIP PROPOSAL FOR THE BOSTON MODEL CITIES AREA, B-9 (1968) [hereinafter cited as HOUSING INNOVATIONS].

5 ORGANIZATION FOR SOCIAL AND TECHNICAL INNOVATION, INC., FINAL REPORT ON THE FEASIBILITY OF CREATING ORGANIZATIONS FOR THE MANAGEMENT AND/OR OWNERSHIP OF PUBLIC HOUSING (1969) [hereinafter cited as OSTI].

6 G. STERNLIEB, THE TENEMENT LANDLORD 175-177, 197-199 (1966), cited in REPORT OF THE PRESIDENT'S COMMITTEE ON URBAN HOUSING, A DECENT HOME 96-97 (1969) [hereinafter cited as KAISER COMMISSION]. The New York Housing and Redevelopment Board found a similar relationship but concluded that it was offset by the desire to keep properties debt-free and to avoid increased assessments. NEW YORK CITY HOUSING AND REDEVELOPMENT BOARD, A LARGE SCALE RESIDENTIAL REHABILITATION PROGRAM FOR NEW YORK CITY 29 (1969) [hereinafter cited as HRB Rep. No. 14].

7 *Hearings on the Housing and Urban Development Act of 1967 Before the Subcommittee on Housing of the House Committee on Banking and Currency*, 90th Cong., 1st Sess., pt. 1, at 201 (1967) (testimony of Senator Charles Percy).

8 Interview with Nancy LeBlanc, Associate Director, Mobilization for Youth Legal Services, New York City, February 27, 1969.

9 J. KRASNOWIECKI, CASES AND MATERIALS IN HOUSING AND URBAN DEVELOPMENT 244 (1969).

the course of writing this article generally agreed with the latter observation.

Despite these qualifications of the advantages of home ownership, the idea has the support both of low-income families and of a society imbued with the value of private ownership of property. This article will discuss the possibility of linking resident ownership with the ready supply of low-cost property obtained through the *in rem* process of tax foreclosures by the New York City government (hereinafter the City).

At present, New York City contains 10,000 to 15,000 abandoned buildings.[10] The City owns directly approximately 650 pieces of improved residential property, acquired in *in rem* foreclosure proceedings.[11] In time, more abandoned buildings will enter the *in rem* pool. Such buildings represent a loss both in housing supply and in tax revenue to the City. Thus far the City and outside landlords have been unable to deal with this property effectively.[12] A program of home ownership utilizing the foreclosure process and state and local programs available for rehabilitation of housing might be a step toward the solution of the problem, while bypassing the need for new legislation or for substantial capital investment in new housing.

I. The In Rem Process

A. *Foreclosure and the Taking of Title*

The New York City Administrative Code provides for a court proceeding resulting in foreclosure and the taking of title by the City if taxes, assessments, sewer or water charges remain unpaid

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10 Interview with Arthur Spiegel, Assistant to the Administrator, Housing and Development Administration (HDA), March 25, 1969.

11 Interview with Marvin Bogner, Public Relation Director of the New York City Real Estate Department, March 24, 1969. This estimate includes 456 multiple dwellings and about 200 one and two family dwellings. In addition, the City has foreclosed about 11,000 unimproved properties. Many of these are small pieces, useless for development.

12 It must be remembered that a substantial proportion of the *in rem* properties consist of old law tenements, designed to house a high density of immigrants and outlawed as obsolete in design and health and comfort standards in 1901. There are 43,000 such tenements in the City. Any rehabilitation on such buildings should be short run (ten to fifteen years). *See* Institute of Public Administration (IPA), Rapid Rehabilitation of Old Law Tenements 1 (1968). They will not be considered further in this study.

for four years.[13] The City then publicly auctions the property, thereby selling a fee simple absolute to the highest bidder.

Under the existing procedure, the City Director of Finance files with the appropriate county clerk a list of all parcels in the particular tax district of the City upon which assessments remain unpaid for four years. However, some properties may be excluded by the Board of Estimate if it finds that a meritorious question has been raised by an interested party or that payments of delinquent charges have been arranged to be made within two years.[14]

Notice and due process requirements are satisfied by a mailing to the last known owner and publication of a description of the property, the name of the last known owner, and the amount due in the City Record and two local newspapers within the county where the property is located at least once a week for six consecutive weeks.[15] Therein the Director of Finance sets a date at least seven weeks from the first publication as the last date for redemption. Defense of objections to the foreclosures must be served on the attorney for the tax district within 20 days of that date. "In the event of failure to redeem or answer by any person having the right . . . such person shall be forever barred and foreclosed of all his right, title, and interest and equity of redemption . . . and a judgment in foreclosure may be taken by default."[16] A deed given pursuant to a summary foreclosure judgment is presumptive evidence of proper proceedings. Two years after the date of the record of the deed, the presumption becomes conclusive evidence thereof.[17]

About 95% of the titles assumed are clear of equitable and legal claims when they are later disposed of by the City. The remainder generally fail because of an encroachment made by abutting

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13 NEW YORK, N.Y., ADMIN. CODE § D 17-1.0 to § D 17-25.0 (1963) [hereinafter cited as ADMIN. CODE]. In practice, it takes five to six years from the time taxes are due to the time that the City obtains title and control of the property. This process was upheld as not depriving taxpayers of property without due process of law in City of New York v. Feit, 200 Misc. 998, 110 N.Y.S.2d 425 (1951).

14 ADMIN. CODE, § D 17-5.0(2).

15 ADMIN. CODE, § D-7-6.0. The constitutionality of the notice provision was upheld in In Re Foreclosure of Tax Liens (Brooklyn), 131 (109) N.Y.L.J. (6-5-54) 11, col. 8 f.

16 ADMIN. CODE, § D-7-6.0.

17 ADMIN. CODE, § D-17-12.0(6).

owners over the years.[18] The properties so acquired are then either managed by the Real Estate Department (hereinafter the "Department") on behalf of the City or transferred to other municipal departments which make use of them. Residential properties are either demolished or rehabilitated to "liveable standards,"[19] depending on the existence of tenancy and the Department's evaluation of the buildings' worth.[20] The Department attempts to collect rents whenever possible.

B. *Sale at Public Auction*

Either after inspection or without inspection, and after routine circulation of a list of available properties among City departments, randomly selected parcels together with other surplus city properties are sold at public auctions conducted by the Department every two months.[21] Average attendance at these auctions is about 200. Though generally bidders are a diversified group, purchasers of deteriorated residential property are largely speculators.[22]

The sale is conducted in accordance with section 384(b) of the City Charter, which provides:

> Except as otherwise specifically provided by law, the Board of Estimate may sell or lease only for the highest marketable

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18 Interview with Saul Agulnek, City Law Department, March 24, 1969.

19 NEW YORK CITY REAL ESTATE DEPARTMENT, ANNUAL REPORT 17 (1967).

20 A few buildings are given to the Housing Authority for rehabilitation and subsequent use for public housing. Interview with Jacki Plumez, HDA, February 13, 1969. Such a scheme may be a simpler, preferable use to the home ownership scheme outlined in this article.

21 Interviews with New York City Real Estate Department Assistant Deputy Commissioner Golden and Chief of Sales Division John Hearn, June 1968. Hearn stated that if an individual expresses interest in a parcel, the Department can arrange to expedite its sale. Politics may also play an important role in the decision to make a building available for auction. For instance, the Real Great Society was successful in bidding for two buildings in East Harlem only after it bested the efforts of other groups interested in blocking the growth of their influence in the neighborhood. (I was also told that a person seeking to block the sale of a parcel can have it removed from the list of properties to be auctioned if he is properly connected).

22 Mr. Agulnek and Mr. Bogner expressed this view. Officials in the Boston Real Property and Law Departments agreed that speculators dominated their public sales. The New York City Real Estate Department maintains no summary records on who purchases its properties or of the ultimate use to which they are put. One can obtain the names of the purchasers of individual parcels from Mr. Agulnek.

> price or rental at public auction or by sealed bids and after advertisement for at least thirty days in the City Record."[23]

Properties are first offered at a minimum upset price equal to their assessed valuation, but if they are not sold, the Department routinely receives permission from the Board of Estimate to lower the minimum price.[24] In addition, the Board of Estimate has the power to determine any other terms of sale.[25] Such terms are vitally important considerations in determining the ability of a low income group to acquire and rehabilitate property with little or no increase in rents.

Naturally, the City strongly favors cash sales. Its standard credit terms, as set forth in each sales announcement,[26] are cash for sales of $5000 or less, 7% interest on outstanding balance and annual repayments equal to 12% of the mortgage amount. However, in February, 1968, the Board of Estimate approved the Department's request to improve the terms for one special sale.[27] The sale consisted of parcels that had been previously offered but for which there were no buyers. To increase the marketability of these parcels on the second go-around, the cash requirement was reduced to $1000, and the interest rate reduced to 5%, with payments to be extended over 20 years.

C. *Purchases by or for Low Income Groups*

Information on who buys what is available in summary form. Saul Agulnek, the City Law Department's assistant-in-charge of negotiating the closings in public sales, stated that in ten years he could recall only four instances of purchases of improved parcels by nonprofit groups; two of which were to religious organizations.[28] While the terms may be so stringent as to preclude nonprofit groups from bidding against the speculators in some instances, it is also possible that until recently low income groups

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23 NEW YORK, N.Y., CITY CHARTER §§ 39(16), 384 (1963).

24 Interview with Saul Agulnek, *supra* note 18.

25 This power is derived from the power to sell. Interviews with John Hearn, June 18, 1969, and Marvin Bogner, Feb. 14, 1969.

26 *See, e.g.*, N.Y. CITY DEPARTMENT OF REAL ESTATE, PUBLIC AUCTION 30 (January, 1969).

27 NEW YORK CITY DEPARTMENT OF REAL ESTATE, PUBLIC AUCTION 30 (February, 1968).

28 Interview with Saul Agulnek, *supra* note 18.

were not contemplating ownership of their own property. The Real Great Society (hereinafter, "RGS") and the 268 Ashland Street Corporation appear to be the only community groups to have obtained buildings from the City.

1. The Real Great Society

In 1967 in an acquistion financed by the Astor Foundation, RGS purchased two buildings containing roughly 20 units and some storefronts for $6700.[29] RGS plans to use the first two floors of each building for offices and community facilities and to renovate the upper three floors for residential purposes. Federal financing, particularly the "221(d)(3)" program,[30] was unavailable because of the multi-use aspect of the building. FHA was unwilling to insure a project in which more than 15% of the property would be put to non-residential uses. Negotiations have been completed for financing under the City's Municipal Loan program,[31] which has no such constraint. Another advantage of the Municipal Loan program is the absence of the prevailing wage requirements characteristic of federal construction programs under the Davis-Bacon Act. The program also permits the utilization of non-union labor — in this case, black and Puerto Rican contractors. On the other hand, the Municipal Loan program sets a maximum cost of rehabilitation of $8500 per unit while the extensive rehabilitation planned will run $12-$14,000. RGS is seeking private funds to meet this difference.

Although there is a feeling that resident ownership at some time would be desirable, there are at present no concrete plans to convert the building into a cooperative or condominium. RGS will own and operate the building but it will consult with the residents to whom it has pledged to keep rents below $80 per unit, about double their current level.

A plan to do a less extensive job remodeling was considered

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29 Some information was obtained during the summer of 1968 in meetings with William Watman, Angelo Giordani and Robert Rivera of the RGS staff. It was verified and updated in an interview with Richard Rinsler, an RGS lawyer, on April 14, 1969.

30 12 U.S.C. § 1715 (1964). For a discussion of the 221(d)(3) program, *see* Note, *Government Housing Assistance to the Poor*, 76 YALE L.J. 508 (1967).

31 *See* discussion of municipal loans *infra* at 95.

but dropped for two reasons. First, it would interfere with plans for reconditioning the downstairs commercial space. Second, the residents voted for the most expensive plan. The residents' vote is neither surprising nor an absolute rejection of minimal work. The residents chose the alternative which maximizes their benefits while imposing little addition cost. Self-help is not envisioned. More than half of the tenants will have their rents paid by the Welfare Department anyway.

In short, while the RGS experience to date is not a prototype of what is proposed herein, it is the only example of what a community group has done with an *in rem* building. RGS is also studying and making cost estimates for a minimal rehabilitation program at the level outlined above or perhaps slightly below — $4000 to $5000 per unit.

2. 268 Ashland Place Corporation[32]

The 268 Ashland Place Corporation purchased a 20 unit building with an assessed valuation of $20,000 for $2600 at public auction on March 18, 1969. 268 Ashland Place Corporation, an offshoot of the Bedford-Stuyvesant Restoration Corporation, financed its purchase with Office of Economic Opportunity funds previously granted to the parent corporation as part of a larger rehabilitation and training program. Neither the ultimate ownership format of the building nor the rehabilitation-financing mechanism has been determined. The parent corporation, which had earlier purchased and completely renovated two duplexes foreclosed by the FHA, presently plans to acquire more properties from private owners, the City, or the FHA. The earlier projects were financed out of a mortgage pool assembled by metropolitan banks and constructed by local personnel at a cost of $15,000-$20,000 per unit.

The subsequent history of this plan indicates some of the difficulty in moving such a program through the City bureaucracy. In late July, 1969, notwithstanding his own pessimism, Otto Bonaparte was selecting and appraising buildings suitable for negotiated sales to Housing Development Companies to be established by

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32 Interview with Ronald Huntley, Attorney for the Corporation, April 3, 1969.

the Community Corporations and the Bedford-Stuyvesant Restoration Corporation, pursuant to Private Housing Finance Law Article XI.[33] Bonaparte was not sure of his authority to lower the sales price, and he expected harassment from speculators interested in purchasing these properties. Moreover, in addition to commonplace inertia and lack of interest on the part of the City, opposition to the sales was also forthcoming from the local Model Cities committee, an unlikely source, which is resentful of the Restoration Corporation's growth in this area.[34] Presently, however, negotiations are underway for the sale of four "new law" buildings on East 130th Street to the Community Association of East Harlem Triangle, a community action and church group organization under Article XI of the Private Housing Financing Law.[35]

II. Alternatives to the In Rem Process

The existing disposal policy does not facilitate the distribution of properties to low-income groups. The City is reluctant to place restrictions on bids or to rely on negotiated sales which bypass the auction and competitive bidding.[36] Such reluctance has its roots in immediate past history. In 1965 the City attempted to restrict bids to nonprofit corporations and to limit the use of such property to educational and religious purposes. However, in *Tarshis v. City of New York*,[37] a New York Supreme Court struck down a sale to a synagogue as a violation of section 384(b) of the New York City Charter which provides that the Board of Estimate can sell or lease property only for the "highest marketable price."[38] The opinion is not clearly reasoned and fails to define the scope of permissible restrictions. The uncertainty thus created encourages

33 See discussion of Article XI on p. 76.

34 Interview with Jacki Plumez, HDA, March 25, 1969.

35 Interview with Fran Levenson, HDA, April 7, 1969.

36 Interview with John Hearn, Chief of the Sales Division, Real Estate Department, June 18, 1968. Mr. Hearn was unreceptive to the attempted use of such exceptions in any case. He felt that the only way that nonprofit sponsors could be favored was by the goodwill of other bidders who might stand aside when such an organization is interested in a particular parcel.

37 24 App. Div. 2d 644, 262 N.Y.S.2d 538 (1965); *modified*, 24 App. Div. 2d 723 263 N.Y.S.2d 307 (1965); *aff'd*, 17 N.Y. 2d 451, 266 N.Y.S.2d 811, 213 N.E.2d 890 (1965).

38 New York, N.Y. City Charter § 39(16), 384(b) (1963).

a search for alternative methods. Of the possible methods, the Private Housing Finance Law (Article XI) and the use of Housing Development Fund Companies seem most promising.

A. *Private Housing Finance Law (Article XI)*

In response to the *Tarshis* decision, the 1967 state legislature enacted Article XI to give the City the power to transfer property it already owns, without public auction or sealed bids, to housing development companies and to acquire property on their behalf.[39] The Article's purpose is to assist charitable institutions and other nonprofit institutions in building or rehabilitating housing for low-income families and to provide temporary financial assistance for organizing and managing housing projects.[40] Such Housing Development Companies can be incorporated under the General Business Corporation law, the State Membership Corporation law, or as a limited-profit housing company (Mitchell-Lama).[41] The last-mentioned method, which is generally employed by nonprofit institutions, requires the organization to be formed exclusively for the purpose of developing a low-income housing project. The use restrictions sought in *Tarshis,* are both permitted and enforceable under a covenant in the deed.[42]

Under the Article, the state provides loans or advances from a housing development fund. Once a loan is made, the State Commissioner of Housing has the power to appoint a majority of the Board of Directors of such a company and to place certain rent qualifications on the property if he determines that the loan or advance is in jeopardy.[43]

At present, the revolving fund has a ten million dollar authorization. But no money has been allocated for rehabilitation, though such projects are expressly included in the statement of legislative findings and purposes.[44] In any event, the temporary loan is repayable as soon as permanent state, federal or local financing

39 N.Y. PRIVATE HOUSING FINANCE LAW, Art. IX. § 570 ff. (McKinney Supp. 1968).
40 *Id.* § 571.
41 *Id.* § 573.
42 *Id.* § 576(a)(3); interview with Lloyd Deutsch, lawyer, HDA, March 25, 1965.
43 *Id.* § 573(a)(3).
44 Information on the status of the fund and applicability to this program from interviews with Calvin M. Spivak, Housing Development Fund Coordinator, and Maurice Kreiner, legal associate, July 24-25, 1968.

is obtained. The principal value of the law is not so much the financial aid it gives, which is relatively insignificant, but rather the power given to the City to dispose of its property without public auction or public bidding.

B. *General Municipal Law, Section 507*[45]

Section 507 permits the City, acting through the Housing Development Administration, to bypass the public auction procedure when disposing of property located in urban renewal areas where much of the *in rem* property is located.[46] Such a disposition may be made to a qualified sponsor designated by the appropriate local public agency, including non-profit organizations which apply for assistance under Article XI of the Private Housing Finance Law.[47] A proposed sponsor must match any bid higher than a minimum fixed for him by the renewal agency.[48] However, this section would not be applicable to all properties that should be included under the proposal.

C. *Membership Corporation Law (Article XIX)*

Pursuant to Article XIX, the local legislative body, or Board of Estimate, where one exists, may determine that the real property it owns be sold or leased to a local development corporation, without appraisal or public bidding, at a price or rental as may be agreed upon between the City and the local development corporation.[49] In cities of over 1,000,000 population (i.e. New York) the sale must be approved by a majority of the borough improvement board.[50] However, under section 384(b) of the New York City Charter, property may only be leased by the Board of Estimate.[51] This limiting provision, combined with the fact that local development corporations are designed primarily to increase em-

45 N.Y. GEN. MUN. LAW, §§ 506, 507 (McKinney, 1962).

46 Although no definite information is available, a preliminary mapping of *in rem* property begun in March 1969 by HDA indicates that 90% of these properties are in Urban Renewal or Model Cities areas. One would expect a high figure since it is in these areas that property is most depressed.

47 N.Y. GEN. MUN. LAW, § 507(2).

48 *Id.* § 507(2)(c)(3).

49 N.Y. MEMBERSHIP CORP. LAW, Art. XIX, § 230 ff. (McKinney, 1962).

50 *Id.* § 231(a)(2).

51 Amended by Laws of 1967, ch. 757.

ployment and industrial possibilities, make its employment in the implementation of a tenant ownership program doubtful.[52]

Thus, the Private Housing Finance Law provides the most general and attractive alternative for circumventing the *in rem* process. However, to date few funds have been provided for such a purpose.

III. To Whom, How Many, and In What Condition?

If the City chooses to exercise its power to negotiate sales of *in rem* property, the questions of organizing ownership must be faced. There are three basic problems here. First, to whom should the City transfer the property? Idealism must be balanced with realism so it would be best to consider the long range goals through the perspective of immediate tools. Second, how large should the individual groups be? The number of buildings that each aggregate controls points to a basic tension between economy of size and personal involvement from below. Perhaps the best solution would be two-stage control with an umbrella corporation for a whole neighborhood and smaller clusters of power and responsibility in each building. A certain fluidity of structure could allow the small clusters of power to grow into full ownership. The third consideration is the condition of the buildings when they are transferred. How much of the burden of rehabilitation can be placed on the tenants of the building? If the property is immediately transferred to them, their responsibility will last longer and will be greater. A careful allocation of responsibility must be made to prevent the demoralization of the tenants who could come to see the benefits of the plan hopelessly postponed.

There are many degrees of rehabilitation; the cost can run from $2,000 to $15,000 per unit.[53] Extensive renovation requires outside

52 Section 230 which sets forth the purposes of this Article reads as follows:
"Operated for the exclusively charitable or public purposes of relieving and reducing unemployment, prompting and providing for additional and maximum employment, bettering and maintaining job opportunities, instructing or training." It also mentions research to attract new industry, the development or retention of industry in the community or area, lessening the burdens of government, and acting in the public interest.

53 It should be noted that the LENA project discussed below is concerned with a more modest refurbishing effort based upon a cost of $400 per unit. Thus, it may be possible to begin with more modest efforts at a lower cost.

contractors and advisors, resulting in high costs which in turn create a pressure for higher rents. In weighing the merits of the programs along this spectrum, the idea of the "alienated" tenant should be considered. The theory is that slum dwellers regard their environment as hostile and tend to lose all respect for it. As long as they consider their landlord to be an antagonist, they will use little care to keep his property in good condition. If they owned their own property or at least had some control over its management, this alienation would be greatly reduced. The planner should always keep in mind that he is dealing with a human problem as well as one of construction. A less ambitious plan that allowed planning on the grass roots may go further in restoring dignity than one imposed from the top that looks better to the middle-class liberal.

A. *Tenant Experience in Controlling Buildings*

Is is helpful at the outset to explore what little experience exists with regard to tenant initiative and low-income ownership programs. There appears to be no successful experience in New York City or elsewhere with low-income home ownership programs undertaken in rehabilitated multiple dwellings. However, programs have been conducted through nonprofit intermediaries concerned almost exclusively with single family dwellings. Many of these have included "sweat equity" inputs.[54] However, this approach has not been successfully attempted on a group basis. This phenomenon is probably attributable to the difficulty of organizing such projects, the negative experience in efforts requiring less commitment, and to a lesser extent a lack of adequate financial assistance.[55]

The discussion will concentrate on tenant experience in controlling buildings short of ownership, including tenant unions and tenant management arrangements in both public and privately owned buildings.[56]

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54 *See* discussion of present programs, III, *infra.*

55 The 1968 Housing Act includes several provisions relating to home ownership which will be discussed below at pp. 88-91 *infra.* However, at present, none of them have been adequately funded.

56 Omitted is discussion of tenant advisory councils which are now common in large projects and concern themselves with matters such as party rooms and laundry

1. Tenant Unions

A tenant union is an organization of tenants formed to bargain collectively with landlords for agreements defining the parties' mutual rights and obligations.[57] At present there are few examples of successful tenant unions which have had more than ephemeral existences.[58] More characteristic are short term rent strikes of the type led by Jesse Gray in New York. Such strikes do not, however, form the basis for lasting organizations of the type necessary to build groups able to participate in home ownership. The basic dilemma is that a tenant union loses support if it fails and is undercut by the very factors that created its original cohesion when it succeeds.

2. Tenant Management

There has been little successful tenant management experience in either large public projects or smaller dwellings. What evidence there is indicates that considerable effort and substantial training will be necessary before tenant groups could assume full management responsibility.[59] This is not to say, however, that it would be impossible for them to assume ultimate decision-making control over the condition of their property immediately, but only that experience thus far is not encouraging.

The Organization for Social and Technical Innovation, Inc. (OSTI), a Cambridge-based research firm, was retained by the Office of Economic Opportunity to investigate the feasibility of tenant management and/or ownership in public housing projects of 500 to 1250 units.[60] The firm examined tenant involvement in four projects in Baltimore and Cleveland. Its findings illustrate

machines, but whose responsibility and power is as yet minimal. Michael Mazer, Chief of the OEO housing division has described them as "company unions."

57 Most of the discussion of tenant unions is based upon Davis and Schwartz, *Tenants Unions: An Experiment in Private Law-Making*, 2 HARV. CIV. RIGHTS—CIV. LIB. L. REV. 237 (1967).

58 Such organizations have been in existence for short periods on the Lower East Side of New York and the South End of Boston. Many tenant organizations and strikes on the Lower East Side are not "grass roots," but led by coordinating groups of outside professionals. They have had little long term significance. After landlords met initial demands, most tenants were satisfied and bypassed further activity. Interview with Nancy LeBlanc, *supra* note 8.

59 *See* Note, *The Michigan Tenants Rights Statute*, 6 HARV. J. LEGIS. 563 (1969).

60 OSTI, *supra* note 5.

the paucity of experience in large projects. Activity was confined to social matters, laundry rooms, agitation for street lighting and one-way streets.[61] The report describes tenants' efforts to persuade the local housing authority to give them a voice in choosing a project manager as "great initiative," but concludes that the job ahead is tremendous.[62]

On occasion, the Real Estate Department of New York has turned over management responsibilities to tenant associations.[63] This was done by leasing property to the associates for one dollar per year. The lessees were responsible for collection and maintenance of *in rem* and other surplus property, but were free to attempt to operate on a profit-making basis and retain any profits. The experiments failed because the new managers were unable to raise funds to make the improvements necessary to maintain the buildings in a livable condition. The City then took possession, made the repairs and operated the buildings at a bookkeeping loss. In St. Louis, the public housing authority there turned over management responsibility to a tenant council. This experiment failed because the new managers demanded high performance standards from other tenants and encountered a general lack of cooperation.[64]

In Detroit, a landlord agreed to contract management responsibility of his property to a tenant union following a rent strike against a number of his buildings. The plan provided for the union to collect rents, to do necessary maintenance, and to turn over a percentage of the remaining funds.[65] A purchase option was also included. The contract covered 17 dilapidated but structurally sound buildings containing 900 units. Management responsibility for these properties was shifted almost overnight to the leaders of the tenant union — four inexperienced blacks employed in low and middle level civil service positions. Within three or four months, the contract proved unmanageable, building conditions

61 *Id.* at 63-68.

