Recent Developments

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RECENT DEVELOPMENTS

CIVIL PROCEDURE — COLLATERAL ESTOPPEL — THIRD CIRCUIT INTERPRETS PENNSYLVANIA LAW TO ALLOW OFFENSIVE USE OF COLLATERAL ESTOPPEL.


Plaintiff, as administrator of the estate of an automobile accident victim, was awarded a default judgment against the estate of the driver of the car in which plaintiff’s decedent was riding. Defendant’s policy covered the owner of the car as well as any other person driving with the owner’s permission. After defendant’s refusal to defend the driver’s estate in the default judgment action, plaintiff commenced the present diversity suit for a declaratory judgment that the driver was operating within the scope of the owner’s permission at the time of the accident, and was therefore insured according to the terms of the policy. Two other victims of the same accident, one injured and one deceased, were joined as plaintiffs, but the owner was not joined. In a jury trial with the defendant present, the district court entered directed verdicts for the estates of the two deceased passengers and rendered the declaratory judgment sought by the surviving plaintiff in accordance with the jury’s verdict. On appeal, the Third Circuit reversed and remanded on procedural grounds.

1. Edward S. Dutcher, the named insured, was the owner of a passenger car which he lent to Donald Cionci. While driving the car Cionci collided with a truck driven by Thomas W. Smith, and as a result Smith, Cionci and John R. Lynch, a passenger of Cionci, were killed and John Landis Harris, another passenger of Cionci, was injured.

When Cionci borrowed the car in Bryn Mawr, Pennsylvania, Dutcher gave him permission to drive to Ardmore and return in one-half hour. Instead of driving to Ardmore, which is two miles southeast of Bryn Mawr, Cionci drove to Media, which is ten miles southwest of Bryn Mawr. The accident in question occurred while returning from Media. The issue of deviation from the scope of Dutcher’s permission was the sole question before the jury and only Dutcher was capable of testifying as to this issue.

2. Provident Tradesmens Bank & Trust Co. v. Lumbermens Mut. Cas. Co., 218 F. Supp. 802 (E.D. Pa. 1963). The trial judge excluded Dutcher’s testimony against the Lynch and Smith estates on the ground that he was incompetent to testify under Pennsylvania’s Dead Man’s Act, Pa. Stat. Ann. tit. 28, § 322 (1958). Dutcher was allowed, however, to testify against Harris on the issue of deviation. The judge then directed verdicts for the Lynch and Smith estates and submitted the dispute between Dutcher and Harris on scope of permission to the jury, which found for Harris.

3. Provident Tradesmens Bank & Trust Co. v. Lumbermens Mut. Cas. Co., 365 F.2d 802 (3d Cir. 1966), _noted in_ 12 Vill. L. Rev. 672 (1967). The majority held that Dutcher was an indispensable party under Rule 19 of the Federal Rules of Civil
but the Supreme Court granted certiorari and unanimously reversed that ruling.\(^4\) On remand the Third Circuit ruled on the merits, *holding inter alia*\(^5\) that the defendant was not prejudiced by the exclusion of the owner’s testimony as against the plaintiff estates since the defendant had a full and fair opportunity to litigate the issue of deviation from the scope of the owner’s permission as against the surviving plaintiff, and he was therefore collaterally estopped from raising the issue against the other two plaintiffs. Judge Kaldoner, however, dissented, despite the protracted litigation,\(^6\) on the premise that the court should have reversed on other grounds\(^7\) and that under Pennsylvania law\(^8\) the use of collateral estoppel was inappropriate in this case. *Provident Tradesmens Bank & Trust Co. v. Lumbermens Mut. Cas. Co.*, 411 F.2d 88 (3d Cir. 1969).