62 *Id.* at 67.

63 Interview with Otto Bonaparte, General Counsel, New York City Real Estate Department, July 1968.

64 Interview with Harold Bell, Director, Columbia University Urban Action and Experimentation Center, July 1968.

65 Interview with Fred Fecheimer, lawyer for the United Tenants for Collective Action, April 3, 1969.

declined further and rents were withheld. The purchase option has been exercised, however, in nine of the buildings comprising 300 units.[66] In theory, the properties will become part of one large cooperative with rehabilitation and acquisition costs of about $13,500 per unit financed under the new section 236 of the National Housing Act.[67] In practice, however, it will be the leaders of the tenant union who will be responsible for the project. Thus there is no certainty of success.

In sum, the two most important reasons for the failure of the management arrangement seem to be (1) lack of experienced managers and (2) lack of capital for maintenance and improvements, problems which will have to be overcome if the tenant management program is to prove viable.

3. Mobilization for Youth[68]

Mobilization for Youth (MFY), operating through a legally independent nonprofit housing corporation, is the sponsor-landlord of a renovated 13-family tenement on the Lower East Side of New York. Eventually, MFY intends to turn the building over to its tenants. A medium for cooperative activity now exists in the form of Tenants United, a group comprised of the building's residents. This group has a written agreement with MFY which gives the tenants certain powers in the management of the property, including control over the day to day operation of the building through the superintendent, veto over the selection and retention of a management firm and the right to recommend budget changes.[69]

The housing corporation's board is comprised of three representatives of local churches, three from MFY, and one from Tenants United. The immediate objective is to reduce institutional control and increase tenant representation in the corporation. However, Peter Abeles, ex-director of the project, believes that the level of authority now exercised by Tenants United is the

66 *Id.*

67 12 U.S.C.A. § 1715z-1 (1969).

68 Mobilization for Youth is a community action organization in New York City. The building discussed is located at 277 East 4th St. Information on the project is derived largely from MFY, PROPOSAL FOR A PROGRAM OF MAJOR URBAN COOPERATION DEVELOPMENT IN NEW YORK CITY'S LOWER EAST SIDE (undated) (copy in author's possession).

69 Interview with Nancy LeBlanc, *supra* note 8.

most one can expect residents to handle without extensive and costly community organization efforts.[70] In the year since the completion of the building, there has been little change in attitude toward common property but substantial improvements have been made in many units.[71]

MFY's building was stripped clean when purchased and was rebuilt to the best standards, including new interior walls, tile bathrooms, metal doors and gates, marble stair treads, new windows, frames, high quality appliances, a new fire escape and new heating, water and electrical systems. About 25% of the work was done by untrained youths under skilled supervision. However, to meet FHA requirements of quality standards and prevailing wages and to salvage the project, the youths were replaced with skilled workmen. Construction costs for rehabilitation are very high — $15,000 per unit — attributable in part to the experimentation with unskilled labor and in part to the small number of units which prohibits economies of scale. MFY received a Ford Foundation grant to cover part of the construction expenses, and the rest was met with a 221(d)(3) insured loan. To meet the interest charges on this loan and to provide operating capital, there has been heavy pressure for rent increases which has forced rents up as high as $148 for a two or three bedroom apartment.[72] Rent subsidies and larger welfare allowances are used to allow low income families to live in the units.

MFY's extensive effort illustrates a possible organizational mechanism comprised of an existing community group plus tenants, and the difficulty of obtaining cooperation even with the promise of eventual control.

4. Samuel Trayman and LENA[73]

An interesting example of split control between a property owner and his tenants comes from the actions of Mr. Samuel Trayman, who decided to employ the efforts of his tenants in

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70 Interview with Peter Abeles, Architect and Director of project, July 1968.

71 Interview with Nancy LeBlanc, *supra* note 8. The internal improvements may have nothing to do with the prospect of ownership, but stem simply from a desire to live in better conditions even as tenants.

72 This paragraph is derived from interview with Peter Abeles, *supra* note 70.

73 *See* R. Weinreb, A Cost-Benefit Analysis of Three Rehabilitation Projects (mimeo) (January 1968) (copy in author's possession) for a discussion of the project.

the rehabilitation of his building, a pre-old law tenement with ten units. Trayman encouraged his tenants to decide what they wanted done, to clear their projects with him, and to use their own labor. Material costs were covered through rent credits. Trayman also provided materials and hired tenants and other local people who were skilled repairmen to work on the common areas of the building. These improvements were paid for in cash.

LENA, the Lower East Side Neighborhood Association, has tried to get other landlords to follow Trayman's example. They have generated some interest, because the project costs have been very low because of the modest goals — about $400 per unit out-of-pocket.[74] Rehabilitation has been done according to the standards desired by the particular occupant. This has usually involved a new stove, refrigerator and combination sink, separate enclosed bathrooms, and repaired walls. Many units have new windows and frames and a few have fireproof doors. The major expense has been labor, which has been paid for through rent credits. The owner has only to absorb the operating deficit on the property with his own capital while the credits are being used up.

A recent inspection by the Building Department did not find any code violations. There were minor cracks in the walls and a few weak boards, but all stairs and exterior walls were in good condition. Plumbing is old, and pipes are cracked; periodic replacements will be necessary for these items, although the tenants have not complained about the plumbing. Continual repairs on other parts of the building systems will be necessary. Despite these difficulties the units are sound, clean, and apparently functioning. Rents run about $60 a month per two bedroom apartment. In both its costs and participation aspects this project may be the optimal model for treatment of the *in rem* properties.

5. Office of Economic Opportunity — Housing Corporation

The Office of Economic Opportunity's Community Action Program has been experimenting with a number of forms of nonprofit housing development corporations in an effort to find the most effective way of building homes and providing counseling and

74 *Id.*

assistance in working with other federal programs.[75] These corporations, which have been formed at state, metropolitan, city, and neighborhood levels, bring together lawyers, architects, real estate and construction specialists necessary for the development of low income housing. They have the power to build, rehabilitate, lease, or sell. A statewide corporation in North Carolina is the most successful both in terms of units built and the development of working arrangements with local FHA offices.[76] Metropolitan and city-wide corporations have been funded in Philadelphia, Washington, D.C., Seattle, Denver, and Baltimore. The theory behind the neighborhood corporations funded in St. Louis and Cleveland is that they are better able to develop effective roots and understand the problems of a given area than an organization with a larger geographical scope.[77]

In Philadelphia, the Philadelphia Housing Development Corporation (PHC), a delegate agency of the Community Action Agency, has received administrative support from OEO and a two million dollar capital fund from the City.[78] It has concentrated on rehabilitating houses in the North Central Philadelphia area. The present program in Philadelphia grew out of an earlier effort by the Philadelphia Housing Authority (PHA) to supplement its regular low rent project development with scattered site housing. At the same time that PHA was seeking a more effective method of operation, the Philadelphia City Council set up the PHDC to purchase vacant properties, rehabilitate them, and sell them to residents in the city's blighted areas.[79]

As a result of an agreement with PHA, PHDC has taken on a "landbank" function. Properties acquired through tax default are turned over to PHDC, who puts them into its "landbank." Properties in the bank are held for various purposes. Some are released to neighborhood housing corporations; others may be turned over to the Board of Education for a new school or play-

75 For a general discussion of OEO's involvement in housing, *see* OEO, *supra* note 3.

76 Interview with Michael Mazer, Chief, OEO Housing Division, March 20, 1969.

77 An evaluation of all the OEO-funded housing development corporations is now being completed by Urban America, Inc. of Washington, D.C.

78 Information on the P.H.D.C. is from Fielding, *Philadelphia*, 24 J. HOUSING, 221 (1967) and an interview with Dan Winchell, P.H.D.C. staff, March 25, 1969.

79 Fielding, *supra* note 78, at 222.

ground. In effect, PHDC has taken on the responsibilities carried on by the *In Rem* Division of the New York City Real Estate Department. PHDC has acquired much of its property from the city at no cost. This property has been acquired by the city through *in rem* proceedings for non-payment of taxes similar to those in New York. Often these houses are little more than vacant shells that the city could sell for very little. By turning them over to PHDC, the city can hope for substantial social improvement at a minimal cost to itself. Other houses are donated by owners who can no longer find tenants for them and who are happy to relieve themselves of the tax burden. PHDC does purchase some of its buildings and is willing to pay up to $1,200 for a vacant lot or an owner occupied dwelling.[80]

As a result of lower acquisition cost, PHDC has been able to offer completely rehabilitated, two-story, three bedroom houses with two baths for $7,500 to $8,500. As of March, 1969, it had sold about 200 homes, financed under the FHA 221(d)(2) and 221(h) programs.[81] Its buildings are far more than minimum shelter, providing such features as hardwood floors, fully equipped kitchens with built-in cabinets, and chandeliers in living rooms. However, several studies cited in this article[82] indicate that this

80 *Id.* at 225.

81 Interview with Dan Winchell, *supra* note 78.

82 It is extremely difficult to locate and analyze cost figures for rehabilitation projects. During interviews and in printed reports, figures were loosely used. Sometimes people are speaking only of "brick and mortar," *i.e.*, construction costs. Acquisition costs, organizational expenses and insurance fees may or may not be included, and their inclusion or absence may not be specified. The most useful guide for comparing alternative methods might be costs per usable square foot, but it is rarely used.

The figures cited for minimal and moderate rehabilitation are from HRB Rep. No. 14, *supra* note 6, table 2, at 11. For gut rehabilitation, a figure of $15,000 may be used, because it was confidently offered by several persons and is not incompatible with a number of estimates that have been published.

Included below are estimates of various well known extensive rehabilitation projects, excluding acquisition cost. Because of the different methods of computation possible, sometimes estimates for the same project will differ.

Rapid Rehabilitation	(East 5th St.)	$22,300 a
Conventional Rehabilitation	(West 114th St.)	8,725 b
Conventional Rehabilitation		10,000 c
Model C	(old law walkup)	6,500 d
Model D	(old law walkup)	7,600 e
U.S. Gypsum	(East 102d St.)	7,870 f
Row		13,636 g
Walkup		8,201 h
Arthur Spiegel		15-20,000 i

level of rehabilitation would cost roughly twice as much in New York City.

An important aspect of the Philadelphia program which distinguishes it from other rehabilitation-ownership projects is that low income persons are given little voice in building design, nor are they expected or encouraged to contribute labor. Furthermore, attempts to assist local contractors are minimal.[83] When the buildings are completed, low income families select from the available stock. All self-help efforts are felt to be unnecessarily expensive, complicated, and time consuming.

6. The Philadelphia Interracial Council of the Clergy

The Interfaith Interracial Council of the Clergy (IICC) is a private social services organization formed in August, 1964, as a response to the riots that summer in Philadelphia. Its home ownership program was separately incorporated as an independent branch in March, 1967.[84]

IICC is able to purchase deteriorated but structurally sound brick row houses at low cost. It guts these shells, replacing pipes and rearranging floor patterns. A group of houses is purchased in a particular neighborhood and rehabilitated in packages of seven, which take about twelve weeks to complete. As of March, 1968, home owners were living in twelve finished houses. Forty additional houses were in the process of rehabilitation and another 150 were in the negotiation stage.[85] First priority is given to families presently living in the neighborhood, regardless of in-

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a. IPA *supra* note 12, at 38.
b. HRB Rep. No. 14, *supra* note 6, at 39.
c. Joint Center for Urban Studies, Rehabilitating New York's Old Law Tenements (Preliminary Interim Report 23, 1967) [hereinafter cited as Jt. Center].
d. HRB Rep. No. 14, at 12.
e. *Id.*
f. Engineering News Record, Sept. 21, 1967, at 64.
g. KAISER COMMISSION, *supra* note 6 at 101.
h. *Id.*
i. Interview with Mr. Spiegel, March 25, 1969.

83 Interview with Dan Winchell, *supra* note 78. Opinion among interviewees was almost universal that rehabilitation projects involving anything more than minimal repairs will be more expensive, if not impossible, with inexperienced families.

84 The information on this program is taken from Newman, Home Ownership for Low Income People 38-42 (unpublished M.I.T. master's thesis in city planning 1968).

85 *Id.* at 40.

come. To date, all of the home owners have been from the same block.

Each contractor hired by IICC to do rehabilitation work signs an agreement to hire and train a certain number of local unskilled men (usually five) to work on that property. Under a $30,000 grant from the Department of Labor the contractor is paid up to $300 per house for any losses caused by the trainees. According to IICC, the program has been well received by the contractors, who face a labor shortage, and by the unions. As of June, 1968, 42 men had gone through the program and were employed by private construction industry.

Funding is provided by an $84,000 grant from the Economic Development Administration and a $30,000 job trainee grant from the Department of Labor. Working capital is borrowed commercially. No "sweat equity" is required, but a down payment of $200 to $700 is required for 221(h) mortgages, depending on what a family can afford, and a 3% down payment plus closing expenses under the 221(d)(2) mortgage program.[86] The incomes of the families served have ranged from $3000 to $8400. The prices for the homes have ranged from $8000 to $11,000. Thus, on a $10,000 221(d)(2) 30 year mortgage, the home owner pays $72 monthly as opposed to $54 monthly under the 221(h) program.

This program has been relatively successful given its short life. Indeed, the directors of IICC have incorporated a national organization to promote home ownership for low-income families, the National Interfaith Council for Housing and Employment (NICHE). NICHE has started a similar project in Camden, New Jersey.

7. The Bicentennial Civic Improvement Corporation

The Bicentennial Civic Improvement Corporation (BCIC) is a private non-profit corporation in St. Louis, Missouri, formed both to help low-income black families to buy their own homes and to upgrade a nine block slum area.[87] It began informally in

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86 *Id.* at 39.

87 Information on this project from Mazer and Granat, *St. Louis*, 24 J. HOUSING, 200 (1967) [hereinafter cited as St. Louis] and HOUSING INNOVATIONS, *supra* note 4 at B62-67. The articles are virtually identical in their content.

1963 through the efforts of a parish priest to help families who were being evicted from a public housing project because of an increase in their income, to buy rehabilitated housing. It was formally incorporated in 1964 when it became clear that a more systematic effort would be necessary to solve this problem. Since then, it has been involved in both housing rehabilitation and provision of community services. BCIC has received $100,000 from local business and $100,000 in an OEO demonstration grant.

Rehabilitation has been limited to a nine block area of family, semi-detached and row houses. The houses are structurally sound but need complete overhauling inside. Because of the high vacancy rate in the area, BCIC has been able to buy them from the absentee owners for approximately $1500 per structure. Improvements cost about $5000 per building so that the average cost per house is about $6500. The total cost to the home owner is approximately $6000-$7000 on conventional mortgages.[88] No down payment is required and the typical monthly payment is $55-$72 per apartment.[89] The area includes about 308 dwelling units. By June, 1968 BCIC had purchased and resold about 75 of these units to families whose incomes ranged from $2500 to $8000.[90]

Initially, the houses were financed through a local savings and loan association and a downtown bank. The savings and loan association provided the maximum permissible 80% mortgage, and in order to create a 100% loan, BCIC has deposited the remaining 20% which it borrowed from the bank. The deposit is returned to BCIC after 20% of the mortgage is paid off by the home owner, a period of six to seven years. This financing device has in effect provided poor people with 100% financing.[91] More recently, BCIC has taken advantage of the FHA 221(h) program, proposed by St. Louis Congresswoman Lenore Sullivan, which makes available 100% below-market-interest-rate mortgages (3%, 20 years) to nonprofit groups that rehabilitate homes and sell them to poor people.

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88 Newman, *supra* note 84, at 34.

89 *Id.*

90 *Id.* at 33.

91 Housing Innovations, Inc., in Roxbury, uses a similar interest earning blocked deposit arrangement with funds it has borrowed from the John Hancock Insurance Co.

However, houses rehabilitated under 221(h) have tended to cost more because of stricter FHA standards.[92]

BCIC has been successful in achieving its goals. In large measure its success is attributable to low acquisition and rehabilitation costs. As stated above, in the BCIC experience, acquisition costs for single family units have averaged $1,500 a building. In addition, gutting has not been necessary. BCIC has also been fortunate in having a man with construction experience as its program director. BCIC has thus been able to serve as its own general contractor.

BCIC has maintained careful records about home improvement and care on the part of the new owners and information at the end of 1967 indicated a "concerned and conserving attitude toward property." No property had been lost by default, although a few houses had changed hands. The selection process for homeowners has been fairly rigorous. In addition, a trial period of home ownership has been initiated. The last 25 houses have been rented for a year so that the family and the BCIC have an opportunity to evaluate the relationship.[93] Although very poor persons have been admitted, families have had to place $250 in a BCIC credit union to cover closing costs before their application could be accepted. In some instances agreements were made with employers to deposit pay checks directly to the credit union. Finally, BCIC mobilized an impressive amount of volunteer time and effort of the same sort as New York City would probably be able to obtain. In addition to individual assistance, religious, college, and womens' groups have provided volunteer help.

8. Flanner House Homes[94]

Flanner House Homes, Inc., in Indianapolis, Indiana, a nonprofit corporation, built 366 houses in the period 1950 to 1965 and sold them to black families with incomes averaging $4200 to

92 Newman reports that cost of rehabilitation under the 221(h) program is $8000 per dwelling compared to $6000-$7000 per dwelling under 221(d)(2). However, the monthly payments under 221(h) with a 3% interest rate and 221(d)(2) with a 6% interest rate is only $4 per month. Thus the difference is not readily distinguishable to the new owners. Newman, *supra* note 84, at 34.

93 *Id.* at 35.

94 Information on this project from HOUSING INNOVATIONS, *supra* note 4, at B-27-29, and Newman, *supra* note 84, at 42-44.

$4500 per year. The homes were actually constructed in part by their future owners; jobs requiring technical knowledge, such as plumbing, heating and cabinet-making, were contracted out to professionals. The "sweat equity" provided by the owners equalled from 25% to 39% of the total value of the house. Thus a mortgage of only about $9000 was required on a house worth $14,000. Each man spent a minimum of 20 hours per week during evenings and weekends working on his home. "Sweat equity" was calculated at prevailing wage rates for the work being done. Thus monthly payments were reduced to approximately $65-$90.

Prospective owners worked under an agreement negotiated with the Indianapolis Building Trades Council. All of the men went through a training period of one week during which they learned the basics of construction and the corporation decided whether to accept the man. The lumber to be used in the houses was pre-cut and the walls were pre-assembled. The men worked in groups on fifteen to thirty houses at a time. No one moved into his house until all of the houses in that package were completed. The houses usually took from nine to eighteen months to complete.

A donated revolving fund of $200,000 provided the money to buy materials and to pay the professional contractors. When a house was finished the owner obtained a conventional mortgage, usually at 4.5% to 5.5% interest, from a cooperating bank. The mortgage was used to pay the corporation the total value of the house plus a corporate fee minus the calculated value of the "sweat equity." Thus most of the revolving fund remained when the project was ended in 1965.

Flanner House Homes proved that attractive subdivisions could be created for low income families in former ghetto areas. However, it is unlikely that this kind of project would work in central city areas where the initial cost of land is prohibitive. Flanner Homes discontinued operations because the cost of land and money made it impossible to continue the project without a government subsidy. Thus far money on a large scale has not been forthcoming.

9. Better Rochester Living, Inc.

Better Rochester Living, Inc. (BRL) is a private non-profit organization which helps low-income families to find homes any-

where in the Rochester area.[95] It was incorporated in June, 1964, under Mr. Welton Myers, a former farmer and building contractor. Myers had collected donations of $45,000 from private sources, obtained a commitment from local commercial banks to loan working capital to BRL, and persuaded savings banks in the area to form a mortgage pool which would make loans to the home owners.

The home owner finds a home with the aid of a local realtor. The house selected must need enough rehabilitation to provide "sweat equity" in lieu of down payment and closing costs. After the house is selected, a construction expert employed by BRL inspects it to determine how much to offer for it. Purchase is made by BRL if it meets that standard and also that of an FHA inspector. The home owner then moves into the house and becomes one of the subcontractors. BRL serves as the general contractor. The family lives as a tenant for a period of eight to twelve months while it completes its "sweat equity" under the direction of a construction supervisor. The value of the family's labor is calculated at prevailing market rates.

BRL pays an average of $7000 to $8000 to acquire its houses and adds about $2000 to $4000 for repairs. The family must do enough "sweat equity" to cover the required 3% down payment plus about $500 in closing costs.[96] When the rehabilitation is complete, the family obtains an FHA-subsidized mortgage 221(d)(2) or 221(h) mortgage, which is used to purchase the house from BRL. BRL includes a fee of $650 in the price of each house to cover its administrative expenses. Monthly expenses would be approximately $85-$100 under the 221(d)(2) program and $70-$85 under the 221(h) program.

As of February, 1968, 36 families had become home owners, and six more were living in fully rehabilitated houses, waiting to take title. Forty-eight houses were in the "sweat equity" stage and 78 others were in various stages of negotiation with FHA.[97]

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95 Newman, *supra* note 84, at 35-38.

96 *Id.* at 37.

97 *Id.* at 38.

B. *Summary*

In urban areas, evidence exists that single families, even those on welfare,[98] can participate in rehabilitation efforts and meet the responsibilities of ownership. Inexperienced workers, however, may well raise project costs as was evidenced in MFY and Philadelphia. Therefore, in difficult buildings, the use of self-help beyond a very minimal level may be too expensive, unwieldy, and fraught with union problems.[99]

Ownership on a group basis is nonexistent and management experience is untested. With proper financing, both the Detroit and the earlier New York City Real Estate Department leasing projects might have been successful. OSTI believes that within two years a tenant management corporation capable of directing a large public housing project could be operating.[100] It seems reasonable that a shorter period would be adequate for the smaller *in rem* properties. Major rehabilitation, if not impossible, would be more expensive and time consuming if done on an amateur basis. Rehabilitation beyond the LENA level would probably have to be done by outsiders, but decisions as to the extent of rehabilitation to be undertaken could certainly be made by the prospective owner-residents.

An important question, however, is whether the difficulties involved in rehabilitation and management do not dictate that resident responsibility and ownership be phased through a nonprofit sponsor, be it a church or quasi-governmental or community corporation. The complexities and risks may be too great for an inexperienced group to undertake and a more experienced and professional corporation could be created specifically to take title, secure FHA or other insurance financing, hire and supervise con-

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98 Fair Housing, Inc., a housing service organization, has helped eighteen families purchase homes in Roxbury, Mass. All eighteen of the homeowners are welfare recipients. This was made possible by obtaining a waiver in each case from the Welfare agency stating that Welfare will make no claim on any equity built up by the family. The Department has been able to justify the waiver by showing that it is cheaper for large low income families to own their homes than to rent apartment. HOUSING INNOVATIONS, *supra* note 4, at B-48. If a similar arrangement could not be made in New York, welfare families would have to be excluded from participation.

99 *See* discussion of unions and labor costs, *infra*.

100 OSTI, *supra* note 5, at viii.

tractors and perhaps negotiate further acquisitions from the city or private owners. Sometime soon after acquisition, this corporation would offer individual interests in the building or buildings which it has acquired.

The experience in other low-income ownership programs suggests that a trial period of about a year may be helpful to allow participants to determine whether they have the desire and capability to assume ownership responsibilities. In Rochester a trial period of eight to ten months is standard,[101] but Fair Housing, Inc. in Boston has no trial period, and Housing Innovations, Inc. will offer a choice of immediate or later purchase.[102]

IV. A Suggested Tenant Ownership Plan

A. *The Use of a Non-Profit Intermediary*

One way of dealing with *in rems* would be to establish a nonprofit intermediary on the model of Philadelphia or St. Louis. Not only would it more ably cope with the organizational problems associated with this venture, but it could also provide the temperance which was apparently lacking in the St. Louis experiment. Furthermore, it could provide strength and support for new managers and owners who may be somewhat reluctant to be tough on their fellows when it is necessary.[103] The corporation would contract for management and maintenance with a provision that this work would include training for the new owners. Participation by the residents in management is essential for the long run success of a nonprofit venture. Without these, the nonprofit sponsor will appear as just another landlord.

Aside from the financing problem, which may be alleviated by the greater flexibility accorded FHA in the 1968 Housing Bill,[104]

101 Housing Innovations, *supra* note 4, at B-34.

102 *Id.* at B-48, B-56.

103 Peter Abeles, *supra* note 70, suggested that tenants tended to be "too soft" on those who delayed payment and littered common areas.

104 Throughout most of its history, FHA has been required to operate on an actually sound basis. This requirement compelled FHA to refuse to write insurance in risky neighborhoods. In 1966, § 203 of the National Housing Act was amended to allow waiver of the "economic soundness" requirement of an individual mortgage. Kaiser Commission *supra* note 6, at 97-98.

New § 237 in the 1968 Act (12 U.S.C.A. § 1715z-2 (1969)) authorizes FHA to make

the arguments for the large intermediary are not convincing. Experience thus far indicates that the tenants' ability to cooperate and maintain faith in a program would seem to be limited to a LENA-type minimal rehabilitation level where there were substantial and fairly immediate benefits. Nevertheless, the City should transfer buildings on an individual basis. Equity participation should yield even more cooperation and work than did the LENA experiment. Reasonably well selected and organized residents, perhaps brought together by a church or community organization, should have sufficient cohesion and stature to purchase one or two buildings, assume management responsibilities and hire their own contractor with the assistance of the HDA, graduate students, and professional volunteers. Perhaps a technical assistance pool could be created through which these persons could be connected. The Urban Coalition would be another likely source.

It must be realized that the outside help required would be substantial. Management, maintenance, income budgeting, purchasing, and filing tax returns are new problems for most low-income people and are difficult matters even for middle and upper class college graduates. An essential adjunct to these programs would be a rehabilitation consultant. He would bring experience in building management and maintenance, the ability to demonstrate use of relevant tools and materials, and the ability

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mortgage insurance programs available to families who could not previously qualify for reasons of their credit history or irregular income patterns if the Secretary of HUD finds the mortgager to be a "reasonably satisfactory" credit risk. § 237(c)(3). Budget and debt management and related counselling are also included. § 237(d). Benefits of this flexibility are restricted to programs authorized in §§ 203, 220, 221, 234, and 235(j) of the Housing Act. § 237(b).

I have no evidence of whether or not § 235 has resulted in changed practices. (Interview with the Michael Mazer, Chief, Housing Division, OEO, March 20, 1969). However the Kaiser Commission reports that two years after the 1966 requirements had been relaxed, the number of high risk commitments had risen from 150 to 2000 per week. (KAISER COMMISSION, *supra* note 6 at 98.)

Section 223(e) (12 U.S.C.A. § 1715n (1969)) complements § 237. Whereas § 237 eases the credit requirement, § 223(e) relaxes physical eligibility requirements. The FHA is permitted to insure mortgages in declining urban areas if the Secretary of HUD finds that the area is "reasonably viable" and there is a need for low and middle income housing.

In the same vein, new § 239 (12 U.S.C.A. § 1715z-4 (1969)) requires the Secretary of HUD to formulate regulations granting extensions of time for curing defaults and modifying the terms of FHA insured multi-family mortgages.

to communicate to residents or young people working in these buildings either independently or as part of a wider training program. These consultants could serve several buildings and could be made available through HDA or TAP, or hired privately by a number of buildings.

Greater cost savings would be possible if entire blocks or adjacent buildings could be used, but this is not possible when buildings are scattered. Therefore, one of the arguments for a larger scale corporation is blunted.

A cooperative, nonprofit management and/or maintenance association might be established to provide some services necessary for economical operation in a specific area.[105] Under this system, individual groups may preserve their independence and set their own standards of rehabilitation and monthly payments. This cooperative association may overcome a number of disadvantages of small scale operations and obtain many of the cost savings supposedly available only through ownership of a number of closely located properties. For instance, major purchases of new fixtures could be pooled. In addition, it could help in locating additional property for rehabilitation, advising residents of available property, and providing rehabilitation consultant services. In general, it would take on many of the functions of the nonprofit corporations of Philadelphia and St. Louis and be able to receive additional governmental or foundation funds. At the same time, buildings would be independent and they would have the option of withdrawing at any time. The major operating responsibility for this entire program should be vested in HDA, which would not only select buildings suitable for sale and rehabilitation, offer technical assistance and coordinate volunteer assistance, but would also handle negotiations with the Welfare and Real Estate Departments and the FHA or other financial backers to ensure expeditious financing arrangements.

B. *Resident Selection and Participation*

All residents of a building should participate in its ownership in order to ensure their stake in the success of the venture as well

105 For a model see the Brownsville and Central Brooklyn Maintenance Corporations Proposals prepared by the City Planning Commission and HDA (draft copies in author's possession).

as to provide a large pool of persons to perform the required duties. Once a building is acquired, all residents should be given the option to stay and participate or take up residence in another building. Reasonable alternative residences should be found by the HDA, so that people who do not wish to participate will not be forced to join because they do not wish to move into less adequate accommodations. It is especially important to have willing participants in the early projects, because many organizational problems will have to be worked out at that time. After the program has worked for a while, procedures, structure and other arrangements can be altered to better fit the realities that the program encounters. Also, early successes should help stir enthusiasm and a willingness by others to participate in such a program.

In any case, three demands should be made on all who participate. First, all should contribute some sort of down payment in an amount which is not prohibitive and yet is large enough to create a sense of participation and commitment to the project. A sum as low as $50 would achieve both purposes.[106]

Second, there should be an increase in rent to reflect the increased costs for the rehabilitation process. However, residents should be able to use time spent on the project as an alternative to a rent increase. In any case, some initial indication should be given that "you can't get something for nothing."[107]

Finally, the tenants must agree to participate in the rehabilitation process itself. While day-to-day authority for the project might be delegated to a superintendent or board of managers, as in a typical middle-income cooperative, there should be a commitment of a given hours per month from each member. More realistically, a choice between payment of standard rental or receiving credits or even cash payments might be provided.[108]

106 A small down payment would also alleviate the total reliance on outside organizations for seed money to cover initial organization and insurance fees. However, a survey sponsored by Housing Innovation, Inc. in Roxbury in 1967 documents down payment difficulties. Eighty percent of those expressing a desire for ownership and earning less than $4000 indicated an inability to make any downpayment. The remaining 20%, all said they could afford less than $500 (HOUSING INNOVATIONS, *supra* note 4, Appendix C, Table IX).

107 *See* the recent difficulties in connection with the Boston Rehabilitation project with regard to quality and cost of work. URBAN PLANNING AID, INC., AN EVALUATION OF THE BOSTON REHABILITATION PROGRAM (1969).

108 A few people said that cash payments and rent credits are clearly delineated

Great care and explanation should be given participants to insure that one or two tenants do not appear to be reaping all benefits of the association or else the assumed incentives for cooperation and maintenance will be lost.

Welfare regulations exist which, if enforced, could bar people from the program by permitting or requiring the Welfare Department to consider equity in real property as an asset which must be exhausted before welfare payments are made. However, exceptions have been made for homeowners who suffer financial misfortune and apply for welfare; they have not been required to choose between welfare and their home.[109]

Income and credit requirements of participants shoud not become barriers. The stability and economic mix generated by the occasional non-low-income participant may prove decisive to the project's success. However, individuals who can afford to pay more should be required to pay back to the City a pro rata share of its investment and administrative costs.

One should expect some withdrawals from the program despite careful selection. For some period, perhaps two years, withdrawal should mean forfeiture of equity. This would strengthen the incentive to remain and support the financial base of the organization. Those who withdraw and forfeit their equity would still be in no worse position than if they had merely been renters during this period.

The expected withdrawals, the minimal down payment, and the occasional lapses in meeting monthly obligations will create hardships for the remaining participants. These burdens, more than the problem of initial financing, might argue for a nonprofit sponsor to bear this risk. However, some rescue provision or reserve fund provided by the City or built up as part of the monthly payment might prove a suitable substitute.[110] In any event, the financial loss to the remaining participants if the build-

in the minds of many and the former strongly favored. This may be an exaggeration. Rent credits apparently were adequate in the LENA project. The by-laws of the organization can resolve this question in either way.

109 Interview with Nancy LeBlanc, April 10, 1969. *See also* the Boston experience, *supra* note 98.

110 Maurice Kreinen, legal counsel of the New York State Housing and Renewal Commission, specifically confirmed this approach in the case of Article XI Housing Development Fund Companies, Interview, July 25, 1968.

ing were lost will be more apparent than real if monthly payments are kept at the current levels. What would have been equity payments then revert to rental payments. The real losses are limited to the opportunity cost and the psychological cost. On the other hand, given the current social climate, such costs should not be underestimated.

C. *Ultimate Ownership Form*

An important choice remains as to whether to use a condominium or a cooperative form in this plan, regardless of whether or not a nonprofit intermediary corporation is used.[111] Federal programs have been broadened so that condominiums qualify equally with cooperatives for assistance.[112]

In a stock cooperative, the corporation holds title to the building and is its sole mortgagor. The corporation is therefore the entity which is directly responsible for paying the real property taxes assessed against the building and the mortgage. The tenant in the cooperative (a) owns stock in the corporation entitling him to a voice in the management of the property, either by direct vote or through the selection of directors, and (b) receives a "proprietary" lease covering his apartment. According to the provisions of his lease, the tenant makes monthly payments to the corporation to cover the mortgage and tax obligations, in addition to the maintenance, management, and miscellaneous expenses.[113] If an individual shareholder defaults, the deficiency generally must be made up by the others.

Since the entire property is subject to common mortgage and tax liens, [114] some method of assuring their payment must be found to prevent foreclosure. Possibilities include: (1) the requirement of substantial down payments by cooperators as they join the corporation,[115] (2) the use of reserve funds, or (3) the assessment

111 *See generally* Berger, *Condominium, Shelter on a Statutory Foundation*, 63 COLUM. L. REV. 987 (1963); Welfeld, *The Condonimium and Median Income Housing*, 31 FORDHAM L. REV. 457 (1963); Rohan, *Perfecting the Condominium as a Housing Tool: Innovations in Tort Liability and Insurance*, 32 LAW & CONTEMP. PROB. 305 (1967).

112 See discussion IV, H, *infra*.

113 Quirk, *supra* note 2, at 366.

114 KRASNOWIECKI, *supra* note 9, at 268.

115 Quirk, *supra* note 2, at 366.

of the other cooperators when a default occurs.[116] On an individual level, the corporation could sue the defaulter on his lease and/or rent his apartment to someone else.[117] These remedies, however, are only applicable to non-recurring defaults. Should it become clear that a defaulting cooperator will not be able to meet his obligations for a considerable period of time, other means of relief must be used. To meet this contingency, a power is usually retained by the corporation either to repurchase the delinquent cooperator's interest at a special price reduced by the amount of unpaid monthly charges or to force a resale of the interest and deduct from the proceeds all deficiencies and costs.[118]

For people with low incomes, alternatives one to three and the repurchase plan impose difficult financial burdens.[119] Bringing suit on the lease is of no avail if the defaulter is not merely recalcitrant, but is simply insolvent. Renting the apartment introduces other landlord-tenant problems into the situation, while not completely eliminating the burden imposed on the other cooperators.

The City, of course, could step in to help finance the project until new participants are located and processed, but this may be inconsistent with the goal of reducing the government's involvement. Such action might also weaken the feeling of personal responsibility each participant has to contribute his share of the expenses and to participate in the decision-making processes of the cooperative. Alternatively, rapid replacement of such cooperators could be facilitated by maintaining a waiting list for vacated apartments in much the same way as lists are now kept for public housing. Yet such rapid turnover should not be emphasized in a program such as the one under discussion. Instead fairly generous terms for curing the default should be granted.

In some circumstances, though, the ultimate remedy of sale of

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116 Note, *The Cooperative Apartment in Government-assisted Low-Middle Income Housing*, 111 U. PA. L. REV. 638, 642 (1963) [hereinafter cited as *Coop*].

117 *Id.* at 642, n.38.

118 *Id.*

119 Similarly, the various regulations and eligibility requirements which the FHA has established to protect individuals in the cooperatives it insures against defaults by their neighbors would likely exclude most of the persons envisioned for participation in this project or at least impose additional financial burdens on them.

the defaultor's interest is likely to be necessary. Under favorable market conditions, the sale of shares in a good building should not be difficult. The new cooperator then assumes responsibility for future assessments. However, it is reasonable to consider that the cooperators in this program would be faced with unfavorable conditions, particularly declining real estate values. In such a market, especially with a poor building, the shares may be difficult, if not impossible, to sell because the market value of the equity may well be less than all future assessments.[120] This will leave the entire deficiency to be made up by the other cooperators.

When those cooperators must take on extra financial burdens, the likelihood of additional defaults increases.[121] It should be kept in mind that the participants in this program, no matter how much they may desire to retain their shares and their apartments, have limited resources. As the number of defaults grows, so does the probability that the corporate mortgage will have to be defaulted. This would happen despite the fact that many cooperators had been meeting their proportionate shares of the normal cooperative obligations.

Although a cooperative gives a member more of the concomitants of ownership than he would have as a renter, a condominium is designed to give him still more. The realization of this goal depends mainly on whether the individual units will gain independent recognition as mortgage security and as a basis for property taxation.[122] Unlike the cooperative where individuals are dependent on the solvency of the entire project, a condominium owner is responsible only for his own payments.[123]

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120 *Coop, supra* note 116, at 642.

121 It has been noted that the "fatal pyramiding of arrearages is especially likely in those many cooperatives whose members, employed in the same or connected industries, are similarly affected by economic fluctuations." Note, *Federal Assistance in Financing Middle-Income Cooperative Apartments,* 68 YALE L.J. 542, 598, n.344 (1959). This same dangerous pyramiding is likely in the case of the poor. Their job opportunities are limited and are closely tied to general economic conditions. Their incomes and obligations are often dependent on government regulation and administrative policy (e.g. welfare and federal poverty programs).

122 Berger, *supra* note 111, at 989.

123 Quirk, *supra* note 2, at 367. Individual mortgages are rare in cooperatives. KRASNOWIECKI, *supra* note 9, at 268, summarizes the practice as follows:

> Although a few banking laws authorize individual mortgages on a long-term renewable leasehold estate in a personal residence, it has not been the practice of lenders to offer individual mortgage

Even in a condominium, however, interdependence is not completely eliminated. One owner's upkeep of his property naturally affects the value of his neighbor's. But even more basic is the fact that a common obligation does exist on the common portions of the building, and if one person defaults, the others will have to meet his share of those expenses.[124] Yet since common shares are much smaller under this arrangement, the obligation of the non-defaulting tenants is much less than it would be in a similar situation in a cooperative. Furthermore, since condominiums are not limited in the amount of income they can receive from commercial use of the property, there may be less pressure on a condominium's tenants to make up these expenses themselves. Cooperatives, on the other hand, are often limited by law to a certain percentage of their income, usually 20%, that can be derived from commercial use.[125] This could be an important factor if there are commercial or manufacturing establishments on the street level of these properties.

Financing in a condominium comes in two stages: (1) the project mortgage, which is a blanket mortgage used to finance rehabilitation or construction, and (2) the individual unit mortgages. Both can be covered by FHA insurance.[126] Individual unit mortgages allow for more flexibility in each participant's financing terms than would be available in a cooperative where the mortgages cover the entire property. These mortgages also simplify the resale and refinancing of the units because only one mortgage — which covers just the unit being sold and not the entire property — is involved in the transaction.

In sum, both condominiums and cooperatives provide the tenant with some sense of ownership, a voice in the management of

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financing on cooperative interests and lending institutions are prohibited from doing so under the applicable laws.

124 In addition, the New York Condominium Act of 1964 passed to provide for limited liability allows the manager to bring a court action for injunctive relief against a unit owner who fails to comply with the by-laws or other rules and regulations of the condominium. Act of March 2, 1964, ch. 82, § 339-e, 1 Laws of N.Y. 96 (1964); N.Y. REAL PROP. LAW § 339-e (McKinney Supp. 1967). *See also* MEMORANDUM OF THE JOINT LEGISLATIVE COMMITTEE ON HOUSING AND URBAN DEVELOPMENT, McKinney's Session Laws 1839 (1964).

125 For a discussion of this restriction see *Coop, supra* note 116, at 642.

126 *See* §§ 234 and 235 of the Housing Act of 1968 discussed *infra*.

the property, an opportunity for permanent tenancy, an absence of landlord profits, and the realization of tax savings.[127] Of the two, however, the condominium seems preferable for the following reasons:

(1) The purchaser has concrete ownership of a *distinct* dwelling unit.

(2) The owner is limited in his liability for the default of a neighbor, since each unit is mortgaged and taxed separately.[128]

(3) Each individual owner has the possibility of determining the amount and terms of his own mortgage. Yet individual mortgages may be only a theoretical advantage. Lenders willing to take such a mortgage in this program, even with FHA insurance, may be rare.

(4) There is no limitation on the amount of income that can be derived from commercial uses on the property.

(5) Condominiums enjoy slightly more liquidity in resale and refinancing because of the unit mortgages.

(6) There is some value in giving the participants in this program the experience of maintaining their own mortgages. Yet this distinction may also be merely theoretical. It is likely that the individual may have little influence on the terms of the mortgage drawn up for him by the program's and mortgagee's lawyers, and he may not discern the difference between mortgage and rent payments. Of course, much the same could be said of home owners outside this program.

(7) The rating of the participants as credit risks might be favorably affected if they are able to maintain the payments on their mortgages. Low income people are often unable to demonstrate their financial responsibility for lack of someone who is willing to give them a chance. This program, with government backing, would give them that chance. Individual accountability, instead of the anonymity of corporate mortgages, will improve the rating of those who meet their own mortgage payments.

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127 Discussion of the Federal tax benefits which accrue to owners, *i.e.*, deductibility of mortgage interest and property tax payments which are available to homeowners but not to renters, is omitted herein.

128 As a practical manner foreclosure is not likely in an experimental program in which the government is the insurer.

D. *Resale Price*

Whether a condominium or a cooperative format is adopted, some decision must be reached on resale policy. Two important questions must be answered. First, should the market for resale be restricted to those low-income families who are to benefit from the ownership programs? Second, should residents be allowed to enjoy any appreciation in value if they remain in the project beyond an initial period?

In principle, the right to purchase at resale, like initial participation, should be limited to low-income families. As mentioned previously, however, this involves foregoing the benefits of economic integration. Also, any restriction on free alienability or on the opportunity to capture whatever price the market delivers, however justified, does represent some departure from the notion of absolute ownership. Although the importance of absolute ownership is untested, it is a factor worth considering.

Aside from the possibility of avoiding full market price, which will always include some increment based on government subsidy, a participant's return should reflect the care and investment he has made in his unit. Ordinary homeowners view repairs and upkeep as investments and the same incentive should be provided in this program.[129]

Sale at par would fail to provide this incentive. It has been suggested that it is desirable to reach a compromise between permitting a departing resident to retain the full benefits of equity accumulations and maintaining a price at par which would allow the entire benefit of amortization to be given to the family that occupies the apartment at the expiration of the mortgage term. It is argued that permitting full accumulation would raise the purchase price beyond the reach of low- and middle-income families.[130] If market prices were awarded, the new owner in either a cooperative or condominium would have to compensate the grantor immediately for his investment, as well as assume the monthly charges. Any installment plan which delays payment to the departing owner will prejudice him since he may be relying

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129 *Coop, supra* note 116, at 658.

130 *Id.* at 659.

on a lump sum payment for a down payment on a better home. A combination by which the departing owner receives market value while easy payment arrangements are made available to the incoming owner would be desirable. An additional long-term loan or mortgage might be made from some governmental unit to the new owner to cover some portion of his obligation to the old owner.

A simpler approach to the financing problem would be possible with a condominium format. In a condominium, later purchasers would be able to make a single financing arrangement and eliminate the problem of having to make separate payments on both the existing mortgage and the prior owner's equity.

E. *Rehabilitation Level*

Much discussion of rehabilitation costs and levels is imprecise. For simplicity one can postulate three levels of rehabilitation: (1) minimal rehabilitation: elimination of code violations, minor repairs, improvement of the building's facade and other "cosmetic" treatment; (2) moderate rehabilitation: all of the above plus some changes in layout, general interior and exterior repairs, replacement of fixtures and modernization of heating, plumbing, and electrical systems; and (3) extensive or "gut" rehabilitation: complete remodeling or redesigning, rigorous interior and exterior repairs and new heating, plumbing, and electrical systems.[131]

Costs attached to these alternatives in old-law buildings are estimated at $1000 to $2000 for minimal rehabilitation, $4000 for moderate rehabilitation and from $13,000 to $15,000 for extensive rehabilitation.[132]

A number of policy alternatives arise. One must consider three variables: (1) two stages of development of the project (pre-transfer and post-transfer; (2) two parties (City and tenants) who must bear decision-making responsibility for selection of rehabilitation level and other questions of construction; and (3) three levels of rehabilitation. The easiest way to assure high quality work would be for the City to take responsibility and transfer an extensively renovated building to a tenant group. However, this approach

131 HRB Rep. No. 14, *supra* note 6, at 11.

132 *See,* note 82, *supra* for details on the specific costs of rehabilitation.

defeats various goals of the program such as inculcating initiative, training, and pride within the tenants. At the other end of the scale is the simple method of having work performed by tenants on nights and weekends. An improvement on this second method would be the inclusion of training funds in order to make construction a full-time occupation for the new owners and to combine the home ownership and skill training potentialities of the program.

It is difficult to advocate complete reliance on self-help. This might lead only to a complete abrogation of responsibility by the City. Assurances must be given that tenants get something more than control. Before a building is transferred, the City should: (1) determine its condition; (2) estimate the cost of bringing it to minimum code standards as well as the cost of more expensive rehabilitation if such rehabilitation is feasible; and (3) require evidence of some preliminary plans for improvement. Included in the sales contract should be an agreement to bring the property up to code standards.[133] There are a number of reasons why the new owner rather than the City should assume responsibility for meeting code requirements. First, unburdened by public bidding requirements, new owners may be able to make better deals with contractors. Second, they may be able to lower costs by using volunteer or tenant labor and donated materials. Third, owner responsibility and pride is encouraged especially since this minimal rehabilitation may be the most that can be undertaken on a self-help basis.

Most of the properties being considered should receive extensive or "gut" rehabilitation at costs of up to $15,000 per unit. At least one study has concluded that gutting and rebuilding interiors costs approximately as much as new housing per usable square foot.[134] Rather than attempt to duplicate such extensive and expensive

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133 The Boston Redevelopment Authority includes a "write up and cost estimate" in its disposition agreement and requires a "certificate of completion" which asserts that certain prearranged requirements be met before title passes. Interview with Robert McGilroy, Chief of Rehabilitation Division, Boston Redevelopment Authority, March 13, 1969. Such a requirement is probably too rigid for our purposes.

134 IPA, *supra* note 12, at 8. *See* KAISER COMMISSION REPORT, *supra* note 6 at 107-110 for a discussion of the rehabilitation process and proposals, not altogether hopeful, for increasing efficiency.

projects in such poor buildings, something smaller should be attempted. Such an approach is consistent with the conclusions to be reached from existing rehabilitation experiments.[135] Without exception, the projects to date appear to have raised rents substantially even with government subsidy.[136] Robert Weinreb argues that the best test for adequacy of a dwelling unit is resident behavior.[137] If tenants stay, pay rent, and do not damage the building, the housing is deemed to be adequate. While this approach seems to be a method of evaluating a housing program, making apathy into a positive virtue, it does help us to understand what should be invested in the type of building with which we are dealing.

When a sale is made, the buildings should contain operating interior plumbing, heating, hot and cold water and electricity. Major leaks in roofs, falling plaster, and broken stairs should be repaired, and rodents controlled. Any other modifications would be the new owners' responsibility. The City, of course, would continue to supply all regular municipal services and might consider some additional services such as pest control. Of secondary importance would be items such as leaky pipes, security systems, new bathroom fixtures, new appliances, and new windows. These items should be left to the discretion of the new owners. Continued and staged upgrading would be possible and encouraged at a pace the occupants can afford. Self-help should be maximized and rent credits encouraged.

In both condominiums and cooperatives, resident-owners are responsible for the condition of their units with the exception of basic features such as heat, electricity, and water that are irrevocably connected with the management of the entire structure. Residents should have complete control over renovation, standards, and materials used within their unit, obtaining such

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135 The IPA study, *id.*, concluded that very high costs "raise grave questions respecting drastic rehabilitation of ordinary old law tenements." It recommends the replacement of these structures with new buildings. An interim evaluation of rehabilitation old law tenements by the Joint Center of Urban Studies concludes that rehabilitation should be less ambitious, with shorter term financing. Jt. Center, *supra* note 82.

136 HDA estimates that with 3% financing real increases even for minimal rehabilitation would be between 11 and 17%. HRB Rep. No. 14, *supra* note 6.

137 Weinreb, *supra* note 73, at 22.

materials centrally or independently. Similarly, it should be permissible to do the work personally or to hire a management crew or outsiders. Certainly unit rehabilitation will vary by individual taste and ability. It will be delayed if one sees that his neighbors do not share his concern. Therefore, cooperative and building-wide improvements should be encouraged.

The cost of such a minimal effort is difficult to determine; $1,000 to $2,000 per unit, as estimated by the Housing and Development Administration, seems reasonable. Two sources of information which should be considered and evaluated to estimate the costs of an adequate program are the Emergency Repair Program[138] and the LENA project.[139] Acquisition costs for the *in rems* could be as low as one dollar by negotiated sale under any of the plans discussed.[140] In the event that market value was changed, $500 per unit would be an approximate maximum.[141]

F. *Labor Costs and Training*

As a secondary goal, the program should train low-income persons in rehabilitation and related skills. Rehabilitation as proposed in this article will still be traditionally labor intensive and

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138 Traditionally, enforcement of housing violations has been premised upon the use of criminal sanctions, but the City also has the power to perform direct repairs and recover expenses. N.Y. MULTIPLE DWELLING LAW § 309 (McKinney Supp. 1967). Recovery is made through a civil suit against the owner (§ 309(3)) by creating a lien against rents with tenants paying directly to the City (§ 309(7)(a)-(b)), or by filing a lien against land and building which is prior to existing mortgages (§ 309(4)(a)). In October 1965, the Real Estate, Health, and Buildings Departments, financed partly by OEO, instituted a program to repair violations and restore essential services. The only information I was able to locate were broad summary figures for the entire program. Costs for individual buildings should be available from departmental records. For a description of the program, *see* New York City Department of Buildings, *A Program for Housing Maintenance and Emergency Repair*, 42 ST. JOHN'S L. REV. 165, 178-181 (1967).

139 Nancy LeBlanc estimates that $10,000 per building would bring the worst property on the Lower East Side up to minimum code standard. Interview, February 27, 1969. Professor William Poorvu of the Harvard Business School suggests three to five thousand dollars. Interview, April 8, 1969. The LENA project's costs were lower, but this building may have been in better condition than the ones to be dealt with in this program. Interview with Robert Weinreb, April 3, 1969.

140 BRA frequently does this. Federal renewal funds allow the BRA to cover the write-down. Interview with Robert McGilroy, *supra* note 133.

141 Information on sales prices are not readily available, but the 268 Ashland Place Corporation paid $2,600 for a 24 unit building, and the Real Great Society paid $6,700 for 20 units. Similar unit-price ratios are common in sales to speculators.

subject to criticisms of inefficiency and delay. If housing is not to be too expensive for residents, labor costs will have to be minimized and voluntary labor contributions accepted whenever possible. These may come from residents and outside volunteer groups. Aside from the very real possibilities that professionals may be needed for much of the work, and that inexperience may offset hourly wage savings, unions pose a considerable obstacle to the success of the program.