The doctrine of collateral estoppel was developed by the courts to minimize litigation and protect litigants from the danger of harassment. Collateral estoppel precludes a party from raising an issue of law or fact which has been determined in a prior action in which he was a party or in privity with a party.\(^9\) Two major limitations, however, have developed over the years concerning those parties affected by the doctrine. The first states that it is a violation of “due process” to bind a party to a prior

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4. Provident Tradesmens Bank & Trust Co. v. Patterson, 390 U.S. 102 (1968), noted in 54 ABA J. 396 (1968); 56 Ill. B.J. 864 (1968). The Supreme Court held that Dutcher was not an indispensable party and that the pending state court actions were not on the same issue.

5. Provident Tradesmens Bank & Trust Co. v. Lumbermens Mut. Cas. Co., 411 F.2d 88 (3d Cir. 1969). The judgment of the district court was vacated and the cause remanded with direction to modify the declaratory judgment decree to protect the interests of Dutcher, who was not joined. *Id.* at 98-99. Judge Freedman wrote the opinion of the court, which split 1-1, with Judge Ganey concurring and Judge Kaldoner dissenting.

6. Although the accident in question happened in January of 1958, the two state actions involving the accident remain untried. The present decision was filed in April of 1969, indicating that better than eleven years have elapsed and final disposition is still not at hand.

7. In an action under Pennsylvania’s Wrongful Death Act, Pa. Stat. Ann. tit. 12, § 1602 (1953), it is settled law that the state’s Dead Man’s Act, Pa. Stat. Ann. tit. 28, § 322 (1958), does not render a witness incompetent because “the action of wrongful death is not for damages sustained by the decedent but for damages sustained by the plaintiff by reason of the decedent’s death.” Dennick v. Scheiber, 381 Pa. 200, 201, 113 A.2d 318, 319 (1955). For the above reason the dissent stated that: “If the District Court erred (1) in ruling that the Pennsylvania Dead Man’s Act, 28 P.S. § 322, rendered [the owner] incompetent as a witness against the . . . estates [of the two deceased plaintiffs]; and (2) in its instructions in the [surviving plaintiffs’] trial on the score of deviation. 411 F.2d at 100.

8. The Pennsylvania cases in the field show that whatever might be this Court’s view of the “modern” rule, the Pennsylvania courts still adhere to the doctrine of mutuality and have made no exceptions applicable to . . . the instant case. 411 F.2d at 104.

9. *See* Note, 52 Cornell L.Q. 724 (1967); *Note*, 1966 Duke L.J. 283, 285. For the traditional definition of collateral estoppel, *see* RESTATEMENT OF JUDGMENTS § 68 (1942), which states that “where a question of fact essential to the judgment is actually litigated and determined by a valid and final judgment, the determination is conclusive between the parties in a subsequent action on a different cause of action.”
judgment unless that party has had his day in court.10 The second limitation is the rule of mutuality, which precludes a party from invoking collateral estoppel unless both he and the other party are bound by the prior judgment.11 Mutual estoppel obtains whenever a court in a prior proceeding rendered a judgment that bar a plaintiff from relitigating issues which were litigated and determined in the prior action.12 It is apparent that although mutuality remains law in a majority of states,13 its often inapplicable results have led most courts to riddle it with exceptions.14 Some courts have chosen to abolish the absolute requirement of mutuality altogether,15 but this approach has led to unfair results in a number of cases.16 It has, therefore, become apparent that neither strict technical adherence to mutuality nor its complete disregard produces satisfactory results. Substitutes for mutuality, such as the "full and fair opportunity to litigate the issue" test17 and the "rule of thumb" approach18 have been tried. Of the two, the former is the more popular, and it involves reviewing the first trial to insure that the party against whom collateral estoppel is being invoked had an ample opportunity to litigate the disputed issue.

11. For excellent discussions of the rule of mutuality in collateral estoppel, see 1B. J. Moore, Federal Practice §§ 0.412[1]-[9]; Currie, Civil Procedure: The Tempest Brews, 53 Calif. L. Rev. 25 (1965); Semmel, Collateral Estoppel, Mutuality and Joinder of Parties, 68 Colum. L. Rev. 1457 (1968).
13. 1B. J. Moore, supra note 11, ¶ 0.411[1], at 1251. For recent cases see Semmel, supra note 11, at 1461 n.23.
14. Two of the more common exceptions to mutuality are the so-called indemnitor-indeemnitee and principal-agent anomalies. The rationale for these exceptions is that one who is liable only because of the acts of another should not be liable where the other has been legally exonerated. Taylor v. Denton Hatchery, Inc., 251 N.C. 689, 111 S.E.2d 864 (1960) (collateral estoppel was available to employer following exoneration of driver); Hinchey v. Sellers, 7 N.Y.2d 287, 165 N.E.2d 156, 197 N.Y.S.2d 129 (1959) (collateral estoppel available to owner following exoneration of liability insurer). For an excellent discussion, see generally Restatement of Judgments §§ 96, 97 & 99 (1942); Comment, The Impacts of Defensive and Offensive Assertion of Collateral Estoppel by Nonparty, 35 Geo. Wash. L. Rev. 1010 (1966).
16. See Lustik v. Rankila, 269 Minn. 515, 131 N.W.2d 741 (1964) (where a judgment in the first action was asserted as a bar against a counterclaim, notwithstanding the fact that the issue of negligence was never litigated in the first action). Contra, Berner v. British Commonwealth Pac. Airlines, Ltd. 346 F.2d 532 (2d Cir. 1965) (where plaintiff was not allowed to use a technically adverse judgment against defendant in the second trial since it was not properly defended because of the small amount involved in the first action). For an examination of some of the problems caused by abolishing mutuality, see Semmel, supra note 11, at 1468-71.
18. The "rule of thumb" test proposes that where mutuality is lacking, collateral estoppel should be available for use only against a party who was the plaintiff in the first action. Such an approach would reduce litigation, but not as extensively as the "full and fair opportunity" test. Professor Currie recognized this when he stated: "[T]he mutuality rule is deservedly dead, and . . . any reservations about the totality of its demise should rest on particularized inquiry rather than on rules of thumb . . . ." Currie, supra note 11, at 31.
at that time. The multiplicity of factors involved in this particularistic case-by-case approach, however, has deterred many courts from abolishing mutuality altogether. The fate of the rule of mutuality, therefore, remains in a state of flux.

The question of whether collateral estoppel could be invoked under the factual situation in Provident required that the court evaluate the applicability of mutuality. Recognizing that the doctrine of mutuality had yielded with time to many piecemeal exceptions, the court first examined the case which pioneered the attack on mutuality, Bernhard v. Bank of America Nat'l Trust & Sav. Ass'n. In that case, Justice Traynor stated that there was no compelling reason why a non-party could not invoke a prior judgment since once a person has had his full day in court on an issue, he should not be allowed to relitigate that issue. Although the prior judgment in Bernhard was used defensively in the second action, that opinion also seems to imply that the offensive-defensive distinction is without merit. The court in Provident, however, pointed out that abandoning mutuality altogether, as proposed in Bernhard, would lead to results equally as inappropriate as strict adherence to mutuality, in certain types of cases. The position taken by the Third Circuit in its

21. Id. at 811-12, 12 P.2d at 894. See also Currie, supra note 12, at 283.
22. See Currie, supra note 12, at 289-94. But see Comment, supra note 14. Professor Currie suggests that there is no reason behind the offensive-defensive distinction, but that some courts use it to adhere to mutuality while allowing defensive use to resolve indemnitor and multiple claimant anamolies.

For purposes of discussion, it will be helpful to represent the offensive-defensive distinction graphically. The vector in the first action (A-1) will be enclosed by a rectangle and the party invoking collateral estoppel in the second action (A-2) by an oval. In Bernhard v. Bank of American Nat'l Trust & Sav. Ass'n, 19 Cal. 2d 807, 122 P.2d 892 (1942):

A-1: heirs v. executor
A-2: heirs v. bank

This is defensive use of collateral estoppel by a non-party. In B.R. DeWitt, Inc. v. Hall, 19 N.Y.2d 141, 225 N.E.2d 195, 278 N.Y.S.2d 596 (1967), the following diagram applies:

A-1: truck-driver v. jeep owner
A-2: truck-owner v. jeep owner

This is offensive use by a non-party and amounts to the rejection of mutuality. This graphic aid is suggested in J. Rosenberg & M. Weinstein, Elements of Civil Procedure 960 (1962).