One basis for the unions' objection is section 212 of the National Housing Act[142] which requires that FHA-insured projects and projects aided by direct federal loans or grants pay wages in accordance with the Davis-Bacon Act as amended.[143] The Davis-Bacon Act requires that wages and fringe benefits paid construction and other workers be paid at the rate prevailing in the area (defined as city, town, or village) where the work is to be performed.[144] Rehabilitation work that was federally financed would come under the high wage rates persently paid for construction, though currently rehabilitation is largely a non-union business paying wages only one-third to one-half the union rate.[145] The threat of bodily harm to whites working on a project in Harlem or Bedford-Stuyvesant does not seem a reasonable way of blocking the unions, although it has been raised in some militant circles as an alternative to union insistence on bringing whites to work on projects in ghetto areas.[146] Black contractors may offer no relief. SPARTACUS and other new black-owned firms mentioned by the Real Great Society will employ blacks and residents, but probably at union wages. Mobilization for Youth (MFY) is paying union wages in a five-building 221(d)(3) project it has begun to construct. MFY did secure an exception from these standards for the summer as a demonstration program, but they are very pessimistic about the chances of extending it. Most of the work in the one-building LENA project was done by unlicensed

142 12 U.S.C. § 1715c (1964).
143 40 U.S.C. § 276(a) (1964).
144 29 C.F.R. § 1.2(a)-1.2(6) (1967).
145 Interview with Peter Abeles, *supra* note 70, July 1968.
146 Jason Nathan, Administrator of the Housing and Development Administration, believes, however, that unions are increasingly sensitive to charges of racism and inefficiency and are willing to make special arrangements. Interview, April 10, 1969.

workmen and approved by friends for payment of a fee.[147] Ronald Huntley stated that the Bedford-Stuyvesant Corporation had made an agreement with local unions, but did not wish to discuss it.[148] An arrangement was also made in the Flanner Homes project in Indianapolis.[149]

The federal provisions seem to exempt work done on one's own home. For instance, section 212(a) makes the Davis-Bacon Act applicable to the blanket construction mortgage for a condominium under section 234, but allows donation of services in 221(d)(3) and 221(d)(4) cooperatives and 221(a) and 235(j) (nonprofit rehabilitation sponsors) projects by prospective owners or others not otherwise employed in construction or rehabilitation of the project.[150]

In any event, it is probably wiser not to concentrate on a training program where a time schedule is important. The efforts must be kept separate to a great extent. Tenants could select a contractor-consultant. If feasible, they could comprise rehabilitation crews, but ownership transfers should not be tied to this arrangement.

G. *City Tax Treatment*

The City receives no tax payments from the *in rem* property it owns and operates. Any income the City earns is in its capacity as a landlord. The Real Estate Department assumes that an operating loss exists for such projects, though it has no specific estimates.[151] Several options are open to the City. First, the property could be returned to the tax rolls. This, of course, could be done immediately or established as a long-term goal. However, this would be unwise for it would mean higher monthly rental payments for the tenants. A second option, payments in lieu of taxes, presents the same drawback on a slightly reduced scale. A third option, payments for direct services, may be the most reasonable.

Precedents for abatement and exemptions are well known. The federal government has no general policy on what it requires

147 Interview with Robert Weinreb, *supra* note 73.
148 Interview with Ronald Huntley, *supra* note 32.
149 *See* III, A, 8, *infra*.
150 *See* discussion of these programs, IV, H, *infra*.
151 Interview with Bogner, *supra* note 11.

or requests of local communities in which HUD-assisted projects are located.[152] Regular low-income public housing is conditioned upon local exemption. Rent supplements may go to projects which are making local payments. Budget Bureau personnel have indicated that as a practical matter FHA will not approve a project unless New York City grants exemption. In the case of 221(d)(3) projects, exemption may be necessary for the project to proceed.

Currently, the City provides a twelve-year tax exemption for increased valuation due to improvements of multiple dwellings and a nine-year credit against real estate taxes otherwise payable, up to a limit of 8⅓% of the cost of improvements per year.[153] The total credit is thus limited to 75% of the improvement's cost. In effect, the City is paying 75% of the improvement cost over a nine-year period. For the program being discussed here, where the value of the improvements done would be very high in relation to a correctly-assessed valuation and in fact may exceed it, the credit due would be so great that the result would be a virtual tax exemption for nine years.

The Annual Record of Assessed Valuation of Real Estate indicates that the assessed valuation for a twenty-unit slum building is in the $15,000 to $20,000 range.[154] The cost is $750 to $1000 per unit, which would mean a per-unit annual tax of $37.50 to $50 before exemption. This would not appear to be a crucial loss to the City. It would seem, then, that under this existing program, total tax exemption for nine years could be granted. Beyond that, an extension could be obtained. This is often done now. Thus, tax problems should not be an obstacle.

H. *Financing*

A detailed financial analysis of a model building is not presented here because of the uncertainty surrounding costs and the availability of various federal, state, and municipal programs. Existing rent structures are also unavailable. It is hoped that the program will keep rents near their current level which is estimated to be

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152 Information in this paragraph gathered from various New York City Budget Bureau personnel.

153 NEW YORK, N.Y., ADMIN. CODE § J51-2.5 (1963).

154 Cited in Quirk, *supra* note 2, at 388 n.113.

about $60 per average old law unit of two bedrooms.[155] Three separate areas must be considered: acquisition and organization; repairs and modification; and debt service, amortization and normal operating expenses.

Acquisition and organizational costs should not be serious obstacles. Market value is low as indicated, and negotiated sales could assure that this would be true. The object of minimal repairs is to keep the second component and the mortgage payment as low as possible. Yet Weinreb's study of the LENA project, where rehabilitation costs ran about $400 per unit and rents about $60, indicates that some increase may be inevitable. However, that project pays taxes.[156]

Outside money will be needed to cover the capital costs of rehabilitation and to supplement operating income during the period when rent credits are widely utilized. An initial blanket mortgage followed by individual long-term mortgages is probably the answer. Another possibility would be a revolving fund created to facilitate project start-up. Some of the available federal resources are described below, both in providing insurance to private tenants and direct assistance.

The FHA may be a difficult source of insurance because of their wage and quality standards. The extent of this problem is illustrated by the rapid rehabilitation demonstration project in which FHA waived 17 requirements of "Minimum Property Standards for Rehabilitation."[157] These included room size, entrance widths and fire alarms. The study concluded that some of the existing standards cannot be met in old law tenements.[158] However, there are indications, both formal and informal, that

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155 Whether or not most buildings are old-laws is still an open question. I have the general impression that a substantial part of the multiple dwellings are, but this is unconfirmed. The oft-cited HRB study, *supra* note 6, conducted in 1967, uses a figure of twenty dollars per room. My interviewees indicated that rents range from zero to sixty dollars per unit. A family earning $3000 to $5000 a year, by commonly accepted standards, should expect to pay twenty to twenty-five percent of its gross income or between sixty and one hundred dollars per month for shelter (*See* U.S. Department of Labor, Bureau of Labor Statistics, *City Worker's Family Budget for a Moderate Living Standard*, Bulletin No. 1570-1, Autumn 1966, which finds a twenty-one percent average).

156 *See* Weinreb, *supra* note 73.

157 IPA, *supra* note 12, at 27.

158 *E.g.*, distance between dwellings, *Id.*, at 22.

FHA might be easier to deal with than in the past.[159] If FHA insurance is available, private sources including banks and insurance companies, separately, pooled, or encouraged by groups like the Urban Coalition, will be a more likely source of funds.[160]

1. Section 221(h)

Section 221(h) of the National Housing Act,[161] passed in 1966, extended below-market interest loans to nonprofit sponsors who rehabilitate and resell deteriorating or substandard homes to low-income persons. Under the previous 221(d)(3) program, participation was limited to blanket project mortgages. While 221(d)(3) aims at rental housing, 221(h) sponsors must agree to "resale to low-income home purchasers." This program was used in both the St. Louis and Philadelphia projects discussed herein. Income limits, set forth in 221(h)(5)(a), are the same as those of section 101(c) of the Housing and Urban Development Act of 1965,[162] which sets limits at the public housing level.

Section 221(h) operates as follows: A nonprofit sponsor obtains a take-out commitment from FHA for a 100% blanket mortgage and a commitment from the Government National Mortgage Association (GNMA) to take over the mortgage at closing. Upon completion, costs are paid out of proceeds of the permanent mortgage. Individual purchasers follow the same two-stepped process, i.e., FHA and GNMA commitments. As individual sales are closed, the blanket mortgage is released on individual units and replaced by individual ones. The unsold units are operated just as a rental unit would be.[163]

Section 221(h) underwent two important changes in 1968. The Housing and Urban Development Act of 1968 lowered the interest rate to 1%-3% and extended the program to four or more individual units in a structure for which a plan of family

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159 *See* note 82 *supra,* and a variety of directives by the Secretary of HUD.

160 *See* KAISER COMMISSION, *supra* note 6, at 96-97, for a brief discussion of the problems of housing financing in the slums.

161 12 U.S.C. § 1715e (Supp. 1967). Paragraph (h) was added by Sec. 310 of the Model Cities and Metropolitan Development Act of 1966, 80 Stat. 1268.

162 P.L. 89-117 (1965), 79 Stat. 451.

163 KRASNOWIECKI, *supra* note 9, at 386.

unit ownership approved by the Secretary is established.[164] Mortgage terms could have been authorized for forty years, but by regulation they have been limited to twenty or twenty-five years.[165] A family earning $3200 paying 25% of its revenue for housing can afford to pay $66 per month. Payments on a twenty year mortgage of 1% still come to $4.60 per $1000 loan.[166]

2. Section 235

Section 235 of the National Housing Act[167] represents a change in the form in which the federal subsidy is delivered. The object of this change is to use the private market rather than the government's special assistance funds as a source of capital as was the case under earlier programs, such as section 221(d)(3).

Under section 235, the Secretary of HUD makes payments directly to mortgagees in behalf of the mortgagors. The payments cannot exceed an amount which would reduce the mortgagor's contribution below that which he would pay on a 1% mortgage.[168]

The maximum mortgage amounts available in high cost areas are $17,500 for single family units and $20,000 when the family contains five or more members.[169] Our program fits well within these limits.

Definite income restrictions are imposed. No more than 20% of the funds may be allotted to families whose incomes at the time of initial occupancy exceed 135% of the maximum public housing level.[170] The down payment requirement for these families is just $200.[171]

Although Congress did not so state in the act, its intent was to provide shelter at cost between 20% and 25% of gross income.[172] Section 236, which deals with rental housing, requires renters to

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164 § 221(h)(2)(A)(ii); 12 U.S.C.A. § 1715e (1969). Previously the section had applied only to single family detached, semidetached and row buildings.
165 KRASNOWIECKI, *supra* note 9, at 387.
166 *Id.*
167 12 U.S.C.A. § 1715z (1969).
168 § 235(i)(3)(a).
169 § 235(b)(2).
170 § 235(h)(2).
171 § 235(i)(4)(c)
172 *See* S.R. No. 1123, 90th Cong., 2d Sess. (1968).

pay 24% of their income, as does the rent supplement program.[173]

Serious questions have been raised as to whether section 235 brings total shelter costs within the 20% to 25% range which it is assumed low-income families can afford.[174] The section 235(c) payment formula specifies that the government's payments shall be computed on the basis of the sum of payments for principal, interest, mortgage insurance premium, taxes and insurance. It does not include heat, utilities, and maintenance charges. Mild and warm areas are not severely affected by this exclusion, but in New York its effect is substantial. In Boston, for instance, these items comprise about 30% of monthly housing costs.[175] Because of the formula, Field and Schaefer concluded that it is improbable that section 235 will be utilized in new or rehabilitated housing in northern sections of the country.[176]

While it may be true that the formula is so drawn to make the program inapplicable where extensive rehabilitation is undertaken, the formula may be workable when the effort is minimal as proposed in this article. Monthly repayments of principal would be much smaller than in the extensive projects the cities have postulated. There is still, however, reason to doubt section 235's applicability because the act calls for "new or substantially rehabilitated" housing. It may be that such a program would not qualify.

3. Section 234

Section 234[177] authorizes the FHA to insure individual and blanket mortgages in multifamily structures under the condominium form of tenure. When rehabilitation is completed the blanket mortgage is released, and separate mortgages are substituted. Section 234(c) permits section 234 insurance on individual units in two to eleven-unit condominiums that had not been first covered by an FHA-insured project mortgage. This provision is

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173 12 U.S.C.A. § 1715z-1 (1969).

174 *See* KRASNOWIECKI, *supra* note 9, at 425; HOUSING INNOVATIONS, *supra* note 4, at 32; and Field and Shaefer, § 235 of the National Housing Act: Home Ownership for Low Income Families? (undated and unpublished) (in author's possession).

175 Field & Schaefer, *supra* note 174, at 13.

176 *Id.* at 18.

177 12 U.S.C. § 1715y (1964).

significant because it makes possible the mortgage of units under section 235 even though the work itself may have been financed by other than federal sources, such as municipal loans.

4. Section 115

Section 115 of the Act of 1949, as amended,[178] permits grants of up to $3000 to owner-occupants of residential property in areas where the governing body has determined that a substantial number of structures are in need of rehabilitation and a rehabilitation or code enforcement program is planned in a reasonable time. This program could be the cornerstone of a program of minor rehabilitation.

5. Section 312

Section 312 of the Act of 1964 authorizes 3% twenty year loans similar to section 115.[179] Mortgages range up to $14,500 in high-cost areas. In late 1967 the Kate Manemont Foundation announced that it would utilize section 312 in a $1.2 million, eleven-building, 156 unit project in Chicago. Monthly payments were expected to be less than $100.[180] This section combined with section 115 provides the broadest support for our program.

6. Section 106

Section 106[181] authorizes the Secretary to contract with public and private groups to provide technical assistance "with respect to the construction, rehabilitation, and operation" by nonprofit organizations. It also authorizes 80% loans to nonprofit organizations to cover their preconstruction expenses. Such loans could ease the city's administrative burden and pay the cost of processing the applications and financial arrangements for this project.

7. Section 207

Section 207 of the Housing Act of 1961[182] permits the Secretary of HUD to make grants to public and nonprofit agencies for de-

178 42 U.S.C. § 1466 (Supp. 1967).
179 42 U.S.C. § 1452b (Supp. 1967)
180 113 CONG. REC. S.13, 555-56 (daily ed. Sept. 25, 1967).
181 12 U.S.C.A. § 1701x (1969).
182 42 U.S.C. § 1436 (1964).

velopment of new or improved means of providing housing for low-income persons. In Philadelphia, it was used to establish a $93,000 revolving fund to explore the feasibility of rehabilitation and eventual resale.[183]

In addition to HUD, two potential sources of "seed" money and training are the Economic Development Administration (EDA) and the Office of Economic Opportunity. OEO's major concern has been the Housing Development Corporations discussed above. The Office has also awarded $90,000 to the National Council of Negro Women for training participants in a Turnkey III project in money management and home maintenance.[184]

The EDA and OEO programs do not seem to provide the basic funding this program would require. However, additional possibilities under the programs would certainly be worth pursuing. There is no reason why some loan aspect could not be included in one of these programs. One of the OEO corporations (Washington, D.C.) may, by this time, include short-term loans.

The Departments of Labor and Health, Education and Welfare are also possibilities although their interest in an ownership program may be somewhat tangential. If job training and vocational education were to be included in the experiment, securing their assistance should be fairly routine. Labor Department funds are being used for acquisition as well as training by the 268 Ashland Place Corporation.[185] Other sources of initial, and perhaps permanent, fundings are foundations; for example, the Ford Foundation has long been a leader in urban areas and is now assisting in the funding of a guaranteed income pilot project in New Jersey. The Astor Foundation funded the Real Great Society purchase.

8. Municipal Loans

New York City maintains a Municipal Loan program which offers direct thirty-year, five-percent rehabilitation loans to owners of multiple dwellings.[186] Loans are limited to 90% of the value

183 Fielding, *supra* note 78, at 225. See discussion of the IICC above.

184 Interview with Michael Mazer, October 1968.

185 *See* discussion of the 268 Ashland Place Corporation, I, C, 2, *supra*.

186 N.Y. PRIVATE HOUSING FINANCE LAW § 402 (McKinney 1962). *See* N.Y. CITY HOUSING AND DEVELOPMENT ADMINISTRATION, PROFILE OF NEW YORK CITY'S MUNICIPAL LOAN PROGRAM 11 (Report No. 15 — December 1967).

of the property.[187] The average loan per unit granted through March 31, 1967, was just over $7000;[188] current administrative limits are between $8000 and $9000.[189] Structures rehabilitated under the program tend to be four and five-story walkups averaging 18 units of 3.5 rooms each in poor areas where private financing is unavailable.[190] Rents average $27 per room or $95 per unit.[191]

Standards under the Municipal Loan program are generally understood to be less demanding than those of the FHA. Although further relaxation would be necessary, the loans would be directly applicable to the *in rem* properties. The major drawback to their use would be the city's limited borrowing power, which may dictate that city funds be spent elsewhere. All other sources of funds suggested have the advantage of drawing on outside sources.

In conclusion, there are many possible sources of funding for rehabilitation and home ownership projects. However, at present there are not many funds available for that use. Private funds or guarantees by private institutions must be used to initiate large projects.

I. *Specific Proposals for New York City*

At present, it is extremely difficult for the City of New York to implement any program for the disposal of *in rem* property. First, the City lacks an adequate inventory of its *in rem* property and data on the rent-rolls of landlords and sales prices for property. Thus one of the first steps must be a study utilizing the general records of the Real Estate Department to create a record system detailing every building, its rent level and number of tenants. Disposal records could be ascertained from auction sale records so that one would have a better idea of the actual market value of the property, not the inflated assessed value.

Second, legislation should be sought to reduce the period for acquiring *in rem* property to two years or less and to increase the penalties for delinquency in payment of taxes. Improved

187 N.Y. PRIVATE HOUSING FINANCE LAW § 402(2) (McKinney 1962).
188 Computed from table one, page 4, MUNICIPAL LOANS, *supra* note 186.
189 Interview with Jason Nathan, *supra* note 146.
190 MUNICIPAL LOANS, *supra* note 186, at 2, 6.
191 *Id.* at 11.

methods should be sought to keep up-to-date records on tax delinquent properties so that the City can deal with them as usable assets. The use of data processing would create a useful tool for city management and stimulate private investment interest in this source of land.

Certain procedures should be enacted to aid in expediting this process. The Real Estate Department should designate a single officer responsible for selecting these buildings and working with groups interested in acquiring them. In general, only buildings that are structurally sound with enough rooms to support at least two families comfortably (6-7 rooms) should be selected. The project should be oriented toward the development of a particular block or neighborhood, *i.e.*, a series of buildings in one area rather than one building where a number of buildings are vacant.[192]

The Housing and Development Administration has greater experience in rehabilitation and is generally more receptive to innovative programs. It should authorize an official to contact community groups with the offer of technical advice, to work with the Buildings and Welfare Departments and to secure financing for the new owners.

In addition, the City should encourage persons to stay in their present residence by limiting the level of rent increase immediately following rehabilitation. A maximum level of rent increase, perhaps 20%, for the first three year period might be written into the land sales contract. To compensate for this loss of revenue the City should consider some form of subsidy to the project, perhaps in the form of a tax abatement.

Religious, fraternal and community organizations should be actively sought to serve as intermediaries before the project is finally given to the tenants. Such groups are more likely to possess the leadership necessary to maintain momentum on the project and to obtain financing. One possibility might be the assignment of management responsibilities by such an organization to a tenant group for a nominal fee. However, such efforts by the

192 These recommendations are largely taken from a memorandum from Robert Brodsky, Staff Attorney, to Development Commissioner Robert Hagen, dated July 10, 1968.

Real Estate Department in the past have failed because either the tenants have looked upon the arrangement as a sham and have demanded equity participation or the new managers have been too soft on the tenants, encouraging lags in payment and cooperation. However, an installment-sale arrangement in which maintenance and management contributions by the tenants can be credited to equity over a period of two to three years might be a reasonable compromise and would be analagous to the Rochester experience related herein.

Finally, a careful study should be made of the costs of the *in rem* operation itself by the Real Estate Department. It is difficult to believe that the costs of the innovation proposed will be too great in the present case.

V. Conclusion

The lure of home ownership as a remedy for some of the miseries of low-income people has been strong in the past several years, although there is little hard data to support the optimistic conclusions usually expressed. Even if the procedural and legal problems connected with selling land at reduced prices to community groups through the *in rem* foreclosure procedure are resolved, there remain problems involving the type of tenant organization developed to receive the rehabilitated housing, the financing of the rehabilitation process and the level of rehabilitation that should be sought. The use of nonprofit intermediary organizations and tenant cooperatives appears to be the most reasonable solution at present. However, the financing and construction problems are so enormous that the use of *in rem* properties can only be viewed as a small-scale, short-term program when viewed against the enormous need. Yet, in this area any small step is significant.

AN ACT TO PROHIBIT UNFAIR AND DECEPTIVE TRADE PRACTICES*

Introduction

This draft presents a model statute to prohibit unfair and deceptive trade acts or practices. This proposal includes the statutory language and explanatory comments to a modified draft of the recently amended Massachusetts "Regulation of Business and Consumer Protection Act."[1] This legislation can be considered as a companion piece to several other articles, each covering an analytically distinct area of consumer protection problems and all contained in a comprehensive code. This code would provide a consumer protection plan for the large number of states — approximately one-third — which do not have adequate consumer protection programs.[2] A brief outline of such a code consisting of eight articles is presented in this introduction.

Article I would be purely formal; it would provide for the short title and general definitions. Article II would cover disclosure of information by vendors.[3] Provisions would require dis-

*This statute is identical to the current Massachusetts statute (see note 1 *infra*) except where otherwise indicated in the comments. The revisions and comments were prepared by Robert E. Goodman, B.A. 1964, Dartmouth College; J.D. 1969, Harvard Law School; Clerk to Chief Judge Walter Hoffman, Federal District Court for Eastern District of Virginia. Mr. Goodman participated in the drafting of the Massachusetts statute.

1 Mass. Acts, ch. 690, ch. 814 (1969), *amending* MASS. ANN. LAWS ch. 93A, §§ 1-8 (Supp. 1968).

2 W. MAGNUSON AND J. CARPER, THE DARK SIDE OF THE MARKETPLACE: THE PLIGHT OF THE AMERICAN CONSUMER, 28-30 (1968).

3 D. CAPLOVITZ, THE POOR PAY MORE: CONSUMER PRACTICES OF LOW INCOME FAMILIES 170-179 (1963); A. MOWBRAY, THE THUMB ON THE SCALE AND THE SUPERMARKET SHELL GAME (1967); L. RICHARDS, CONSUMER PRACTICES OF THE POOR IN LOW INCOME LIFE STYLES (L. Ireland ed. 1968); RISK TAKING AND INFORMATION HANDLING IN CONSUMER BEHAVIOR 605-625 (D. Cox ed. 1967); Barber, *Government and the Consumer*, 64 MICH. L. REV. 1203, 1207-1227 (1966); J. Spanogle, *How Much Truth in What Kinds of Lending?*, 16 J. OF PUB. LAW 296, 298-299 (1967); CONSUMER REPORTS, *Some Truth-in-Packaging . . . But Not Enough*, partially reprinted in THE CONSUMING PUBLIC 49 (G. McClellan ed. 1968); *Hearing on H.R. 11601 (Consumer Credit Protection Act) Before the Subcomm. on Consumer Affairs of the House Comm. on Banking and Currency*, 90th Cong., 1st Sess. (1967); *Hearings on Consumer Information Responsibilities of the Federal Government Before a Subcomm. of the House Comm. on Govt. Operations*, 90th Cong., 2d Sess. (1967).

closure of hazards to health and safety and instructions for proper use. Consideration should be given to the effect of these requirements on strict liability under state law. Prohibition of unfair and deceptive packaging and labeling can be established by drawing a parallel to the Massachusetts unfair and deceptive trade practices provisions, which incorporated federal standards by reference;[4] here the incorporated federal standard would be the Fair Packaging and Labeling Act.[5] Some of the current state regulation of insurance policy clauses could also be included in this article, thus bringing it within the enforcement provisions of this article. Enforcement would be patterned after the public and private enforcement of article III. The article covering unfair and deceptive trade practices, which is presented below, has been designated as article III. Article IV would prescribe minimal standards for the protection of health and safety by combining or at least indexing all existing state law, establishing coordination with federal enforcement, and selectively employing a private cause of action. Article V would cover miscellaneous problems in consumer sales by incorporating and revising retail installment sales acts, regulating unordered merchandise and disclaimers of implied warranties, and extending the unconscionability doctrine of section 2-302 of the Uniform Commercial Code to services.[6] Article VI would enact a revised draft of the Uniform Consumer Credit Code.[7]

Article VII would provide for specific representation of consumer interests in government. In addition to primary problems such as deception and inadequate information, the consumer faces a second obstacle: the governmental bodies responsible for remedying his primary problems may be apathetic, unsympa-

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4 MASS. ANN. LAWS ch. 93A, § 2 (Supp. 1968); compare comment to art. III, § 3-201 of model draft of unfair and deceptive trade practices legislation, *infra.*

5 Fair Packaging and Labeling Program tit. 15, § 1452-1461 U.S.C. (Supp. III 1965-67).

6 UNIFORM COMMERCIAL CODE § 2-301 (1962 version).

7 UNIFORM CONSUMER CREDIT CODE (1969 Rev. Final Draft); *See, e.g.*, C. James, *Uniform Consumer Credit Code: Inadequate Remedies under Articles V and VI,* 57 GEO. L.J. 923 (1969), R. Shay, *Uniform Consumer Credit Code: An Economist's View,* 54 CORNELL L. REV. 491 (1969); *Consumer Credit Reform: A Symposium,* 33 LAW & CONTEMP. PROB. 639 (1968); *Consumer Credit Reform: Symposium,* 44 N.Y.U.L. REV. 1 (1969).

thetic, or functionally incapable of effective action. This inaction has a broad effect since both enforcement and reform of existing law can stagnate. The common assumption that voters and consumers are identical groups is an over-simplification: some consumers cannot qualify to vote, some consumers are politically more powerful than others, and political loyalty usually depends on issues other than personal consumption.[8]

In theory most states already provide specific representation for consumer interests.[9] All states have departments for the regulation of utilities.[10] Over half of the states have special offices for consumer protection, usually in the office of the attorney general.[11] These are state departments for the inspection and supervision of food, drugs, and public eating places.[12] A few states have established consumer councils.[13] A variety of departments in state governments regulate banking, insurance, small loans, and public transportation.