23. Although this interpretation of Bernhard has been suggested by some scholars, a number of California courts view Bernhard's effect very narrowly. See, e.g., Associated Creditors' Agency v. Haley Land Co., 239 Cal. App. 2d 610, 615, 49 Cal. Rptr. 1, 5 (1966); Great Western Furniture Co. v. Porter Corp., 238 Cal. App. 2d 502, 508-09, 48 Cal. Rptr. 76, 81 (1965).
own precedent, *Bruszewski v. United States*,\(^{25}\) was seen as the better view. The defendant in that case was allowed to invoke res judicata\(^{26}\) defensively against the same plaintiff as in the first case, although the defendant was neither a party nor in privity with a party in the prior action. The court said that:

no unfairness results here from estoppel which is not mutual [and] the achievement of substantial justice . . . is the measure of the fairness of the rules of res judicata.\(^{27}\)

In *Provident* the court felt that "the facts uniquely combine to remove any possible element of unfairness or hardship . . ."\(^{28}\) to the defendant since he had a "full and fair" opportunity to litigate the issue of deviation as against the surviving plaintiff. Furthermore, the defendant had the advantage of having all three claims joined and tried together by the same judge and jury. As some scholars in the field have noted, however, the determination of "fairness" requires that the appellate court use its discretion liberally since the "full and fair" test offers no established guidelines to facilitate the evaluation of the lower court record.\(^{29}\) The instant case amply demonstrates the strong split of opinion that can arise when this approach is utilized to determine the issue of "fairness."\(^{30}\)

Since this was a diversity action, however, it was necessary to apply Pennsylvania law.\(^{31}\) The Supreme Court of Pennsylvania ruled in *Posternack v. American Cas. Co.*\(^{32}\) that the defendant, who was not a party in the first action, could amend his pleadings to include defensive use of collateral estoppel against the same plaintiff who had lost the first judgment.\(^{33}\) Mr. Justice Egan made the following statement:

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25. 181 F.2d 419 (3d Cir. 1950), *cert. denied*, 340 U.S. 865 (1950). This case is an example of defensive use of collateral estoppel by a non-party:

A-1: longshoreman v. [owner]

A-2: longshoreman v. [United States]

26. The cases used by the *Provident* court involve res judicata rather than collateral estoppel, but it is settled that the rule of mutuality operates identically under both doctrines. See Note, 52 *Cornell L.Q.* 724 (1967).

27. 181 F.2d at 421.

28. 411 F.2d at 95.


30. See note 7 *supra*.


33. There is some possibility that this case falls under the common indemnitor-indemnitee exception to mutuality. See Judge Kaldoner's dissent in the instant case. 411 F.2d at 103. There is no question, however, that this is an example of defensive use of collateral estoppel by a non-party:

A-1: policy holder v. [insurer #1]

A-2: policy holder v. [insurer #2]
Recent cases have recognized exceptions to the general rule . . . thus showing a tendency by this court, at least in limited areas, not to allow the technical formalities of res judicata to stand in the way of justice.\textsuperscript{34} Relying solely on this language in Posternack, the court in Provident then concluded that there was “no doubt that the Pennsylvania courts would recognize collateral estoppel in a case such as this.”\textsuperscript{35} Whether Posternack is amenable to such an interpretation or not can be determined only by viewing it in the context of recent Pennsylvania decisions on mutuality. As is pointed out in the dissent in Provident,\textsuperscript{36} a long line of Pennsylvania supreme court cases has firmly established mutuality as part of Pennsylvania law.\textsuperscript{37} Although certain limited exceptions to mutuality have been recognized by the Pennsylvania courts, none are applicable to the instant case. For example, in Brobston v. Darby Borough\textsuperscript{38} and in Helmig v. Rockwell Mfg. Co.,\textsuperscript{39} defensive use of collateral estoppel was allowed where the same plaintiff brought suit against a defendant whose liability arose from the alleged wrongful act of another person who was exonerated in the prior judgment. These two cases represent one of mutuality’s best established exceptions, which provides that an indemninee can use a favorable judgment of the indemnitor defensively.\textsuperscript{40} The only Pennsylvania case allowing offensive use of collateral estoppel is Hurtt v. Stirone.\textsuperscript{41} In that case the plaintiff used a jury verdict that the defendant was guilty of extortion as being conclusive of that issue. The court in Hurtt, however, specifically limited the decision to the use of major criminal convictions in this manner.\textsuperscript{42} It appears, therefore, that Pennsylvania courts would not have allowed collateral estoppel under the facts of Provident because there was no mutuality of estoppel.\textsuperscript{43} This departure from Pennsylvania law is clearly opposed to the Supreme Court’s mandate in Erie R.R. Co. v. Tompkins,\textsuperscript{44} which stipulated that