However, criticisms have been made against existing efforts. Aside from typical budgetary and organizational problems, communication between the agency and its consumer constituency is often meager, unrepresentative, and counterbalanced by the

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8 A. ETZIONI, MODERN ORGANIZATIONS 104 (1964).

9 *See* C. BELL, CONSUMER CHOICE IN THE AMERICAN ECONOMY 328-331 (1967); D. Rice, *Remedies, Enforcement Procedures, and the Quality of Consumer Transaction Problems*, 48 B.U.L. REV. 559, 605 (1968).

10 COUNCIL OF STATE GOVERNMENTS, THE BOOK OF THE STATES 1968-1969 (1968).

11 Telephone interview with Office of Assistant General Counsel for Federal-State Cooperation, Federal Trade Commission, Washington, D.C., Nov. 4, 1969. These states are: Arkansas, Alaska, Arizona, California, Colorado, Connecticut, Delaware, Florida, Hawaii, Illinois, Iowa, Idaho, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, New Jersey, New Mexico, New York, North Dakota, North Carolina, Ohio, Oregon, Pennsylvania, Rhode Island, South Dakota, Texas, Utah, Vermont, Washington, West Virginia, and Wisconsin.

12 *E.g.*, DEPARTMENT OF AGRICULTURE AND MARKETS, STATE OF NEW YORK, 1967 ANNUAL REPORT (1968).

13. *E.g.*, FLA. STATS. ANN. § 570.282 (Supp. 1969); MASS. ANN. LAWS ch. 6, § 115 (1966); R.I. GEN. LAWS § 42-42-1 to 7 (Supp. 1967). The 1968 budget for the Massachusetts Council was $75,000. The Council has done studies for the executive and legislative branches. In 1966 the Council "equitably adjusted" about one-half of the 2000 written complaints they received. MASSACHUSETTS CONSUMERS' COUNCIL, 1966 ANNUAL REPORT (1967). The Council also is authorized to appear at rate hearings of regulatory agencies, but it does not have a full-time rate expert. *See* N.M. STATS. ANN. § 68-11-5 (Supp. 1969) (public utility regulation counsel); S. 607, 91st Cong., 1st Sess. (1969); 115 CONG. REC. 860-869 (daily ed. Jan. 24, 1969) (Sen. Metcalf on S. 607 to establish a federal consumer utility counsel and assist such state efforts).

internal pressures of team loyalty and obedience to supervisors.[14] Moreover, the tendency to evolve into the "industry-oriented agency" is always present.[15]

Perhaps, a new kind of agency or office developed from existing models could ameliorate at least the communication problem. This new body would serve as a coordinator of consumer activity carried on in other departments and in the legislature, as a clearinghouse for consumer-oriented research, and as a consumer advocate before other agencies.[16] The advocacy function would include conducting investigations, proposing legislation, appearing in the administrative hearings, channeling specific consumer complaints, conducting consumer education programs, and filing amicus curiae.[17] It might provide for consumers a representative not unlike that elusive character known as the "ombudsman."[18] Finally, some consideration should be given to whether this office should take on a more "activist role"; for example, the agency might encourage consumer cooperatives[19] and credit unions[20] by establishing counseling services through private businessmen if its studies show that these structures provide benefits which could not be attained by increased competition in the relevant market areas.[21]

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14 A. ETZIONI, MODERN ORGANIZATIONS 98-102 (1964).

15 For an ambivalent view of this problem in general, *see* L. JAFFE, JUDICIAL CONTROL OF ADMINISTRATIVE ACTION 10-27 (Abridged Stud. Ed. 1965).

16 *See* PRESIDENT'S COMMITTEE ON CONSUMER INTERESTS, CONSUMER ISSUES 1966, 39 (1966). *Cf. Hearings on H.R. 7179 Before a Subcommittee of House Committee on Government Operations*, 89th Cong., 2d Sess. (1966); S. 860, 91st Cong., 1st Sess. (1969); S. 2045, 91st Cong., 1st Sess. (1969); N.Y. Times, Oct. 31, at 22, col. 2 (President Nixon's proposal to establish an executive office of consumer affairs and a consumer protection division in the Department of Justice).

17 *See* text to note 53 *infra*.

18 *See* J. Moore, *State Government and the Ombudsman*, in OMBUDSMAN FOR AMERICAN GOVERNMENT (S. Anderson ed. 1968).

19 *See* S. Dreyer, *The Role of Cooperatives*, in THE CONSUMING PUBLIC 210 (G. McClellan ed. 1968); Consumer Cooperative Manager's Conference, Report on Neighborhood Cooperative of San Francisco, Inc. (1968) [hereinafter cited as Neighborhood Cooperative Report]. This last report describes the initial effort of a private food chain to provide free consultants to the cooperatve. It also notes that the cooperative did not have the undivided loyalty of its members.

20 *See* statement by Mr. W. M. O'Brien, Assistant Director of Bureau of Federal Credit Unions, Social Security Administration, Department of Health, Education, and Welfare in FTC, *Record of National Consumer Protection Hearings* (November 25, 1968).

21 As to the need for increased competition, *see, e.g.*, FTC, *Economic Report on Installment Credit and Retail Sales Practices of District of Columbia Retailers* XV (March, 1968); Sturdivant, *Better Deal for Ghetto Shoppers*, 46 HARV. BUS. REV. 130

Article VIII would establish a structure for implementing a consumer education program. Consumer education theoretically offers a solution to a number of consumer problems. The consumer could learn to allow for emergencies,[22] to budget his income,[23] to shop "wisely" by utilizing all available information,[24] to exercise an "intelligent" purchasing decision, to buy only what he "needed" at the most economical price and quality. He could learn to stretch his dollars by a variety of "do-it-yourself" techniques.[25] He could learn to take full advantage of his legal rights including legal self-help when he is wronged.[26]

In practice, education is probably not going to change the basic attitudes which are at the heart of many consumer problems.[27] Education is counterproductive if it fails to recognize and accept the compensatory gains that many low income con-

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(1968); PRESIDENT'S COMMITTEE ON CONSUMER INTERESTS, THE MOST FOR THEIR MONEY: A REPORT OF THE PANEL ON CONSUMER EDUCATION FOR PERSONS WITH LIMITED INCOMES (1965).

22 Studies of personal bankruptcy indicate that unexpected medical expenses are a significant cause of financial trouble. E. Reed, *Personal Bankruptcy in Oregon* (1967) at 82 (questionnaire to attorneys, collectors, and credit managers), at 93-95 (questionnaire to petitioners in bankruptcy); R. Herrman, *Causal Factors in Consumer Bankruptcy* 17-18 (1965); CAPLOVITZ, *supra* note 5, at 111-112; Neighborhood Cooperative Report, *supra* note 19, supplement at 10 (welfare check does not allow for emergencies).

23 Low income consumers are major purchasers of consumer durables. CAPLOVITZ, *supra* note 5, at 36-41. Most "official" budgets do not recognize the extent of this trend; nor would many persons establishing minimum guidelines recognize durables as necessities. E.g., Bureau of Labor Statistics, U.S. Department of Labor, Retired Couples' Budget for a Moderate Living Standard (1966), City Worker's Family Budget: Pricing, Procedures, Specifications, and Average Prices (1966), Three Standards of Living for an Urban Family of Four Persons (1967), Revised Equivalence Scale for Estimating Equivalent Incomes or Budget Costs by Family Types (1968).

24 For example, the consumer thinks he has adequate funds either because of his own ignorance or because of pressures from "salesmanship." Reed, *supra* note 22, at 80-81. R. Dolphin, *An Analysis of Economic and Personal Factors Leading to Consumer Bankruptcy* 71-72 (1965). Or he may not know the true cost of his purchase, especially the cost of credit. *E.g.*, Comment, *Translating Sympathy for Deceived Consumers into Effective Programs for Protection*, 114 U. PA. L. REV. 395, 399, n.33 (1966); Neighborhood Cooperative Report, *supra* note 19, supplement at 26.

25 *E.g.*, home production. RICHARDS, *supra* note 5, at 81-82.

26 CAPLOVITZ, *supra* note 5, at 171-172. For example, the record of complaints made to the Massachusetts Consumers' Council indicates that the poor are not taking advantage of the benefits provided by this consumer-oriented agency. MASSACHUSETTS CONSUMERS' COUNCIL, 1966 ANNUAL REPORT (1967).

27 CAPLOVITZ, *supra* note 5, at 127; RICHARDS, *supra* note 5, at 72-73.

sumers receive from conspicuous consumption.[28] At the very least there must be viable alternatives to such consumption in order to induce a change in attitudes. Furthermore, efforts to tell people how not to spend their welfare check may undermine the potential value of a whole program. As one lady remarked in a recent study, "If I didn't know how to spend my welfare check, my kids would be dead."[29] Middle class buying practices may or may not be the answer for the ghetto, but the question is probably academic.

There are educational efforts, however, which should be made. First, for those consumers who are interested, courses should be available in consumer budgeting and purchasing. Consumer education should be included in elementary and high school education by integrating consumer problems into the regular curriculum;[30] for example, elementary math classes could quite appropriately include calculations of budgets and English classes could study the deceptive use of emotive words. Second, the consumer office established in article VII or the attorney general's office can implement a variety of programs generally authorized by this article. The office could draft the materials for consumer education courses, publish a pamphlet describing rights and remedies under state law, and use the news media to warn against particularly common deceptive trade practices.[31] Third, efforts at consumer education, while addressed to the entire purchasing public, should concentrate on the elderly as well as the ghetto-dwellers.[32] Fourth, programs such as consumer counselors in store-front clinics should be included since ". . . just as the local merchants have learned to personalize their services, so it is necessary to personalize the efforts to help these consumers."[33]

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28 CAPLOVITZ, *supra* note 5, at 187.

29 Neighborhood Cooperative Report, *supra* note 19, at 32.

30 *Cf.* OFFICE OF SUPT. OF PUBLIC INSTRUCTION, STATE OF ILLINOIS, GUIDELINES FOR CONSUMER EDUCATION (June, 1968) (separate course); ILL. STATS. ANN. ch. 122, § 27-12.1 (Supp. 1969).

31 Compare the activities in the New York Attorney General's Office. *See* text to note 53, *infra*. The pamphlet describing state law should be published in two versions: one for lawyers and one for more general consumption.

32 *See, e.g.*, testimony by Steininger, DHEW, Social and Rehabilitative Service Role in Consumer Services and Protection, in FTC, *Record of the National Consumer Protection Hearings* (November 25, 1968).

33 CAPLOVITZ, *supra* note 5, at 182.

Finally, states should take full advantage of federal funds available for consumer education.[34]

ARTICLE III. PROTECTION AGAINST UNFAIR AND DECEPTIVE TRADE ACTS OR PRACTICES

PART A. DEFINITIONS

3-101. ***Person, Trade, Documentary Material, Examination.***

The following words, as used in this article, unless the context otherwise requires, shall mean:

(a) "Person" shall include natural persons, corporations, trusts, partnerships, incorporated or unincorporated associations, and any other legal entity.

(b) "Trade" and "commerce" shall include the advertising, offering for sale, or distribution of any services and any property, tangible or intangible, real, personal, or mixed, including the loan of money or extension of credit, and any other article, commodity, or thing of value wherever situate, and shall include any trade or commerce directly or indirectly affecting the people of this [state].

(c) "Documentary material" shall include the original or a copy of any book, record, report, memorandum, paper, communication, tabulation, map, chart, photograph, mechanical transcription, or other tangible document or recording, wherever situate.

(d) "Examination of documentary material" shall include the inspection, study, or copying of any such material, and the taking of testimony under oath or acknowledgment in respect of any such documentary material or copy thereof.

COMMENT: Unlike the Massachusetts statute, loans of money are specifically included within the coverage of this article. In all other respects the definitions are identical to the Massachusetts statute.

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34 *See* U.S. OFFICE OF EDUCATION, SOURCES OF FEDERAL ASSISTANCE FOR CONSUMER EDUCATION (1966), and the brief explanation in *A Bird's Eye View of Consumer Education Activities under the U.S. Office of Education* in FTC, *Record of the National Consumer Protection Hearings* (November 25, 1968).

PART B. UNFAIR METHODS, UNFAIR AND DECEPTIVE ACTS DECLARED UNLAWFUL; EXEMPTIONS

3-201. ***Unfair Methods of Competition and Unfair and Deceptive Acts Declared Unlawful.***

(a) Unfair methods of competition and unfair or deceptive acts or practices in the conduct of any trade or commerce are hereby declared unlawful.

(b) It is the intent of the legislature that in construing paragraph (a) of this section the courts will be guided by the interpretations given by the Federal Trade Commission and the Federal Courts to section 5(a)(1) of the Federal Trade Commission Act (15 U.S.C. 45(a)(1)), as from time to time amended.

COMMENT: Section 3-201(a) incorporates the language of section 5(a)(1) of the Federal Trade Commission Act.[35] This approach, when combined with 3-201(b),[36] insures a high degree of national uniformity and gives a greater degree of certainty to the law since the federal act has a body of agency and judicial case law built up over more than 50 years.

It might be suggested that by allowing federal amendments in effect to amend state law, the states are surrendering their law making powers. This objection overstates the case since the state may always amend its own statute to modify any subsequent federal amendment, ruling, or decision. The advantage of tying the state law to the latest version of the federal statute is that uniformity is easily insured unless there is a good reason not to do so. In the definition of unfair and deceptive acts or practices a clash between federal and state interests is less likely than in other areas where a state might be reluctant to cede its authority even temporarily.

Like this draft, the Massachusetts statute, along with statutes in three other states,[37] is exactly coextensive with the federal act: the coverage of "unfair methods of competition" is included. Some groups have objected that such coverage may encompass

35 Federal Trade Commission Act, 15 U.S.C. § 45(a)(1) (1964).

36 *See* R.I. GEN. LAWS § 6-13.1-3 (Supp. 1967).

37 HAWAII REV. LAWS § 205A-1.1 (1969); VT. STAT. ANN. tit. 9 § 2453 (Supp. 1968); REV. CODE OF WASH. ANN. tit. 19.86.020 (Supp. 1968).

too many practices not closely related to consumer problems and might amend certain state laws dealing with antitrust problems.[38] Besides section 3-201, three alternative drafts could meet this argument. One alternative is the Uniform Deceptive Trade Practices Act, which has been enacted in several states.[39] This act forbids: undisclosed substitution of other goods or services for those requested by a customer; trade symbol infringement; misrepresentation of the geographic origin of goods or services; false advertising of goods, services, and businesses; disparagement of goods, services, and businesses; bait advertising; price misrepresentation; and any other conduct which similarly creates a likelihood of confusion or misunderstanding.[40] While this language seems fairly comprehensive, this act was drafted primarily to protect businessmen against each other.[41] A broader alternative would cover the same listing of deceptive practices along with a subsection including "any other act or practice which is unfair or deceptive to the consumer."[42] These two alternatives are narrower than language like that in section 3-201; moreover, they sacrifice the incorporation of federal precedent. A more acceptable alternative is simply to exclude "unfair methods of competition" from the language of the Massachusetts statute. This approach provides wider coverage than the alternatives just men-

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38 ANTITRUST LAW SECTION, NEW YORK STATE BAR ASSOCIATION, REPORT OF THE COMMITTEE ON NEW YORK STATE ANTITRUST LAW 10, 11 (1967).

39 CONN. STATS. ANN. § 42-115d (Supp. 1969); FLA. STATS. ANN. §§ 817.69-817.74; IDAHO CODE §§ 48-601-606 (Supp. 1969); N. M. STATS. ANN. ch. 49 §§ 15-1 to 15-14 (Supp. 1969); OKLA. STATS. ANN. ch. 78 §§ 51-55 (Supp. 1969); TEX. STATS. ANN. art. 5069 §§ 10.01-10.05 (Supp. 1968-69). Florida and Oklahoma do not include the last broad provision of the UDTPA covering "any other conduct which similarly creates a likelihood of confusion or misunderstanding."

40 UNIFORM DECEPTIVE TRADE PRACTICES ACT § 2 (1964 version). The act abolishes the requirement of proof of irreparable harm as a condition precedent to the issuance of an injunction. It requires proof that the complainant is "likely to be damaged" but no proof of actual damages. It permits the issuance of an injunction even though the defendant had no intent to deceive and even where the deceptive practice involves misleading, though not false, statements. This act also permits the court, in its discretion, to award attorney's fees to the plaintiff where the defendant's violation was intentional. Its shortcomings in remedies provided for the consumer will be discussed in comments to part D of article III, *infra*.

41 R. Dole, *Consumer Class Actions Under the Uniform Deceptive Trade Practices Act*, 1968 DUKE L.J. 1101.

42 COUNCIL OF STATE GOVERNMENTS, 29 SUGGESTED STATE LEGISLATION 141, 142, 146 (1969) (alternative no. 3); R.I. GEN. LAWS 6-13.1-3.

tioned.[43] It preserves much of the federal body of precedent, while yet limiting the scope to primarily consumer problems.[44] This language is similar to that enacted in several states[45] and now recommended by the Federal Trade Commission.[46]

(c) The attorney general may make rules and regulations interpreting the provisions of paragraph (a) of this section. Such rules and regulations shall not be inconsistent with the rules, regulations and decisions of the Federal Trade Commission and the Federal Courts interpreting the provisions of 15 U.S.C. 45(a)(1) (The Federal Trade Commission Act), as from time to time amended.

COMMENT: The use of the term "interpreting" indicates that the attorney general's opinions may be advisory only. Consideration might be given to broadening his rule-making power by granting the force of law to his regulations. The review provision which would accompany this change should provide an opportunity to challenge his regulations when they are promulgated.

The following provision should be considered: Any person aggrieved or adversely affected or likely to be aggrieved or adversely affected by any rule or regulation promulgated pursuant to section 3-201(c) and who shall within 60 days of publication of notice of such proposed regulation petition the [court] for review of this regulation, shall be entitled to [judicial review]. Such review shall be the exclusive review of this rule or regulation (1) unless the rule is void on its face, (2) unless the individual affected did not know or have reason to know the effects of the rule at the time

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43 COUNCIL OF STATE GOVERNMENTS, *supra* note 42, at 142.

44 Practices expressly *permitted* under other state laws are already exempted. Section 3-202. An additional step to resolve this problem of overlap would be to provide a more specific exemption for acts covered under other state laws such as antitrust statutes.

45 ARIZ. REV. STATS. ANN. § 44-1522 (1956); DEL. CODE ANN. § 6-2513 (Supp. 1968); ILL. ANN. STATS. ch. 121½ § 262 (Supp. 1969); IOWA CODE ANN. § 713.24 (Supp. 1969); KAN. STATS. ANN. ch. 50 § 602 (Supp. 1969); MD. ANN. CODE art. 83 § 21 (Supp. 1968); MO. STATS. ANN. § 407.020 (Supp. 1968-69); N.J. STATS. ANN. tit. 56 § 8-2 (1964 and Supp. 1968-69). *Cf.* FTC, AMENDMENTS TO AND ALTERNATIVE FORMS OF UNFAIR TRADE PRACTICES AND CONSUMER PROTECTION LAW; COUNCIL OF STATE GOVERNMENTS, *supra* note 42, at 146 (alternative no. 2).

46 *Cf.* "false, misleading, or deceptive acts or practices," COUNCIL OF STATE GOVERNMENTS, *supra* note 42, at 142. *But cf.* FTC, AMENDMENTS TO AND ALTERNATIVE FORMS OF UNFAIR TRADE PRACTICES AND CONSUMER PROTECTION LAW (1969).

of its promulgation, or (3) if the party can show undue hardship or gross unfairness.

3-202. *Exemptions.*

Nothing in this article shall apply to transactions or actions otherwise expressly permitted under laws as administered by any regulatory board or officer acting under statutory authority of the [state] or of the United States. The burden of proving the exemption shall be upon the person claiming the exemption.

COMMENT: The word "expressly" has been added to the language of the Massachusetts statute to narrow further the primary jurisdiction of the other agency. It is intended that the court will have jurisdiction to determine whether a transaction is subject to concurrent jurisdiction or whether it has been expressly permitted by other authority.

The Massachusetts statute contains two further exemptions which attempt to resolve the problem of federal preemption.[47] They have been deleted here. One provision exempts persons who derive twenty percent or more of their gross revenue from transactions in interstate commerce, except when the action at issue occurred "primarily and substantially" within Massachusetts and the Federal Trade Commission does not object within fourteen days after notice of proposed state enforcement. The second provision exempts actions for which the Federal Trade Commission has served a complaint but has not terminated the case by dismissal, assurance of voluntary compliance, or a cease and desist order. Both of these provisions fail to solve all the possible preemption issues. Generally the attorney general can be expected to defer action when the Federal Trade Commission is handling the case. On the other hand, if the Federal Trade Commission is acting too slowly,[48] perhaps the attorney general should proceed against the same defendant. In any event, private consumers should not be denied affirmative or defensive use of article III simply because the Federal Trade Commission is also proceeding against the al-

47 MASS. STATS. ANN. ch. 93A § 3(b) and (c) (Supp. 1968).

48 *See* 115 CONG. REC. E-370 (daily ed. Jan. 22, 1969) (report on FTC to be published September, 1969 by Baron Press and authored by E. Cox, R. Fellmeth, J. Schulz).

leged violator, not at least without explicit federal preemption. While there may not be an unconstitutional burden, the severability clause seems the best solution to any possible preemption problem.[49]

PART C. ENFORCEMENT BY ATTORNEY GENERAL

COMMENT: Part C of article III contemplates the establishment of a consumer protection division within the office of the attorney general. Such an office should have a sufficient number of branches throughout the state to enable it to be readily accessible to consumers. Because of the attendant public expense and bureaucratic burdens, an attempt should be made to avoid the establishment of any new governmental agency. Over half of the states (38) have some form of consumer protection agency, generally in the office of the attorney general.[50]

The office established by article III would have the power:

(1) to bring suits (a) to enjoin unfair and deceptive trade acts or practices and, (b) to obtain restitution for victims of such practices, (c) to recover for the state the costs of such investigation, (d) to obtain civil penalties for violations of injunctions or wilful violations of the act, and (e) to seek dissolution of companies which habitually violate the injunctions;

(2) to obtain assurances of discontinuances of illegal practices from companies or persons violating the act;

(3) to investigate possible violations of the law with power to subpoena witnesses and documents subject to specific rules.

In addition, the office would, in cooperation with other state agencies, also enforce other consumer protection laws such as those requiring information disclosure, those setting minimum standards for the protection of health and safety, and those dealing

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49 A further exemption could be provided for the news media for advertising which they do not know to be false, misleading, or deceptive. Publishers and broadcasters would be responsible if they prepared the advertisement or had a financial interest in the goods or services advertised. COUNCIL OF STATE GOVERNMENTS, 29 SUGGESTED STATE LEGISLATION 143 (1969). *See, e.g.*, DEL. CODE ANN. § 6-2514 (Supp. 1968); ILL. ANN. STATS. ch. 121½ § 262 (Supp. 1969); KAN. STATS. ANN. ch. 50-602 (Supp. 1969); MD. ANN. CODE art. 83 § 21 (Supp. 1968); MO. STATS. ANN. § 407.020 (Supp. 1968-1969); N.J. STATS. ANN. tit. 56 § 8-2 (1964 and Supp. 1968-69), VT. STATS. ANN. art. 9 § 2452 (Supp. 1968).

50 *See* note 11, *supra*.

with the regulation of consumer credit. The attorney general's office would be expected to coordinate activities to keep master records of complaints and prosecutions and to prosecute any cases referred to it from these agencies. The attorney general's office also would have the right, if desired, to take over prosecutions from these other agencies.

Finally, the office would be expected to engage in the mediation of consumer complaints, extensive consumer education, legislative consultation and drafting, industry and business orientation, and coordination with other state governments, federal and local governments, and various consumer organizations.

Brief descriptions of the programs in several states may be helpful to show the potential for such an office.

In Illinois the Attorney General's Consumer Fraud Division has offices in six cities throughout the state. From 1961 to 1968, more than 50,000 members of the public were assisted and more than $2,000,000 — primarily in amounts of $15 to $25 — was recovered for those persons. These statistics suggest that each office handled approximately 2000 complaints per year. This volume is especially significant because article III gives broader statutory power than is provided in Illinois.[51]

In Missouri there are offices of the Consumer Protection Division of the Attorney General's Office in three cities. In the first seven months of operation the consumer protection statute saved consumers a total of $133,296.[52]

The New York Bureau of Consumer Frauds and Protection is one of the most active state consumer agencies in the country.[53] It was first established by Attorney General Lefkowitz in 1957. As of December 31, 1968, it had an assistant attorney general in charge, 10 assistant attorneys general, a senior attorney, an accountant, 3 investigators, 2 Spanish-speaking interviewers, 5 mem-

51 Letter from the Office of William Clark, Attorney General of Illinois to author, April, 1969; ILL. STATS. ANN. ch. 121½ § 263 (Supp. 1969).

52 B. Storts, Chief Counsel of Consumer Protection Division, J. OF MO. BAR (November, 1968) 495.

53 *See* Lefkowitz, *Consumer Protection*, 74 CASE AND COM. 10 (1969); Mindell, *The New York Bureau of Consumer Frauds and Protection*, 11 N.Y.L.F. 603 (1965); Note, *Consumer Protection in New York*, 32 ALBANY L. REV. 522 (1968); DEPT. OF LAW, STATE OF NEW YORK, REPORT OF BUREAU OF CONSUMER FRAUDS AND PROTECTION (1967 and 1968).

bers of the administration, and 23 part-time students from the New York Law School Program. For the year ending in 1968 they received some 16,388 complaints of consumer fraud and closed 15,842 cases, instituted actions in 89 cases and closed 85, returned to the consumer over $850,000 by way of mediation or court action, and collected statutory costs of $46,815. In addition, the Bureau also received from the State Department of Agriculture and Markets some 347 cases to be prosecuted. It closed 294 such cases and collected for the state $10,462 in penalties.

The New York Bureau breaks down its activities into six basic areas:

(1) Mediation of individual complaints for most cases;

(2) Consumer education through extensive public speaking engagements by the staff, an educational film and pamphlet on consumer fraud, preparation of a text for consumer education courses in the high schools, timely warnings by radio, TV, or newspaper of seasonal fraudulent practices and other areas of potential interest to the consuming public, and participation on regular radio and TV programs;

(3) Litigation to enforce a number of consumer protection laws including seeking injunctions against various practices and occasionally seeking dissolution of corporations doing business in a persistently fraudulent manner;

(4) Legislative action through proposing draft legislation and informing the attorney general of bills adverse to the consumers' interest;

(5) Industry and business orientation through close contact with legitimate ethical associations and trade groups both in developing effective legislation to deal with fraud and deception, and in promulgating voluntary codes of ethical conduct for particular industries;

(6) Governmental and quasi-governmental coordination by assisting federal, state, local, foreign, and quasi-governmental groups in establishing or implementing consumer protection programs.

In the state of Washington, offices of the Consumer Protection Division of the Office of the Attorney General are in four cities. From July, 1961, to June, 1968, the division processed more than 25,000 complaints, and its enforcement activities have resulted

in contract cancellations or refunds to consumers that exceed $2,000,000.[54]

The functions of the division can be outlined as follows: (1) complaint processing by which complaints are filed and checked for patterns against a master list and a summary of the pertinent fact is given to the firm involved so that it can tell its side of the story and take steps for self-regulation; (2) investigation where patterns of complaints develop; (3) litigation, formal and informal, through obtaining assurances of discontinuances or seeking injunctions; (4) legislative proposals; (5) consumer education through distribution of a *Consumer Protection Handbook*, news releases of enforcement activity, trade conferences, public speeches, comic strips, and spot ads on TV on deceptive practices. The costs of the operation of this division were just over $80,000 a year for the fiscal years from 1963 to 1965.[55]

In addition to the programs of various states there have been a few efforts on a local level: (1) Nassau County, New York, has a county department of consumer affairs which was established in May of 1967; (2) The Federal Trade Commission had an experimental "model consumer protection program" for the District of Columbia with an average of five attorneys working full time on the program.[56]

3-301. *When Attorney General May Seek Injunction.*

Whenever the attorney general has reason to believe that any person is using, has used or is about to use any method, act, or practice declared unlawful by section 3-201 or by other sections in this article [or code] specifically giving the attorney general the right to enforce their provisions, and that proceedings would be in the public interest, he may bring an action in the name of the [state] against such person to restrain by temporary or permanent injunction the use of such method, act or practice.

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54 Letter from Office of John O'Connell, Attorney General of Washington, to author, April, 1969.

55 J. O'Connell, *Consumer Protection in the State of Washington*, 39 STATE GOVT. 230, 234 (1966).

56 The program together with conclusions and legislative proposals is set forth in FTC, REPORT ON DISTRICT OF COLUMBIA CONSUMER PROTECTION PROGRAM (June 1968).

3-302. *Where the Action May be Brought.*

The action may be brought in the [insert name of court] court of the [city or county] in which such person resides or has his principal place of business, or the action may be brought in the [insert name of the court in the state capital] with the consent of the parties or if the person has no place of business within the state.

COMMENT: The court should be one of record, preferably not at the lowest level.

3-303. *Requirement of Notice by Attorney General and Opportunity to Confer with Attorney General.*

At least ten days prior to the commencement of any action brought under this article, the attorney general shall notify the person of his intended action, and give the person an opportunity to confer with the attorney general in person or by counsel or other representative as to the proposed action. Such notice shall be given the person by mail, postage prepaid, to his usual place of business, or, if he has no usual place of business, to his last known address.

COMMENT: Regulation should be designed to encourage and assist the industry in self-regulation and bring the full power of the state to bear only when self-regulation fails adequately to protect the consumer. Thus before formal proceedings are initiated the merchant is always given the opportunity to tell his side of the story, confer with the office of the attorney general, and to make alternative arrangements for self-regulation or restitution rather than to litigate the matter.

However, consideration should be given to revising this section of the Massachusetts statute by leaving it to the discretion of the attorney general whether he should notify one who has violated article III or given an assurance of discontinuance within one year of the present action. The attorney general could judge whether the opportunity to confer would be productive or obstructive, given the circumstances of the individual case.

3-304. *Authority of the Court to Issue Injunctions, to Order Restitution.*

When any action is brought under section 3-301, the court is authorized to issue temporary or permanent injunctions and to make

such other orders or judgments as may be necessary to restore to any person who has suffered any ascertainable loss by reason of the use or employment of such unlawful method, act or practice, any moneys or property, real or personal, which may have been acquired by means of such method, act or practice.

COMMENT: The authority for the court to decree restitution is not at all novel.[57] It may raise a jury trial requirement under state law, however, even though the power is exercised in equity. See sections 3-309, 3-310, 3-406 which may also raise jury trial issues depending on applicable state law.

3-305. *Requirement of Notice and Opportunity to be Heard before Issuance of Injunction.*

No permanent injunction shall issue except upon notice and an opportunity to be heard by the court where the action is pending. The court may issue a temporary restraining order but there shall be a hearing on any such temporary restraining order within 48 hours of issuance.

COMMENT: The Massachusetts statute has been revised to allow the issuance of a temporary restraining order.

3-306. *Court to Retain Jurisdiction When It Has Issued Injunction.*

The court issuing an injunction or order under 3-304 shall retain jurisdiction, and the cause shall be continued, and in appropriate cases the attorney general acting in the name of the [state] may petition for recovery of a civil penalty under section 3-307 or for action by the Court under section 3-308.

3-307. *Contempt of Court and Restitution for Violation of Injunction.*

Any person who violates the terms of an injunction or other order issued under this article may be held in contempt of court and fined up to [ten] thousand dollars for each violation. The court may also order restitution.

COMMENT: The Massachusetts statute provides for a civil fine,

57 *E.g.*, ARIZ. REV. STATS. ANN § 44-1528 (1956); DEL. CODE ANN. § 6-2523 (Supp. 1968); ILL. STATS. ANN. ch. 121½ § 262 (Supp. 1969); KAN. STATS. ANN. ch. 50 § 608 (Supp. 1969); MD. ANN. CODE art. 83 § 22 (Supp. 1968); MO. STATS. ANN. § 407.110 (Supp. 1968-1969).

but does not allow for the court to use its contempt powers. This draft provides more flexibility. The provision for restitution, also added in this draft, is consistent with sections 3-304 and 3-406.

3-308. *Power of Court to Dissolve Corporations for Habitual Violations of Injunctions.*

Upon petition by the attorney general, the court may, for habitual violation of injunctions issued pursuant to section 3-304, order the dissolution, or suspension, or forfeiture of franchise of any corporation or the right of any foreign corporation to do business in this [state], or may prohibit any individual from engaging in, owning, or in any manner being associated with, either personally or through any corporation, any similar or related business or franchise in this [state].

COMMENT: This is not a novel sanction.[58] However, except in this situation, any system of licensing and revocation is too drastic a sanction and is unlikely to be used by the courts even if provided by statute.[59] The provision for individuals has been added to the Massachusetts statute.

3-309. *Payment of Costs of Attorney General's Investigation.*

In any action under section 3-301 where an injunction is issued, the court may order the person against whom the injunction has issued to pay to the state the costs of the investigation of that person by the attorney general.

COMMENT: This additional public remedy is not in the Massachusetts statute. Several states provide for it, however.[60] It seems to be an especially appropriate remedy for the state interest. Note that it is discretionary with the court.

3-310. *Civil Penalty for Wilful Violations.*

In any action brought under section 3-301 in which the court finds that a person is wilfully using or has wilfully used a method, act or practice declared unlawful by Part B of this article, the attorney

58 *Cf.* N.Y. BUS. CORP. LAW § 1101 *et seq.* (McKinney 1963 and Supp. 1970).

59 *See, e.g., In re* Prince Motors, Inc., 15 App. Div. 2d 708, 223 N.Y.S.2d 688 (3d Dep't 1962).

60 *E.g.*, ARIZ. REV. STATS. ANN. § 44-1534 (1956); MD. ANN. CODE art. 83 § 25 (Supp. 1968).

general may recover, on behalf of the [state], a civil penalty not exceeding [two] thousand dollars.

COMMENT: Sections 3-309 and 3-310 are not in the Massachusetts statute. Compare section 3-312. While the courts and society generally have been unwilling to apply criminal sanctions in this area,[61] it may be appropriate to include some greater emphasis on deterrence than is provided in the Massachusetts statute, which limits suits by the attorney general to injunctions and restitution to the consumer.[62] Flexibility is not sacrificed; section 3-316 covers "wilful" violations and thus allows almost as much discretion in judicial application as section 3-309. Compare section 3-406 increasing private recovery for wilful violations.

3-311. *Attorney General Authorized to Accept Assurance of Discontinuance.*

In any case where the attorney general has authority to institute an action or proceeding under section 3-301 of this article, in lieu thereof he may accept an assurance of discontinuance of any method, act or practice in violation of this chapter from any person alleged to be engaged or to have been engaged in such method, act or practice.

3-312. *Assurance May Include Provision for Payment of Cost of Investigation and Restitution.*

Any assurance under section 3-311 may, among other terms, include a stipulation for the voluntary payment by such person of costs of investigation, or of any amount to be held in escrow pending the outcome of an action or as restitution to aggrieved buyers, or both.

3-313. *Filing of Assurance Required.*

Any assurance of discontinuance under section 3-311 shall be in writing and be filed with the [insert name of court of the state capital as given under section 3-302] and shall be indexed by the name of the offending individuals and company.

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61 *But cf.* ARIZ. REV. STATS. ANN. § 44-1531 (1956) (misdemeanor including possible six months imprisonment).

62 COUNCIL OF STATE GOVERNMENTS, *supra* note 42, at 145 (recommends $2,000 civil penalty for wilful violations).

3-314. *Attorney General May Reopen Assurances when in the Public Interest.*

Matters closed by an assurance of discontinuance under section 3-311 may at any time be reopened by the attorney general for further proceedings in the public interest.

3-315. *Evidence of a Violation of an Assurance Prima Facie Evidence of Violation of Section 3-201.*

Evidence of a violation of an assurance of discontinuance under section 3-311 shall be prima facie evidence of a violation of section 3-201 in any subsequent proceeding brought by the attorney general.

COMMENT: Assurances help establish a prima facie case for the attorney general thereby shifting the burden of proof. They also have some moral weight. They are not, however, as powerful as a consent degree and accordingly they should be much easier to obtain.

3-316. *Requirement to Inform Attorney General of Alleged Violations of this Article.*

Any district attorney or law enforcement officer receiving notice of any alleged violation of this article or of any violation of an injunction or order issued in an action brought under section 3-301 shall immediately forward written notice of the same together with any information that he may have to the office of the attorney general.

3-317. *When Attorney General May Investigate.*

The attorney general, whenever he believes a person has engaged in or is engaging in any method, act or practice declared to be unlawful by 3-201, may conduct an investigation to ascertain whether in fact such person has engaged in or is engaging in such method, act or practice.

COMMENT: State statutes vary but most provide a fairly comprehensive investigative power for the attorney general.[63]

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63 *E.g.*, ARIZ. REV. STATS. ANN. § 44-1524 to 1526 (1956); DEL. CODE ANN. § 6-2514 (Supp. 1968); ILL. STATS. ANN. ch. 121½ § 263 (Supp. 1969); MO. STATS. ANN. § 407.040 (Supp. 1968-69); N.J. STATS. ANN. tit. 56 § 8-3 (1964 and Supp. 1968-69); REV. CODE OF WASH. ANN. tit. 19 § 86.110 (Supp. 1968); VT. STATS. ANN. tit. 9 § 2460 (Supp. 1968).

3-318. *Investigatory Powers of Attorney General Specifically Include.*

The attorney general in conducting an investigation under section 3-317 may:

(a) Take testimony under oath concerning such alleged unlawful method, act, or practice;

(b) Examine or cause to be examined any documentary material of whatever nature relevant to such alleged unlawful method, act, or practice; and

(c) Require attendance during such examination of documentary material of any person having knowledge of the documentary material and take testimony under oath or acknowledgment in respect of any such documentary material.

3-319. *Venue of Examinations.*

The testimony and examination under 3-318 shall take place in the county where such person resides or has a place of business or, if the parties consent or such person is a non-resident or has no place of business within the [state], in the state capital.

3-320. *Requirement of Notice; Time of Notice.*

Notice of the time, place and cause of such taking of testimony, examination or attendance under section 3-318 shall be given by the attorney general at least ten days prior to the date of such taking of testimony or examination.

3-321. *Service of Notice of Examinations.*

Service of any such notice may be made by:

(a) Delivering a duly executed copy thereof to the person to be served or to a partner or to any officer or agent authorized by appointment or by law to receive service of process on behalf of such person;

(b) Delivering a duly executed copy thereof to the principal place of business in this [state] of the person to be served; or

(c) Mailing by registered or certified mail a duly executed copy thereof addressed to the person to be served at the principal place of business in this [state] or, if said person has no place of business in this [state], to his principal office or place of business.

3-322. *Contents of Notice Required.*

Each such notice shall:

(a) State the time and place for the taking of testimony or the examination and the name and address of each person to be ex-

amined, if known, and, if the name is not known, a general description sufficient to identify him or the particular class or group to which he belongs;

(b) State the statute and section thereof, the alleged violation of which is under investigation and the general subject matter of the investigation;

(c) Describe the class or classes of documentary material to be produced thereunder with reasonable specificity so as fairly to indicate the material demanded;

(d) Prescribe a return date within which the documentary material is to be produced; and

(e) Identify the members of the attorney general's staff to whom such documentary material is to be made available for inspection and copying.

3-323. *Limitations on Notice.*

No such notice shall:

(a) Contain any requirement which would be unreasonable or improper if contained in a subpoena duces tecum issued by a court of this [state]; or

(b) Require the disclosure of any documentary material which would be privileged or which for any other reason would not be required by a subpoena duces tecum issued by a court of this [state]. Trade secrets are not covered by this section, but are covered by section 3-325.

COMMENT: The privilege for trade secrets granted in the Massachusetts statute has been specifically excluded here, because sections 3-323(e) and 3-325 already afford adequate protection by requiring a court order to disclose the information to anyone but the attorney general's office without the consent of the person investigated.[64] While the same argument may be made for other information protected by 3-323(b), a colorable claim of "trade secret" is easiest to manufacture.

3-324. *Discretion of the Court to Modify Demands of Attorney General.*

At any time prior to the date specified in the notice required under section 3-320 or within twenty-one days after the notice has

64 For a statute treating trade secrets to the same effect, *see* MO. STATS. ANN. § 407.060 (Supp. 1968-1969).

been served whichever period is shorter, the court may, upon motion for good cause shown, extend such reporting date or modify or set aside such demand. The motion may be filed in the [ ] court of the [city or county] in which the person served resides or has his usual place of business, or in [the state capital].

3-325. Information Obtained Under Section 3-318 Disclosed Only to Attorney General Except by Court Order.

Any documentary material or other information produced by any person pursuant to section 3-318 shall not, unless otherwise ordered by a court of this state for good cause shown, be disclosed to any person other than the authorized agent or representative of the attorney general, unless with the consent of the person producing the same.

3-326. Immunity from Criminal Prosecution.

Section 3-318 shall not be applied to any criminal proceeding. No individual shall be prosecuted for any transaction on which he is compelled to testify or produce evidence under section 3-318 after having claimed his privilege against self-incrimination, except that such individual shall not be exempt from prosecution for perjury committed in so testifying.

COMMENT: The general policy behind immunity statutes is that full disclosure may be more valuable than criminal prosecution. Therefore, a witness must be given sufficient fifth amendment protection so that he may be constitutionally compelled to testify. The attorney general always has the option of not using his investigatory powers and prosecuting criminally.

The Massachusetts provision which provided immunity from use in a criminal proceeding has been replaced by an immunity-from-prosecution provision based on a federal immunity provision.[65] An immunity-from-prosecution provision may not be necessary. Although immunity-from-prosecution is constitutionally required for federal statutes,[66] there may be a less rigorous standard for the

65 Federal Communications Act, 47 U.S.C. § 409(1) (1964). For a similar state statute in this area, *see* N.J. STATS. ANN. tit. 56 § 8-7 (1964 and Supp. 1968-69).

66 Counselman v. Hitchcock, 142 U.S. 547, 582 (1892). *But cf.* Note, 33 FORDHAM L. REV. 77, 80 (1964); Note, 10 N.Y.L.F. 627 (1964); Note, 20 RUT. L. REV. 336, 340 (1966) (suggesting that Murphy v. Waterfront Comm'n, 378 U.S. 52 (1964) may have diluted *Counselman* even for federal immunity purposes).

states.[67] An immunity against use of the evidence or its fruits may be a constitutional replacement for the Massachusetts use statute. However, immunity-from-prosecution has been used in this draft because states have seemed willing to follow that approach.[68] Furthermore, the provision would not create an "immunity bath" here, since there is no criminal sanction in this statute, criminal prosecution under related state statutes would probably be rare, and a claim of privilege must be asserted to gain immunity. On the other hand, immunity from the use of evidence or its fruits is a clearly acceptable alternative, especially since the power of the state to exempt from federal prosecution under an immunity-from-prosecution statute is at least as questionable as the constitutionality of the more limited exclusionary immunity.[69]

In any event, the requirement that a claim of privilege be asserted should be included because the courts have read the coverage of immunity statutes expansively.[70] A claim requirement gives notice to the investigating authority that the immunity will be established if the testimony is taken.[71] While in the operation of this statute the investigating authority would presumably be aware of the provision,[72] there seems to be little harm in including it nonetheless.

3-327. *Requirement to Comply with Proper Demand by Attorney General.*

A person upon whom a notice is served pursuant to the provisions of section 3-318 shall comply with the terms thereof unless otherwise provided by the order of a court of this [state].

3-328. *Civil Penalty for Violation of Section 3-327 or Intentional Destruction or Concealment of Evidence.*

Any person who fails to appear, or with intent to avoid, evade, or prevent compliance in whole or in part, with any civil investigation

67 Murphy v. Waterfront Comm'n, 378 U.S. 52 (1964); Note, 78 HARV. L. REV. 143, 230 (1964); Note, 20 RUT. L. REV. 336, 342 (1966).

68 Annot., 53 A.L.R.2d 1030, 1033-35 (1957); 8 WIGMORE, EVIDENCE § 2281, n.11.

69 Note, 20 RUT. L. REV. 331, 345 (1966).

70 Wexler, *Automatic Witness Immunity Statutes and the Inadvertent Frustration of Criminal Prosecutions: A Call for Congressional Action*, 55 GEO. L.J. 656; Comment, 72 YALE L.J. 1568, 1598 (1963).

71 United States v. Niarchos, 125 F. Supp. 214 (D.D.C. 1954); United States v. Marcus, 310 F.2d 143 (3d Cir. 1962), *cert. denied*, 372 U.S. 944 (1963); United States v. H.P. Hood & Sons, Inc., 214 F. Supp. 656 (D. Mass. 1963).

72 *Cf.* cases cited note 71, *supra*.

under this article, removes from any place, conceals, withholds, or destroys, mutilates, alters, or by any other means falsifies any documentary material in the possession, custody or control of any person subject to any such notice, or knowingly conceals any relevant information, shall be assessed a civil penalty of not more than five thousand dollars.

3-329. *Procedure for Enforcement by Attorney General of Investigatory Powers.*

The attorney general may file, in the [ ] court of the [city or county] in which such person resides or has his principal place of business, or of [the state capital] if such person is a nonresident or has no principal place of business in this state, and serve upon such person in the same manner as provided in sections 3-320, 3-321, and 3-322, a petition for an order of such court for the enforcement of sections 3-327 and 3-328.

PART D: PRIVATE LEGAL RECOURSE BY THE CONSUMER

Part D would give the consumer a private right of action whenever he has been harmed by an unfair or deceptive trade act or practice.[73] The purposes of this approach are: (1) to give consumers a convenient process to secure compensation when they are harmed by unfair and deceptive trade practices; (2) to allow consumers to act in certain circumstances as a class and thereby reduce multiple litigation for a number of small claims and at the same time emphasize the broader economic effect of a deceptive practice; (3) to reduce the costs to government of providing protection against unfair and deceptive trade practices without depriving consumers of protection; (4) to provide reasonable protection to the honest merchant against "strike suits" and uncertainty in the law; (5) to encourage settlements rather than litigation.

73 *Cf.* J. Spanogle, Jr., *Why Does the Proposed Uniform Consumer Credit Code Eschew Private Enforcement?*, 23 BUS. LAWYER 1039 (1968). In the area of consumer self-help there are, of course, a number of non-judicial remedies. The Consumers Education and Protection Association of Philadelphia issues a monthly newspaper and organizes picketing and boycotts against unscrupulous merchants. The Consumer Federation of America publishes regular letters advising local consumer groups and others on new developments and pending consumer legislation. In Virginia, a private citizens' consumer council sponsors a Dial-a-Consumer telephone line with daily advice on shopping tips and issues periodic press releases on consumer problems and price comparison.

Existing common law or statutes may not provide a private remedy where there is no private right of action for unfair and deceptive trade practices. While there are possible legal theories for dealing with fraud and misrepresentation on the part of sellers, they may be unrealistic when applied to unsophisticated consumers, and even where they are theoretically available, without legislation, they require the admittedly slow evolution of the common law.[74] The FTC is not bound by common law fraud concepts under section 5 of the Federal Trade Commission Act.[75]

The Uniform Deceptive Trade Practices Act gives much more limited private right of action than is available under this article. It limits the consumer to prospective equitable relief.[76] While such relief may be of benefit to a business being harmed by the unfair practices of the competition, it is of limited help to consumers. Without the right to recover their out-of-pocket losses when harmed by deceptive practices, there is little incentive for consumers to take legal action.

By allowing the aggrieved consumer to take legal action to obtain convenient and speedy redress, part D avoids either (1) creating a "bottleneck" where only a limited number of consumers will get the protection they deserve or (2) forcing the expenditure of tax dollars for a larger attorney general's office to do much that the consumer, if given the opportunity, could do himself.

The "bottleneck" in the attorney general's offices comes from both the volume of complaints given to a staff of limited size and the necessity within the office to establish priorities which may not be the same as those of the complainant.[77] It is more economical and probably more effective to encourage consumers to handle their own individual complaints so that the attorney general can deal primarily with the larger, more organized deceptive

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74 For a good discussion of this issue, *see* S. Hester, *Deceptive Sales Practices and Form Contracts—Does the Consumer Have a Private Remedy?*, 1968 DUKE L.J. 831.

75 Tit. 15 § 45(a)(1) U.S.C. (1964); *see, e.g.*, Gulf Oil Corp. v. FTC, 150 F.2d 106, 109 (5th Cir. 1945) and cases cited therein (puffing).

76 R. Dole, *Merchant and Consumer Protection: The Uniform Deceptive Trade Practices Act*, 76 YALE L.J. 485, 495-500 (1967). *But see* Holstein et al. v. Montgomery Ward, No. 68, ch. 275 (Cir. Ct. Cook County, Ill., March 11, 1969) (sustained consumer class action under Uniform Deceptive Trade Practices Act).

77 D. Rice, *Remedies, Enforcement Procedures and the Quality of Consumer Transaction Problems*, 48 B.U.L. REV. 559, 606-607 (1968).

practices which would be difficult for the individual consumer to challenge. His office would be notified whenever legal action is commenced and whenever any district attorney or law enforcement officer learns of a violation of article III.[78] The attorney general can review these cases along with everyday complaints to his office and act against any large pattern of practices which becomes evident.

Nor is this scheme unfair to the legitimate needs of honest merchants. It provides a number of protections against consumer abuse.

First, no person should recover unless he has suffered an actual loss of money or property as a result of an unfair or deceptive practice.[79]

Second, before any merchant may be sued by a consumer, the consumer must make a written demand for relief and the merchant has 30 days to offer a reasonable settlement.[80]

Third, if the consumer refused the settlement offer, the merchant may tender his offer to the court. If the court later finds that his offer of settlement was reasonable in amount, his liability is limited to the amount of the settlement offer.[81] Thus the consumer gains nothing by pressing a claim where the merchant has made a reasonable offer of settlement; in fact he then risks attorney's fees for which he will receive no reimbursement. The danger that some unethical attorneys might bring a frivolous suit solely for the purpose of harassment should not mean that consumers should be denied an effective legal remedy. The settlement provisions should provide adequate protection against frivolous suits if the bar association cannot.

Fourth, the provision awarding double or triple the actual damages comes into play only when (1) either the violation was a wilful or knowing violation or after a timely demand by the consumer, the merchant knew or had reason to know that the practice complained of was unfair or deceptive within the meaning

78 §§ 3-408 and 3-316.

79 § 3-401.

80 § 3-403.