\textsuperscript{34} 421 Pa. at 25, 218 A.2d at 352. The court in Posternack, however, then went on to state that “[o]n the posture of the present record, it is far from clear whether or not the doctrine of res judicata should be applied.” \textit{Id.} at 25, 218 A.2d at 352.
\textsuperscript{35} 411 F.2d at 95.
\textsuperscript{36} \textit{Id.} at 104.
\textsuperscript{37} \textit{See}, e.g., Evans v. Moffat, 388 Pa. 559, 131 A.2d 141 (1957); Woodburn v. Pennsylvania R.R., 294 Pa. 174, 144 A. 93 (1928).
\textsuperscript{38} 290 Pa. 331, 138 A. 849 (1927).
\textsuperscript{39} 389 Pa. 21, 131 A.2d 622 (1957).
\textsuperscript{40} \textit{See} Semmel, \textit{supra} note 11, at 1462–63.
\textsuperscript{42} \textit{Id.} at 499, 206 A.2d at 627.
\textsuperscript{43} The instant case represents a clear case of offensive use of collateral estoppel by a non-party:

\begin{itemize}
  \item \textit{A-1:} \begin{itemize}
    \item \underline{injured plaintiff}
    \item \underline{& deceased plaintiffs}
    \item \underline{v. insurer}
  \end{itemize}
  \item \textit{A-2:} \begin{itemize}
    \item \underline{deceased plaintiffs}
    \item \underline{v. insurer}
  \end{itemize}
\end{itemize}

\textsuperscript{44} 304 U.S. 64 (1938).
state substantive law is to be applied in diversity actions. It is settled that the rules of collateral estoppel are substantive rather than procedural and, therefore, the Third Circuit's holding in Provident should have conformed to Pennsylvania law.

The rationale for the Third Circuit's disregard of Pennsylvania law lends itself to at least two interpretations. The first is that, due to the protracted litigation, the result in Provident would have been unfair had mutuality been upheld and, therefore, mutuality was disregarded. This view is supported by Judge Freedman's dissent in Provident's first appearance before the Third Circuit:

It seems to me that . . . our discretion should be exerted in order to save for the parties and for the judicial process what has already been validly determined . . .

Furthermore, the strength of this interpretation is augmented by the existence of other grounds upon which the court might have reversed. The second interpretation which can be given to Provident is that the court wanted to abandon the rule of mutuality and replace it with the "full and fair opportunity to litigate the issue" test. The Third Circuit's strong criticism of mutuality and its apparent preference for the "modern rule" add credence to this view. This interpretation is further supported by the particularistic, case-by-case approach that the court adheres to in determining the "fairness" of invoking collateral estoppel.

The preceding analysis of the court's rationale in Provident may not be conclusive of that issue but it does lead to the inference that the "full and fair" test has replaced the rule of mutuality in the Third Circuit. The practical consequences of this conclusion become more apparent when viewed in light of the development of the "full and fair" test since its inception. As originally conceived the test was meant to effectuate a limitation on the Bernhard doctrine, which was construed by some scholars as the complete abandonment of mutuality. The actual effect of the test, however, was the retention of mutuality in cases where the party against whom collateral estoppel was invoked did not have the initiative in the first action and, therefore, did not litigate vigorously. The judicial determination at the appellate level of whether a trial was litigated vigorously or, phrased more appropriately, whether there was a "full and fair" opportunity to litigate the issue below has caused an inordinate consumption of time in those courts. In order to remedy this problem the courts

46. See note 6 supra.
47. 365 F.2d at 823.
48. See note 7 supra.
49. 411 F.2d at 92–95.
50. See Semmel, supra note 11, at 1468. But see note 23 supra.
51. See Currie, supra note 12, at 309.
have identified a number of factors\(^5^2\) as being pertinent to this question, but by its very nature the "full and fair" test is not readily adaptable to standard formulae. Since the purpose of collateral estoppel is to increase the predictability of judgments and thereby reduce litigation, it would seem that the discretion-laden "full and fair" test may well frustrate this doctrine by increasing litigation.\(^5^3\)

\[\text{John V. Bonneau}\]

CIVIL RIGHTS — 1964 CIVIL RIGHTS ACT — A PRIVATELY OWNED RECREATIONAL FACILITY HELD TO BE A TITLE II PUBLIC ACCOMMODATION PRECLUDING DENIAL OF ADMISSION SOLELY ON RACIAL GROUNDS.

\[\text{Daniel v. Paul (U.S. 1969)}\]

The defendant, Euell Paul, Jr., and his wife are co-owners of the Lake Nixon Club. The club property consists of 232 acres located 12 miles west of Little Rock, Arkansas. The principal facilities of the club include: a lake for swimming, aluminum paddle boats, two coin operated juke boxes, a miniature golf course, and a snack bar. These facilities were available only to members of the club. Membership was acquired through payment of a 25 cent membership fee per season and evidenced by a membership card issued upon approval by Mr. & Mrs. Paul. Additional fees were charged for use of the swimming, boating and miniature golf facilities.

On July 10, 1966, the plaintiffs, black residents of Little Rock, drove to the Lake Nixon Club seeking admission. It was quickly denied on the grounds that they were not members. When they inquired about obtaining membership they were told that the quotas for the year had all been filled.\(^1\) Consequently, the plaintiffs brought this class action, pursuant to

\[\text{52. Some of these include size of claim, forum of prior litigation, extent of litigation, existence of new evidence, adequacy of counsel, and the foreseeability of future litigation.}\]

\[\text{53. See Note, 52 CORNELL L.Q., supra note 9, at 730.}\]

\[\text{1. Respondent at trial answered in the affirmative a question as to whether blacks were denied admission because they were blacks. Respondent's reply to an interrogatory of why blacks were refused admission was as follows:}\]

\[\text{[W]e refused admission to them because white people in our community would not patronize us if we admitted negroes to the swimming pool. Our business would be ruined and we have life savings in it.}\]

Title II of the 1964 Civil Rights Act, in the United States District Court for the Eastern District of Arkansas, to enjoin respondents from denying them admission.\(^2\) The district court dismissed the complaint on the grounds that Lake Nixon Club's operations did not affect commerce and therefore it was not a "public accommodation" within the purview of the Civil Rights Act of 1964.\(^3\) On appeal, the Court of Appeals for the Eighth Circuit affirmed with one judge dissenting.\(^4\) The United States Supreme Court granted certiorari\(^5\) and reversed, holding that the Lake Nixon Club is a public accommodation under sections 201(b) and 201(c) of the Act and therefore petitioners may not be denied equal enjoyment of its services and facilities because of race or color. Daniel v. Paul, 395 U.S. 298 (1969).