81 § 3-404.

of section 3-201; and (2) the merchant refused to make a reasonable offer of settlement.[82]

Fifth, the merchant is protected against great uncertainty in the law by an existing body of case law, decisions by the FTC, and regulations by the FTC and the attorney general which deal with unfair and deceptive practices. All these benefits are available if the legislatures are willing to act in this area. In light of their responsibilities as lawmakers vis-à-vis the courts, it is appropriate for the legislatures to respond before the courts imply a private right of action. While an implied private right of action is consonant with the private interest and strained public enforcement in this area, the courts will not be able to employ all the methods available to the legislature.[83]

3-401. *Consumer Right of Action.*

Any person who (a) purchases or leases goods or services primarily for personal, family or household purposes and (b) thereby suffers any loss of money or property, real or personal, as a result of the use or employment by another person of an unfair or deceptive act or practice declared unlawful by section 3-201 may, subject to section 3-403, bring action in the [ ] court [in equity] for damages and such equitable relief as the court deems to be necessary and proper or use the proof of a violation of section 3-201 as a defense in any action to collect a debt arising out of a transaction involving the violation.

COMMENT: The defensive use was added by this draft. Of course, such a provision is worthless in many cases unless coupled with a provision changing the holder in due course doctrine to prohibit waiver of defenses against the assignees of consumer paper.[84]

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82 §§ 3-404, 3-406.

83 Consider the difficulties the courts have discovered after implying a private cause of action under Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1964). SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert denied*, 89 S. Ct. 1454; L. LOSS, 6 SECURITIES REGULATION 3869-3873 (Supp. 1969). *See also* Note, *Implying Civil Remedies from Federal Regulatory Statutes*, 77 HARV. L. REV. 285 (1963).

84 *See, e.g.*, MASS. STATS. ANN. ch. 255 § 12C (Supp. 1969); UNIFORM CONSUMER CREDIT CODE § 2.404 (1969 Rev. Final Draft); COUNCIL OF STATE GOVERNMENTS, *supra* note 42, at 149.

3-402. *Class Actions Allowed Subject to Certain Conditions.*[85]

(a) Any persons entitled to bring such action may, if the use or employment of the unfair or deceptive act or practice has caused similar injury to numerous other persons similarly situated and if the court finds in a preliminary hearing that he adequately and fairly represents such other persons, bring the action on behalf of himself and such other similarly injured and situated persons; the court shall require that notice of such action be given to unnamed petitioners in the most effective practicable manner.

(b) Such action shall not be dismissed, settled or compromised without the approval of the court, and notice of any proposed dismissal, settlement or compromise shall be given to all members of the class of petitioners in such manner as the court directs.

3-403. *Requirement that Complainant Make Written Demand for Relief.*

A written demand for relief identifying the claimant and reasonably describing the unfair or deceptive act or practice relied upon and the injury suffered shall be mailed or delivered to any prospective respondent at least thirty days prior to the filing of any action under section 3-401 or section 3-402 of this article.

3-404. *Right of Defendant to Limit Liability by Reasonable Tender of Settlement.*

Any person receiving such a demand for relief who, within thirty days of the mailing or delivery of the demand for relief, makes a written tender of settlement to the claimant that is rejected by the claimant may, in any subsequent action brought by the claimant, file the written tender and an affidavit concerning its rejection and thereby limit any recovery to the relief tendered if the court finds that the relief tendered was reasonable in relation to the injury actually suffered by the petitioner, including the reasonable costs of making a demand for relief.

3-405. *Special Procedure for Out-of-State Respondents.*

The demand requirements of section 3-403 shall not apply where the prospective respondent does not maintain a place of business

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85 *Cf.* FED. R. CIV. P. 23. *See* Starrs, *The Consumer Class Action: Considerations of Equity and Procedure* in NATIONAL INSTITUTE FOR EDUCATION IN LAW AND POVERTY, HANDBOOK ON CONSUMER LAW 105 (2d ed. 1968).

or does not keep assets within the state but such respondent may employ the provisions of section 3-404 by making a written offer of relief and paying any rejected tender into court as soon as practicable after [receiving notice of] an action commenced under section 3-401 or 3-402.

3-406. *Damages and Other Relief Under this Part.*

Unless the respondent has made a written tender of relief under section 3-404 which the court finds was reasonable in relation to the injury actually suffered by the petitioner, the court when it finds for the petitioner in an action commenced under section 3-401 shall award:

(a) actual damages or [ ] dollars, whichever is greater; and

(b) reasonable attorney's fees and costs incurred in connection with the action; and

(c) such other equitable relief, including an injunction, as the court deems necessary and proper; and

(d) up to three [but not less than two] times the damages awarded under paragraph (a) of this section if the court finds that the use or employment of the act or practice was a wilful or knowing violation of section 3-201 of this article or that the refusal to grant relief upon demand was made with knowledge or reason to know that the act or practice complained of violated section 3-201 of this article.

COMMENT: Attorney's fees and other costs may act as a bar to effective private action without the provisions of 3-406. Note that 3-404 also includes attorney's fees in determining the "reasonableness" of the settlement offer.

Even if the consumer has the legal basis for a claim, he may be unable or unwilling to hire an attorney in view of the potential amount of his recovery. The potential recovery may be too small to secure a lawyer on a contingent-fee basis. To retain a private lawyer under a contingent-fee arrangement almost always requires a consultation fee of $5 and an initial cash retainer of $50 to $100. If he wins, the consumer will not be "made whole" since the attorney's contingent fee will take roughly one-third of the award.[86]

Indigent consumers fortunate enough to have access to a free legal service program may be in a better position than other de-

86 Note, *Translating Sympathy for Deceived Consumers into Effective Programs for Protection*, 114 U. PA. L. REV. 295, 409 (1966).

frauded consumers where the amount at issue is small. If the legal service program has the staff, it will generally handle contingent-fee cases which the private bar refuses because even 100 percent of the recovery would not be enough of a fee. In cases where the victim of a deceptive practice only seeks to be compensated for out-of-pocket losses and where even with such compensation he would still be eligible for free government funded legal assistance, it has been suggested that the legal service program should keep the case.[87]

Section 3-406 makes it economically possible for the aggrieved consumer to enlist the aid of the private bar in seeking convenient and speedy redress. If the court finds (1) that the consumer has been harmed by an unfair or deceptive business practice, and (2) that the seller, after a timely request by the consumer, refused to make a reasonable settlement, then the consumer would recover reasonable attorney's fees as well as his actual damages. In contrast, the Uniform Deceptive Trade Practices Act allows recovery of attorney's fees where there is a wilful violation.[88] To make attorneys gamble on proving wilfulness in addition to proving deception does little to improve their compensatory interest in the case.

In addition to the high costs of legal services, the consumer often suffers other losses. He may have to take time off from work to see a lawyer, to help prepare the case, and to attend the trial. The trial may be postponed by the other side as a tactic to make it more expensive for him to bring suit. He may have to pay experts, such as auto mechanics and construction contractors. Under section 3-406(b) the consumer would recover both his attorney's fees and the costs incurred in connection with the action provided the person complained of did not make a reasonable offer of settlement.

In addition, where the court finds the act to have been a wilful violation or that the violator refused to make a reasonable offer of settlement after he knew or should have known he violated

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87 Note, *Contingent Fees and the Eligibility of the Poor for Free Government Funded Legal Services*, 4 HARV. CIV. RIGHTS-CIV. LIB. L. REV. 415 (1969).

88 UNIFORM DECEPTIVE TRADE PRACTICES ACT § 3(b) (1964).

section 3-201, then section 3-406(d) increases the award of damages to double to triple the actual damages.

As in section 3-304, state law may require a jury trial here, at least if the merchant so requests.

3-407. *Injunctions Issued under Section 3-304 Prima Facie Evidence of Violation of Section 3-201 in Actions Under this Part.*

Any permanent injunction or order of the court made under section 3-304 of this chapter shall be prima facie evidence in an action brought under section 3-401 or 3-402 of this article that the respondent used or employed an unfair or deceptive act or practice declared unlawful by section 3-201 of this article.

3-408. *Clerk of Court to Notify Attorney General of Actions Filed and Final Judgments Under this Part.*

Upon commencement of any action brought under section 3-401 or 3-402 of this article, the clerk of the court shall mail a copy of the [bill in equity] to the attorney general and, upon entry of any judgment or decree in the action, the clerk of court shall mail a copy of such judgment or decree to the attorney general.

PART E: SEVERABILITY

3-501. *Severability Clause.*

The provisions of article III are severable, and if any of its provisions or their application shall be held unconstitutional or invalid by a court of competent jurisdiction, the decision of the court shall not affect or impair any of the remaining provisions or applications of this article.

COMMENT: This provision has been added especially because of the federal preemption problem mentioned in the comment to section 3-202.

NOTES

THE IMPACT OF *KATZENBACH V. MORGAN* ON MEXICAN AMERICANS

Introduction

In 1966 the Supreme Court in *Katzenbach v. Morgan*[1] upheld section 4(e) of the Voting Rights Act of 1965,[2] which prohibited the application of New York's literacy test to thousands of Puerto Ricans who had completed the sixth grade in an American-flag school.[3] The Court recognized that the primary effect of section 4(e)'s enforcement would be to equalize the provision of public services for the Puerto Rican minority. The Court thus underscored the relation of voting rights with the full range of civil rights.[4] Furthermore, the Court indicated that it was within Congress's power to independently determine that the inability of these Puerto Ricans to speak English could not be the basis of denying them the right to vote. In upholding section 4(e), however, the Court did not overrule previous decisions sustaining state literacy tests;[5] nor did the Court completely void the New

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1 384 U.S. 641 (1966) [hereinafter cited as *Katzenbach*].

2 42 U.S.C. §§ 1971, 1973 (1965) (Supp. III 1965-67).

3 An American-flag school is one operated by a recognized United States institution and one which receives full accredidation in the United States. The pertinent part of section 4(e), as summarized by Justice Brennan in *Katzenbach*, provides that ". . . no person who has successfully completed the sixth primary grade in a public school or a private school accredited by the Commonwealth of Puerto Rico in which the language of instruction was other than English shall be denied the right to vote in any election because of his inability to read or write English." 384 U.S. at 643.

4 Section 4(e) was originally drafted by Senator Robert F. Kennedy (D-NY) and co-sponsored with his senior colleague, Senator Jacob Javits (R-NY). The amendment was tacked onto the Voting Rights Act five days before its vote in the Senate, and there were no hearings on this particular provision. However, it was generally understood that Senators Kennedy and Javits sponsored the amendment because they believed that a large percentage of Puerto Ricans in New York were discriminated against in the provision of public services because of their inability to vote. From a conversation with an aide to Senator Robert F. Kennedy, Washington, D.C., July, 1967.

5 Indeed, the Court re-affirmed the soundness of its decision in Lassiter v.

York literacy test. The Court merely sustained the Voting Rights Act as a constitutional exercise of congressional power under section 5 of the 14th amendment, an exercise which pre-empted the authority of any conflicting state statute.[6]

In determining whether the Voting Rights Act was appropriate legislation under the amendment, the Court applied the standard of *McCulloch v. Maryland:*[7] "Let the end be legitimate, let it be within the scope of the Constitution, and all means which are appropriate, which are plainly adapted to that end, which are not prohibited, but consistent with the letter and spirit of the Constitution, are constitutional." In effect, the Court sanctioned limited congressional intrusion into an area traditionally regarded as the states' sole jurisdiction, the determination of voting qualifications. The Court moreover approved the exercise of congressional power to determine specific standards which would give effect to other constitutional rights. *Katzenbach's* uniqueness was that it presented a contrast to a previously predominant trend of the Warren Court: rather than assume the initiative as it had in the past, the Court now indicated that it would lend greater deference to congressional decisions regarding the implementation of certain constitutional rights.

Katzenbach has since been scrutinized by lawyers and by politicians alike, each eager to weigh its consequences for Federal-State relations. Despite the significance of these broad inquiries, however, they have failed as yet to adequately assess the impact *Katzenbach* could ultimately have on the nation's second largest minority group: Mexican Americans. Like Puerto Ricans, the more than five million Mexican Americans share the problems endemic to a bilingual culture. From a legislative perspective directed toward remedial action, the most important problem is that Mexican Americans also suffer from discrimination in public services, discrimination which could be reduced by giving

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Northampton County Board of Elections, 360 U.S. 45 (1959). *See* text accompanying note 29, *infra.*

6 U.S. CONST. amend. XIV, § 5: "The Congress shall have the power to enforce, by appropriate legislation, the provisions of this article."

7 4 Wheat. 316, 321 (1819).

greater effect to their voting rights. For without the electorate power to influence elections, it is extremely difficult for any group to command attention from legislators or government executives, regardless of the numerical size of the minority. Discrimination against this minority in the provision of public services subsequently results more from legislative and administrative indifference than from malevolent designs. To realize the full significance of *Katzenbach* for Mexican Americans, one must initially recognize the breadth of this discrimination.

I. THE PLIGHT OF THE MEXICAN AMERICAN

The substantial majority of Mexican Americans reside in the five Southwestern states.[8] Two of these states, Arizona and California, have explicit literacy tests for voters.[9] Each of these tests requires a prospective voter to be able to read the Constitution in English. While there is no such explicit requirement in the other three Southwestern states, there does exist a de facto literacy test because Mexican Americans must fill out registration and election forms in English. If a Mexican American cannot read the Constitution, it is probable that neither can he cope with these forms. Consequently, there are many Mexican Americans who are eligible to vote but are discouraged from exercising their franchise because of these linguistic hurdles. This is indicated by the fact that in Texas — which has a large percentage of Mexican Americans but no literacy test — only 44% of the State's voting

8 These five Southwestern states are Arizona, California, Colorado, New Mexico, and Texas. Figures on Mexican American populations are very scarce, if indeed they exist at all, partly because of a problem of definition and also because of limitations on methods of taking a census. The most frequently used method of determining approximate Mexican American population statistics is by reference to Spanish surnames. In any event, the figures on foreign-born citizens are indicative: of the 575,902 citizens born in Mexico, 35,834 reside in Arizona; 248,542 in California; 4,882 in Colorado; 10,725 in New Mexico; and 202,315 in Texas, or 87.3% of all United States citizens born in Mexico reside in these five states. U.S. BUREAU OF CENSUS, 1960 REPORT, WORLD ALM. (1968).

9 ARIZ. CONST. art. XVI, § 101; CALIF. CONST. art. II, § 1. The latter reads as follows: ". . . and no person who shall not be able to read the Constitution in the English language and write his or her name, shall ever exercise the privileges of an elector in this State."

age population voted in the 1964 Presidential election.[10] Because voter registration and election forms do not record the applicant's ethnic background, and because ethnic analyses have not been fully recorded by the United States Bureau of the Census,[11] there are no firm statistics regarding the number of Mexican Americans affected by these linguistic difficulties. Nevertheless, having spent considerable time with the Chicano Community[12] in California, it is my impression that the number is quite substantial.[13]

Additional statistics are further indicative of the discrimination practiced against Mexican Americans, both in the public and private sectors of our society. The plight of the Chicanos in California is typical. Of Los Angeles City's 652,474 elementary and secondary school pupils, for instance, approximately 20.0% possess Spanish surnames;[14] yet only 2.7% of the city schools' in-

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10 WORLD ALM. at 864 (1968). By itself, this figure of 44% does not conclusively prove or even suggest the underlying reasons which produced it. Indeed, there are unquestionably many variables to explain it. However, realizing the large percentage of Mexican Americans which make up the population of Texas, and from my own personal experience, I do not think the inference is unreasonable. The comparable percentages for the other four southwestern states in the Presidential election of 1964 are as follows: Arizona (54.7%); California (64.7%); Colorado (68.0%); and New Mexico (63.7%). The National Average was 62.0%. The figures for California may be misleading in light of the fact that California has one of the best state educational systems in the country. It should be surprising, therefore, that its voting percentage was only 2.7% above the national average.

11 In the 1970 Census, the U.S. Bureau of Census will include questions which should pinpoint with greater accuracy the number of Mexican Americans residing in the United States. The questionnaires will ask the country of the parents' origin as well as the languages spoken at home (other than English). See letter from A. Ross Eckler, Director, U.S. Bureau of Census, to Vicente T. Ximenes, Chairman, Inter-Agency Committee on Mexican American Affairs, May 23, 1969.

12 The term "Chicano" is of Spanish origin and, in its colloquial sense, refers to those of Mexican descent who willingly embrace the Mexican culture. By a literal definition, every Mexican is a Chicano.

13 The Urban Coalition in Los Angeles is currently conducting a unique study in this regard. In order to determine those areas where eligible voters do not vote, or where large numbers of Mexican Americans are affected by the literacy requirement, a correlation is made between the number of children attending public schools in a particular voting district and the number of votes recorded from that district in the last election. In other words, the study has shown that where voting percentages are substantially lower than the number of school children would indicate, there is a strong inference that many individuals over 21 years old do not vote. Although such figures are far from precise, they may prove to be the most useful ones to date.

14 These and the following statistics on Los Angeles City Schools were obtained from L.A. BD. OF EDUCATION, RACIAL AND ETHNIC SURVEY (1969).

structional staff is of Spanish surname. Recent figures likewise reveal the high drop-out rate among Mexican American students. For example, in Garfield High School in East Los Angeles, which is 97% Mexican American, it is common for more than 50% of the senior class to fail to fulfill degree requirements. Overall, Mexican Americans constitute 21.4% of the Los Angeles elementary school population, but only 18.0% of the junior and senior high school population — indicating that many Mexican Americans leave school before graduation. Nationwide, the Mexican American child spends only a median of seven years in school as compared with a median of nine for the Negro child and twelve for the white child.[15]

These discrepancies naturally assume broader dimensions in higher education. At the University of California at Los Angeles, for example, only 325 of the school's 18,718 students have Spanish surnames.[16] At the University of Texas in Austin, only 852 of the school's 24,500 students have Spanish surnames. Even at California State College at Los Angeles, which is located in the heart of a Chicano Community, only 10% of the student body has Spanish surnames. Throughout the United States, only one out of approximately 200 Mexican students will emerge with a college degree, as compared to one of every three white students.[17]

The difficulties encountered by Mexican Americans in obtaining a quality education perpetuate later difficulties in obtaining decent employment. In Los Angeles County, Mexican Americans constitute 13% of the population, but only 9.7% of the labor force within the county,[18] which is too large a differential to be accounted for solely by the larger size of many Mexican families.

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15 Report by the Educational Issues Coordinating Committee, L.A. (1969).

16 These statistics on college enrollments were obtained from a report by DHEW, SPANISH SURNAME COLLEGE ENROLLMENT, FIVE SOUTHWESTERN STATE UNIVERSITIES, 1968-69 SCHOOL YEAR (1969).

17 Educational Issues Coordinating Committee, *supra* note 15. These statistics, of course, reveal little of the quality of instruction, counselling and materials available at schools with predominant Mexican American populations. Dr. Julian Nava, a product of the East Los Angeles schools and an elected member of the Los Angeles City Board of Education, has a doctorate in history from Harvard University. Yet when his high school graduation approached, Nava was advised by his counselor not to apply to college because "I would never make it." Interview with Dr. Nava, August 1969.

18 COUNTY OF LOS ANGELES, DIGEST, Vol. 2, no. 11, June 6, 1969.

Of the 55,183 employees working for the county in 1968, only 4.7% were Mexican Americans, with none employed at the top five salary levels.[19] Nor is this situation confined to the public sector. Of the 3,495 employees working for the three major networks in Los Angeles (ABC, CBS, and NBC), only 76 have a Spanish surname.[20] Nationwide, employment in the utilities industry totalled 565,053 in 1967, with only 6016 having Spanish surnames; even in those areas where Spanish surnamed Americans constituted a significant factor in the population, the utilities industry employed fewer members of this minority, proportionately, than industry as a whole.[21]

Finally, like the Puerto Ricans in New York, the Mexican American's need for equal protection of civil rights is heightened by the unmitigated poverty which envelops a major percentage of the community.[22] Symptomatic of this poverty is a 1965 survey by the Office of Economic Opportunity which concluded that the highest incidence of poverty in the United States (30.0% to 31.4% of the population being classified as "poor") existed in three cities where the estimated Mexican American population ranged between 36.0% and 45.0%.[23] The plight of the Mexican American Community is thus more than ripe for corrective action, action which must begin by giving full effect to the Mexican American's right to vote. Such expansion of the Mexican Americans' right to vote would be consistent with our traditional

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19 *Id.*

20 EQUAL EMPLOYMENT OPPORTUNITIES COMMISSION, EMPLOYMENT IN 3 MAJOR TV NETWORKS, LOS ANGELES (1968).

21 EQUAL EMPLOYMENT OPPORTUNITIES COMMISSION, NATIONWIDE EMPLOYMENT IN THE UTILITIES INDUSTRY, 1967 (1968).

22 For a broad description of the Mexican Americans' plight, *see* INTER-AGENCY COMM. ON MEX. AM. AFFAIRS, REPORT ON THE EL PASO CONFERENCE (1968). The El Paso Conference was sponsored by the White House and was held in October, 1967. The possibility of discriminatory treatment in the provision of public services was revealed by two news articles appearing on the same day. One described how Mexican Americans staged a march to protest the actions of Governor Preston Smith of Texas which reportedly allowed such discriminatory treatment. Bigart, *Mexican Americans Stage a Protest March in Texas*, N.Y. Times, March 31, 1969, at 25, col. 1. The other article noted the development of a center in New Mexico through the use of Federal grants; the center would aid the long-neglected education of Mexican Americans and Indians. N.Y. Times, March 31, 1969, at 6, col. 4.

23 OEO, U.S. CITIES WITH HIGHEST POVERTY INCIDENCE, 1965 (1966). The cities referred to are San Antonio, El Paso, and Corpus Christi, Texas.

democratic principles. Moreover, from a political perspective, this legislation would require a minimum of Government resources and thus could be implemented without introducing competition to other social programs.

II. The Decisional Law History

In order to anticipate the Court's disposition to sanction further congressional legislation regarding literacy tests, one should first survey recent Court decisions regarding the use of literacy tests.

Although the tenth amendment of the Constitution[24] allows the respective states to establish individual standards for voter qualifications, the Supreme Court has long recognized the right to vote as one protected by the Constitution.[25] Occasionally the Court has actively asserted this protective power without the impetus of congressional legislation. *Harper v. Virginia Board of Education*,[26] which invalidated payment of a poll tax as a prerequisite to voting, exemplified this assertion of power. Yet if recent litigation is indicative, the primary thrust of the Court's protection on voting qualifications is merely to insure that they will be applied equally. Literacy tests have not been held invalid per se; constitutional restrictions are only operative when the voting standards openly convey the probability of discrimination because of race, creed or national origin. Hence, it is a valid exercise of a state's power to design a literacy test for voters which is fair on its face and does not imply arbitrary or systematic discrimination.[27] On the other hand, if the literacy test is open to subjective application, as in "explaining" the Constitution, it is deemed discriminatory and thus an inappropriate use of the state's right to determine voter qualifications.[28] The limits of

24 U.S. Const. amend. X: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States, respectively, or to the people."

25 *Ex parte* Yarborough, 110 U.S. 651 (1883); Smith v. Allwright, 321 U.S. 649 (1943). *See also* U.S. Const. amend. XV.

26 383 U.S. 663 (1966).

27 Guinn v. United States, 238 U.S. 366 (1914).

28 Davis v. Schnell, 81 F. Supp. 872 (S.D. Ala. 1949) *aff'd*, 336 U.S. 933 (1949).

judicial action in this area are further suggested by the Court's decision in *Lassiter v. Northampton County Board of Education.*[29]

The *Lassiter* decision was announced in a milieu which had encouraged the inchoate civil rights movement. Only five years before, in *Brown v. Board of Education,*[30] the Court had rescinded its sanction of "separate but equal" educational facilities for Negroes. The impact of *Brown* was shortly reinforced in 1957 when Congress passed the first major civil rights legislation since Reconstruction.[31] Yet *Lassiter* upheld a North Carolina statute requiring a literacy test for voters — over Lassiter's contention that the test violated the equal protection and due process clauses of the 14th amendment even when fairly administered. Speaking for the Court, Justice Douglas did acknowledge that "literacy and intelligence are obviously not synonomous;"[32] he concluded, though, that the state could legitimately feel that an understanding of English was a prerequisite to the competent use of the ballot. Since Lassiter neither alleged nor proved that the statute cloaked operational discrimination, Justice Douglas reasoned that there was no basis on which to void the statute. The Court ignored the inherent difficulties of proving actual discrimination.

Because of these obstacles to litigation, and because of the emotionalism aroused by Martin Luther King, Jr.'s march in Selma, Alabama in March of 1965, Congress passed the Voting Rights Act of 1965. Besides section 4(e), the act also included section 4(b), providing that literacy tests would be suspended in any state where 50% of the voting age population failed to vote in the 1964 Presidential election. An analysis of section 4(e) one year later in *Katzenbach* required the Court to focus on the rights of Puerto Ricans. Two threads of that opinion, though, have particular relevance to Mexican Americans.

First, the Court recognized the right to vote as the "preservative of all rights"[33] — the means by which the Puerto Rican com-

29 360 U.S. 45 (1959).
30 347 U.S. 483 (1954).
31 42 U.S.C. § 1971 (Supp. III 1965-67).
32 Lassiter v. Northampton County Bd. of Education, 360 U.S. 45, 47 (1959).
33 *Katzenbach* at 649. See Yick Wo v. Hopkins, 118 U.S. 356 (1886), from which Justice Brennan quoted this phrase.

munity in New York could enhance its political power. The Court specifically noted that this political power would ". . . be helpful in gaining non-discriminatory treatment in public services for the entire Puerto Rican community."[34] The Court realized that this interest in acquiring non-discriminatory treatment for Puerto Ricans had to be balanced with the State interest in requiring a minimum level of literacy among its voters. But the Court would not actively review the congressional resolution of these conflicting interests: "It is enough that we be able to perceive a basis upon which the Congress might resolve the conflict as it did."[35] The Court did not insist that the Congress actually prove, by statistics or otherwise, that deprivation of the franchise resulted in discriminatory treatment of Puerto Ricans in public services. In this light, the Court sanctioned Congress' declaration that, for these Puerto Ricans, an ability to read and write Spanish, as distinguished from English, is constitutionally irrelevant to the right to vote.[36] Observing the pervasive existence of Spanish language news media in New York City, the Court stated that such a declaration was not unreasonable.

Secondly, the Court asserted that the state statute in question did not have to be in violation of the equal protection or due process clauses in order to be superseded by a conflicting congressional law.[37] Thus, it was not necessary to find in *Katzenbach* that the New York law was discriminatory on its face or in its operation. It was sufficient to establish that the Voting Rights Act was an appropriate measure of congressional power under the Constitution. Like its decision in *South Carolina v. Katzenbach*,[38] which upheld section 4(b) of the Voting Rights Act, the Court in *Katzenbach* was merely allowing the Congress ". . . to prevent action which the Court had held would be unconstitutional — racial discrimination in voting in one case and in providing state services in the other."[39]

The relevance of *Katzenbach* to Mexican Americans does not

34 *Katzenbach* at 652.
35 *Id.*, 653. *See* Strauder v. West Virginia, 100 U.S. 303 (1879).
36 A. Cox, The Warren Court 130 (1968).
37 *Katzenbach*, at 648-650.
38 383 U.S. 301 (1966).
39 A. Cox, *The Supreme Court, 1965 Term*, 80 Harv. L. Rev. 91, 103 (1966).

necessarily imply that it alone could be used to avoid the application of literacy tests to any Spanish-speaking people. Indeed, in *Cardona v. Power*,[40] which was decided simultaneously with *Katzenbach*, the Court pretermitted the question of whether New York's literacy test could be invalidated without the benefit of congressional legislation. By remanding the case to the lower court to determine whether petitioner fulfilled the requirements of section 4(e), the Court appeared to re-affirm the literacy test as a valid exercise of state power, barring any congressional declaration to the contrary. It is noteworthy, though, that the Supreme Court has never responded to a challenge that literacy tests are unconstitutional because they resulted in the discriminatory provision of public services for any particular minority. In any event, there is no question that the ultimate significance of *Katzenbach* for Mexican Americans is that it opens the door for further congressional legislation regarding the application of literacy tests for voters.

III. Obstacles to Congressional Action

That congressional legislation exempting Mexican Americans from literacy tests would pass judicial review seems clear. For the language of Justice Brennan in *Katzenbach* leaves little doubt as to the range of Congress' power under the 14th amendment: "It is well within congressional authority to say that this need of the Puerto Rican minority for the vote warranted federal intrusion upon any state interest served by the English literacy requirement."[41] Furthermore, if Congress should consider such a law, it would not be required to portray the actual existence of discriminatory treatment in public services because of literacy tests, but only that the possibility exists. It would merely be necessary to reveal that the state statute conflicts with the congressional legislation, in which case the latter prevails. Given the inherent difficulties of establishing a causal relationship between literacy tests and discriminatory treatment in public services,

40 384 U.S. 672 (1966).

41 *Katzenbach* at 653.

Katzenbach therefore implies that Congress has considerable freedom of action.

This seemingly facile analysis of the constitutionality of any congressional law exempting Mexican Americans from literacy tests assumes such a law would be enacted.

This possibility, in turn, rests on two suppositions. First, it assumes that Congress would have the motivation to formulate such legislation. Unless Congress abolishes literacy tests for all voters, it also assumes that Congress would have the technical creativity to establish a practical criteria for exemption. These assumptions, though, cannot be made safely. For certain social and political obstacles arise in molding such legislation, obstacles not present in the construction and enactment of section 4(e) of the Voting Rights Act.

Certain political factors initially vitiate the possibility of legislation exempting Mexican Americans from literacy requirements. Richard Nixon owes his election largely to those who generally resent the Federal Government's increasing inroads into state and local politics.[42] In this light, the Nixon Administration's growing attention to state revenue-sharing plans reflects a certain responsiveness to this public mood.[43] It would thus seem unlikely that the Nixon Administration would dilute even more the states' respective powers vis-à-vis the Federal Government. And surely Mr. Nixon would find comfortable allies in the Southern congressmen who control the majority of committee chairmanships in Congress, including the Senate Judiciary Committee and its subcommittee on Constitutional Rights.[44]

In this regard, the Attorney General's recent recommendation to Congress to abolish literacy tests for voters in every state, which was incorporated in the Nixon Administration's alternative to the Voting Rights Act of 1965, assumes a paradoxical character.

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42 Kenworthy, *Nixon and the South: Many Democratic Defectors to G.O.P. Now Complaining About President's Actions*, N.Y. Times, March 24, 1969, at 27, col. 1.

43 N.Y. Times, August 14, 1969, at 1, col. 8.

44 James O. Eastland (D-Miss) is chairman of the Senate Judiciary Committee and usually takes a conservative position on such issues as expansion of Federal protection of voting rights, as does the chairman of the Senate Subcommittee on Constitutional Rights, Sam Ervin (D-NC).

Although this proposal to abolish literacy tests would benefit the Mexican Americans as well as many blacks, the proposal was principally motivated by the Nixon Administration's apprehension of becoming embroiled with the Southern states in voting rights cases, especially since literacy tests in four Southern states were suspended under section 4(b) of the Voting Rights Act. Through enactment of his proposal, Attorney General Mitchell sought to avoid Federal interference with state voting laws; if enacted, the proposal would shift from the Federal Government to the states the basic power to insure that the purposes of the Voting Rights Act of 1965 were fulfilled. The recommendation to abolish literacy tests was then included as an appeasement to congressional liberals, although in reality it supplemented the respective states' freedom in supervising elections, which is of particular relevance to Mexican Americans if they are unable to cope with English registration forms. Realizing these motivations, the House Judiciary Committee severely criticized Mr. Mitchell's alternative legislation and subsequently had it tabled indefinitely.[45]

In any event, if there is to be any movement toward specific legislation exempting Mexican Americans from literacy tests, it would probably have to emanate from the congressmen of the five Southwestern states. Two interrelated factors would affect the realization of this possibility.

The first and perhaps more crucial question is the effect such a law might have on electoral politics. Many Republican congressmen might vehemently oppose any legislation to expand Mexican American voting rights, because Mexican Americans usually vote Democratic.[46] On the other hand, opposition based on party interest may be misplaced. Chicanos were a significant factor in electing John Tower to the Senate in 1966 as the first Republican

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45 Weaver, *Mitchell Urges a Wide Revision on Voting Rights*, N.Y. Times, June 27, 1969, at 1, col. 1. Weaver, *Nixon Rights Bill Appears Doomed by a G.O.P. Attack*, N.Y. Times, July 2, 1969, at 1, col. 8. *See* H.R. 12,695, 91st Congress, 1st session (1969).

46 Address by R. Guzman, Statewide Convention of the Mexican American Political Association, May 13, 1961. In his survey, Guzman found that 100% of those interviewed favored the Democratic Party over the Republican Party, and that 97.3% of those interviewed voted for John F. Kennedy in the Presidential election of 1960.

Senator from Texas since Reconstruction.[47] Mexican Americans demonstrated in this election that they are not committed ideologically to either party but, as Cesar Chavez of the United Farm Workers asserts, committed to vote ". . . only for someone who understands."[48] This independent attitude was further confirmed in my numerous conversations with other Chicano political and community leaders.

A recent incident underscores the plausibility of the Republican Party's potential to attract Mexican American electoral support. In April, 1969, the Malabar Project in East Los Angeles, a successful program directed toward minimizing the adverse effects of bi-lingualism in the elementary schools, was threatened with financial extinction when the Department of Health, Education and Welfare refused to fund the three-year-old project under Title VII of the Elementary and Secondary Education Act of 1965. Employing mass pressure through petitions, television and radio editorials, and constituent mail to congressmen, the Malabar Project found a receptive ear in the White House, which reversed HEW's decision within one month. The reversal inspired a belief among many Mexican American leaders that the Republican Party might be responsive to the community's needs.[49] In the end, then, Republican congressional support of legislation exempting Mexican Americans from literacy tests may draw the Mexican Americans even closer to the Republican Party, thereby contributing to the Republican Party's electoral strength as well as making the Republican Party more attractive to other oppressed minority groups.

Other minority groups introduce a second factor which might affect the political acceptability of legislation exempting Mexican Americans from literacy tests. Any law which exempted Mexican

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47 In the 1966 senate election, Tower carried every Texas county in which more than 10,000 voted except one, defeating his opponent by carrying 57% of the popular vote and a 200,000 majority. There are many counties, *e.g.*, San Antonio and Rio Grande, with 10,000 or more voters where approximately 50% of the population is Mexican American. In any event, in order to win that strongly, Tower had to have substantial support among the Mexican Americans.

48 C. Chavez, *Nonviolence Still Works*, Look, April 1, 1969, at 52.

49 Interview with Felix Castro, creator and director of the Malabar Project, in Los Angeles, August, 1969. *See also* editorial, *Funding Found for Bi-lingual Project*, L.A. Times, July 7, 1969, § II, at 2, col. 1; 20 U.S.C. 880(b) (Supp. III 1965-67).

Americans from literacy tests could be viewed (depending on the particular provisions of such a law) as a legitimization of the Mexican American community's failure to assimilate into American life. If such legitimization can be extended to the Nation's second largest minority group, blacks and other ethnic minorities might persuasively argue that similar legitimization be accorded to their respective desires for separatism. Although such a reaction did not set in after passage of section 4(e), it should be remembered that the Voting Rights Act, of which section 4(e) was a small part, was principally directed toward remedying voting indiscretions against the blacks.

There are two strong political arguments in favor of legislation exempting Mexican Americans from literacy tests. First of all, there is a growing recognition that such legislation would actually facilitate the Mexican Americans' assimilation into the mainstream of society. Our society establishes its priorities through electoral pressure, and Mexican Americans have generally lacked the muscle to make the political structure responsive to their needs. As one example, more than 500,000 Spanish-surnamed individuals reside in Los Angeles, with the predominant majority located in East Los Angeles.[50] Yet the districts have been gerrymandered so that registered voters with Spanish surnames do not constitute a majority in any single district. Congressman Emanuel Celler, chairman of the House Judiciary Committee, recognized this absence of voting equality when he announced his support for legislation solely designed to abolish literacy tests.[51] The California state legislature similarly realized this when it passed a bill to provide for a referendum in 1970 to decide whether Spanish-speaking people should be exempt from California's literacy test.[52] This latter bill was further inspired by a recognition that California's literacy test is a violation of the pledge

50 See U.S. BUREAU OF CENSUS, 1960 REPORT, WORLD ALM.; LOS ANGELES COUNTY BD. OF ELECTIONS STATISTICS FOR 1968. In fact, Congressman Edward Roybal and State Assemblyman Alex Garcia are the only two popularly-elected Mexican Americans from L.A. County in either the national or state legislatures.

51 Weaver, *House Unit Backs Voting Rights Act*, N.Y. Times, July 18, 1969, at 10, col. 2.

52 The bill passed in August 1969 is A.C.A. no. 7, introduced by Assemblyman Dave Roberti (D-L.A.).

made by the United States Government in the Treaty of Guadalupe Hidalgo, a treaty made with Mexico which provided that Mexican citizens residing in the ceded Southwest territory would not be deprived of rights they enjoyed in Mexico.[53] In the final analysis, these developments underscored the realization that legislation exempting Mexican Americans from literacy tests would be essential in securing for them non-discriminatory treatment in public services.

A further benefit of such legislation is that it might be a prelude to expanding Mexican Americans' rights in other spheres, such as jury service, where most states presently require that jurors have an understanding of English.[54] *Katzenbach* is particularly relevant to jury service, because in the vast majority of states, jury rolls are either identical to or taken from the lists of registered voters.[55] The constitutional rights to have a trial by an impartial jury in criminal prosecution,[56] and to an impartial jury consisting of persons selected from jury rolls reflecting a fair cross-section of the community,[57] subsequently highlight the fact that the right to vote transcends political consequences.

In spite of the diverse circumstances surrounding the issue of an impartial jury, there is a consistent thread linking recent litigation concerned with this civil right: a strong belief that the most important requirement in jury selection is that juries be chosen from lists representing a fair cross-section of the community and that every citizen, regardless of what minority group he may belong to, be given an equal opportunity to serve on these juries.[58] In *Hernandez v. State of Texas,* the Supreme Court acknowledged that Mexican Americans would qualify as a minority group with respect to this principle. As the appeal court later stated in *Rabinowitz v. United States,*[59] this principle means that

53 *See* H. S. COMMAGER, DOCUMENTS OF AMERICAN HISTORY, 313 (1963).

54 *E.g.,* ARIZ. REV. STAT. ANN. art. XXI, § 202.

55 *See, e.g.,* Hernandez v. State of Texas, 347 U.S. 475 (1954) which referred to this fact.

56 U.S. CONST. amend. VI. "In all criminal prosecutions, the accused shall enjoy the right to a speedy and public trial, by an impartial jury of the State and district wherein the crime shall have been committed. . . ."

57 Arnold v. State of North Carolina, 376 U.S. 773 (1964).

58 Hernandez v. State of Texas, 347 U.S. 478 (1954).

59 366 F.2d 34 (5th Cir. 1966). *See also* Thiel v. So. Pacific Co., 328 U.S. 217 (1946).

even the desire for competence in jurors cannot divert the state from its paramount responsibility to include members of the minority groups on its jury rolls. It was in this vein that *Rabinowitz* upheld section 1861 of the 1957 Civil Rights Act, a provision which lowered the federal standards for jury duty to enable more blacks to serve on juries.[60]

Questions then arise with regard to a community where a substantial percentage of the population is Mexican American and where many speak only Spanish. A crucial issue is whether the jury venires are representative of a fair cross-section of the community if this group is excluded from jury duty. One may question whether a fair trial by an impartial jury is being given if the Mexican American on trial speaks only Spanish and if only those speaking English sit in judgment.[61] The ultimate criteria upon which these questions and future cases may be resolved seems to lie in the Court's definition of the term "community." In areas where a significant percentage of the population speaks only Spanish, can the law and the court ignore them as being part of the community? Legislation exempting Mexican Americans from literacy tests would significantly shape the Court's answer to this question as well as broaden its ability to protect other civil rights of Mexican Americans.

IV. Requisites of a Legislative Solution

In light of this political and social context, it seems that any legislation in the near future should possess three basic features. First of all, unlike Puerto Ricans, not all Mexican Americans are natural-born citizens of an American state or territory where American-flag schools are operated. The temptation therefore arises to establish a sixth-grade education from any school, notably those in Mexico, as a standard. But this standard inevitably places these foreign schools on an equal par with American schools — a

60 28 U.S.C. § 1861 (1964).

61 An interesting, and perhaps academic, question posed here is whether trials for citizens speaking only Spanish should be conducted in both Spanish and English. Where the defendant or party to a trial does not speak Spanish, or does speak English, it might be impractical (and unconstitutional) to conduct a trial in Spanish to accommodate prospective jurors who speak only Spanish.

comparison not readily agreeable to educators or to congressmen. This, of course, could be remedied in part by requiring a higher minimum educational achievement for students of foreign schools, such as an eighth-grade education. Even if only an American-flag school will be recognized, the situation is further complicated by the fact that many Mexican American children are from migratory families. Thus, a child will often attend more than a dozen different schools before completing the sixth grade; consequently, a problem arises in certifying this minimal educational achievement.

In the end, the legislation would probably be restricted to Mexican Americans who have completed the sixth grade in an American-flag school. Although *Katzenbach* implies that Congress could find knowledge of English to be constitutionally irrelevant to voting for *all* Mexican Americans, and although the Treaty of Guadalupe Hidalgo infers that no literacy tests will be applied to Mexican Americans, Congress might demur to adopting this position *en toto*. Congress might reason that to broaden the coverage of the legislation beyond a limited extent would not only be inconsistent with the scope of section 4(e) but would also *too* seriously dilute the right of the states to determine the voter qualifications under the authority of the tenth amendment. Such speculation, however, is counterbalanced by Celler's comment and by the passage of the referendum bill in the California legislature.[62]

To make the first provision of this law effective, the States should be required to provide registration forms in Spanish. The three Southwestern states which do not have literacy tests should also be included within this second provision, thus giving Mexican Americans an equal opportunity to vote regardless of their state of residence.[63] Moreover, it will be necessary to advertise any such changes in voting qualifications and procedures with both English and Spanish publications that would reach the affected individuals.

Finally, the law should offer avenues of enforcement, such as enabling an aggrieved party to file a complaint with the Justice

62 Weaver, *supra* note 51, A.C.A. no. 7, *supra* note 52.
63 *See* WORLD ALM., *supra* note 10.

Department or directly against the particular board of election. But, as the Fair Housing Act of 1968[64] reveals, enforcement procedures encounter diverse obstacles. Not only must there be a means of informing Mexican Americans of any newly acquired rights, but there should likewise be ready access to the enforcement machinery so that non-compliance by state authorities can be remedied within a reasonable time. Remembering that many Mexican Americans are migratory laborers, giving full effect to these enforcement procedures would entail the unceasing commitment of the Federal Government as well as the planned cooperation of numerous Mexican American organizations spread throughout the Southwest.

The efficiency of any enforcement machinery moreover presupposes that situations of non-compliance will be identifiable. For example, assume that a Mexican American, entitled to an exemption from literacy tests finds that he is prevented from registering to vote. Will he be able to detect the reason for this denial since other voter qualifications, such as residence, would still be in effect? Will he know to whom to turn for counsel on his rights and possible remedies? Perhaps the answer to these difficulties would lie in authorizing federal registrars to be stationed at various election booths to insure local compliance with federal law, as provided in the Voting Rights Act of 1965.[65] To be truly effective, these registrars would have to be fluent in Spanish as well as in the law. Realizing the difficulty of placing a registrar at every election booth, Congress might further permit a Mexican American voter to be assisted in the voting booth by a relative or friend. Such assistance would be consistent with section 14(c)(1) of the Voting Rights Act of 1965,[66] which authorizes Congress to render assistance to illiterate voters. Finally, in order to prevent a clog in the courts, Congress should provide a procedure which would enable the courts to rectify violations simultaneously. In the end, though, these practical problems of

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64 CIVIL RIGHTS ACT OF 1968 (Fair Housing Act), tit. VIII, 42 U.S.C.A. §§ 3601-19 (Supp. 1969).

65 *See* McCarthy and Stevenson, *The Voting Rights Act of 1965: An Evaluation*, 3 HARV. CIV. RIGHTS — CIV. LIB. L. REV. 357 (1968).

66 42 U.S.C. § 1973 (Supp. III 1965-67).

enforcement must be carefully considered if any law is to do more than raise expectations. Indeed, by only raising expectations, any law designed to assist Mexican Americans would merely heighten their frustration.

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BOOK REVIEW

AUSTRALIAN SENATE PRACTICE. By *J. R. Odgers,* Clerk of the Senate. Canberra: A. J. Arthur Commonwealth Government Printer, 3d ed., 1967, pp. xiv, 511, table of cases, and index, $4.50 in Australia.

This third edition of Mr. Odgers' celebrated work, first published in 1953 and revised in 1959, is a welcome addition to the growing body of authorities on parliamentary practice and procedure. Its new size and format makes it a handier tool for parliamentarians who must have constant recourse to it.

Fortunately, the author has not tampered with the logical arrangement of the earlier edition consisting of thirty-four chapters encompassing every aspect of the subject. Although the work is largely a compilation of Presidents' rulings and established practice, he incorporates some degree of personal opinion that modestly "is put forward as a contribution to thought and without pretension to be accepted as conclusive." For example, the opening quotation — "Two sieves must be better than one" — reflects the author's espousal of the bicameral system and the place of the Australian Senate in that country's system of government.

As a long-time member of the Association of Secretaries General of Parliaments, and currently a member of its executive committee, Mr. Odgers has had a unique opportunity to study comparative parliamentary practices. He appears to be an advocate of the use of standing committees in parliaments and, since the publication of the second edition, the Australian Senate has established a new standing committee, bringing the total to seven.

Three other developments that have occurred since the publication of the second edition are worthy of note. Since the second edition, the Senate has permitted a free vote on several important bills. The free vote is an occasion when all parties agree to leave Members untrammelled in the exercise of their votes. This is not common with party government, although it is the usual practice in the United States Congress. The author

believes it has particular merit in the Australian Senate, which is also known as the States' House, and especially on matters like the tariff, which so vitally affect state interests.

In the parliamentary system of Australia, question time is the most obvious manifestation of the direct accountability of the Executive to the Parliament. In this new edition a section has been added describing the procedure for questions not answered when Parliament adjourns. In this case arrangements are made by Departments to furnish replies by letter to the Senator concerned, and at the next sitting, the reply is submitted by the Minister to the Senate for incorporation in Hansard.

Students of American congressional procedure are familiar with the constitutional requirement that revenue bills originate in the House of Representatives and with the time-honored custom that appropriation bills also originate there. In Australia there is a jealously guarded constitutional principle that money bills may not originate in the Senate. However, in 1961, the Senate proposed to consider the Estimates simultaneously with the House — a departure from the practice under which the Senate did not consider specific grants until the appropriation bill had passed the House of Representatives. Although this proposal caused a protest by the leader of the opposition of each House, a point of order against the novel proposal in the Senate was not upheld.

Three new sections of this edition are, perhaps, of current world-wide interest. One concerns the powers of police in Parliament House, a matter not covered by the Standing Orders or Sessional Orders of the Houses. The author believes, on principle, that (1) police may not enter Parliament House without the consent of the President of the Senate or the Speaker; (2) police who are present by consent may make arrest for offences committed in their view, but not in the Chamber unless officially requested to do so; (3) police may not enter Parliament House without consent of the President or Speaker to interrogate someone or to execute a warrant; and (4) in case of emergency, common sense is the guiding factor and police action would be expected without seeking permission. Another section concerns disclosure by a Minister of a Senator's correspondence with him

before notifying the Senator of action taken by the Ministry. In the United States, publication by a head of an executive department of action affecting a Member's constituency before notifying that Member is a sensitive matter and is usually criticized by the Member concerned. Another new section deals with whether the employment of a Senator-elect in the Commonwealth Public Services between the time of election and the commencement of his term creates a vacancy in his seat because of the constitutional prohibition against holding any other office. There was no ruling by the Public Service Board, however, on a case that arose in 1962, (Hansard, H. of R. vol. 34, p. 586), and the question remains unresolved.

The volume is completed with a comprehensive and informative index not only to the pages of the volume but also to relevant Standing Orders.

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RECENT PUBLICATIONS

THE CRIME CONFEDERATION, By *Ralph Salerno and John S. Tompkins.* New York: Doubleday & Co., Inc., 1969, pp. 424, index, $7.95. Mr. Salerno speaks from experience as New York City's number-one organized crime investigator when he describes the Organization's institutional amorality. He retired recently from his duties with the Central Intelligence Bureau of the New York City Police Department. John S. Tompkins has worked for the *Wall Street Journal, The New York Times,* and *Business Week,* and is author of a book, *The Weapons of World War III.* Their factual analysis lays to rest much of the fantasy pervading studies of organized crime, leaving the reader with documentary proof that organized crime activities have indeed become an effective business. Their description is complete: crime and business, crime and politics, and the internal "law" which governs the Organization.

THEFT OF THE NATION, By *Donald Cressey.* New York: Harper and Row, 1969, pp. 367, index, $6.95. An expansion of the report which he prepared for the President's Commission on Crime, Professor Cressey's book explores the structural and sociological bases of organized criminal activities. The book is a socio-historical study of the development of the cult of *Cosa Nostra* and its pervasive effect on American society.

TO WALK THE STREETS SAFELY, By *James Scheuer.* New York: Doubleday & Co., Inc., 1969, pp. 231, $5.95. Congressman Scheuer writes his book for the government official and the average citizen concerned about street crime. He argues that the time to expend resources on the development of innovative devices for the detection and apprehension of criminals is now. He outlines some of these proposals, all of them interesting, though at least some seem unrealistic even for the long run.

WATER LAW AND ITS ADMINISTRATION: THE FLORIDA EXPERIENCE, By *Frank Maloney, Sheldon Plager, and Fletcher Baldwin, Jr.* Gainsville: University of Florida Press, 1968, pp. 488, appendices, table of cases, index, illustrations, $25.00. This study, conducted

in conjunction with the Florida Water Resources Research Center, is a highly comprehensive work. Topics include the water needs of Florida; traditional doctrines of the riparian system such as the navigability concept, the upland ownership concept, and major nonconsumptive uses of defined waterbodies; consumptive uses of water under common law rules and statutory developments including the Florida Water Resources Law of 1957; governmental role in water resource management including federal control as well as the particular Florida experience; pollution from the view of common law and the local, state, and federal government; rights in diffused surface water and in submerged bottoms underlying navigable waters; and finally some future problems arising from increasing water requirements. The material is well-organized and clearly presented.

STATE OFFICES OF COMMUNITY AFFAIRS: THEIR FUNCTIONS, ORGANIZATION AND ENABLING LEGISLATION, By *The Council of State Governments*, Washington Office, 1969, pp. 210, charts, $4.00. This publication carries forward the role which the Council has played in the movement to establish state offices of community affairs. Draft legislation for the creation of such an office is contained in the Council's *Suggested State Legislation* in the 1957 and 1963 volumes. This publication is a detailed outline of the office as it exists in the 25 states to date, including functions, staffing, organization, and enabling statutes and executive orders. Included as well is an explanation of community affairs activities in the remaining 25 states. The editors of the *Journal* take particular interest in these developments, because the Harvard Student Legislative Research Bureau, which publishes the *Journal*, has published its own draft establishing such an office (3 *Harv. J. Legis.* 465). The Council has compiled a research volume which is essential to anyone considering legislation in this area.