The 1964 Civil Rights Act was the culmination of bipartisan effort to effectuate the civil rights policy outlined by President Kennedy in his June 19, 1963 special message to Congress.\(^6\) Broadly speaking, this policy is to protect and provide more effective means for enforcing the civil rights of persons within the jurisdiction of the United States.\(^7\) In his special message, the President emphasized to Congress that a most troublesome source of racial discrimination is the denial of equal accommodation to public facilities.\(^8\) Congress' reaction to this problem manifests itself in

2. Petitioners' complaints alleged in substance that Lake Nixon was a "public accommodation" within the meaning of Title II, and that under the provisions of section 201(a) they were granted a federal substantive right to be free from discrimination and segregation on the grounds of race with respect to said public accommodation. Section 201(a) reads:

All persons shall be entitled to the full and equal enjoyment of the goods, services, facilities, privileges, advantages, and accommodations of any place of public accommodation, as defined in this section, without discrimination or segregation on the grounds of race, color, religion, or national origin.


Petitioners prayed for appropriate injunctive relief as provided for in section 204 of Title II. It states in pertinent part:

Whenever any person has engaged or there are reasonable grounds to believe that any person is about to engage in any act or practice prohibited by section 203 [which states that no person shall deny or abridge any of the rights secured by section 201 or 202], a civil action for preventive relief, including an application for a permanent or temporary injunction, restraining order, or other order, may be instituted by the person aggrieved ....


6. For the full text of President Kennedy's speech, see PUBLIC PAPERS OF THE PRESIDENTS, JOHN F. KENNEDY, at 485 (1963).

7. The emphasis here is on the words "more effective" because at this time civil rights legislation did exist. Congress first entered the civil rights arena in 1866. 14 Stat. 27 (1866). This Act was followed by a series of five acts beginning in 1866 and ending in 1875: Slave Kidnapping Act, 14 Stat. 50 (1866); Peonage Abolition Act, 14 Stat. 546 (1867); Act of May 31, 1870, 16 Stat. 140; Anti-Lynching Act, 17 Stat. 13 (1871); The Civil Rights Act of 1875, 18 Stat. 335. No civil rights legislation appeared for the next 82 years until the Civil Rights Act of 1957, 42 U.S.C. § 1975 (1954). This Act was followed by the Civil Rights Act of 1960, 42 U.S.C. § 1971 (1964).

8. On February 28, 1963, in his first special message to Congress outlining the administration's civil rights proposal, President Kennedy underlined the magnitude of this form of discrimination when he said:

[No action is more contrary to the spirit of our democracy and constitution — or more rightfully resented by a negro citizen who seeks only equal treatment —
Title II of the Act. This title is designed to provide aggrieved individuals with injunctive relief from denial of access to public accommodations. Sections 201(b) and 201(c) provide the main thrust of the title since they establish the criteria against which an establishment or facility is measured to determine if it acquires "public accommodation" status.

The question of congressional power to enact the public accommodation provisions was reviewed by the Supreme Court in Heart of Atlanta Motel, Inc. v. United States and Katzenbach v. McClung. In Heart of Atlanta Motel, the Court held that congressional power to prohibit discrimination in public accommodations emerges from the Constitution's grant of specific and plenary power over interstate commerce. The Court

than the barring of that citizen from restaurants, motels, theatres and other public accommodations and facilities.

Public Papers of the Presidents, John F. Kennedy, at 228 (1963).


11. The Civil Rights Act of 1964 § 201(b), 42 U.S.C. § 2000a(b) (1964), provides that:

Each of the following establishments which serves the public is a place of public accommodation within the meaning of this title if its operations affect commerce, or if discrimination or segregation by it is supported by State action:

(1) any inn, hotel, motel, or other establishment which provides lodging to transient guests, other than an establishment located within a building which contains not more than five rooms for rent or hire and which is actually occupied by the proprietor of such establishment as his residence;

(2) any restaurant, cafeteria, lunchroom, lunch counter, soda fountain, or other facility principally engaged in selling food for consumption on the premises, including, but not limited to, any such facility located on the premises of any retail establishment; or any gasoline station;

(3) any motion picture house, theater, concert hall, sports arena, stadium or other place of exhibition or entertainment; and

(4) any establishment (A) (i) which is physically located within the premises of any establishment otherwise covered by this subsection, or (ii) within the premises of which is physically located any such covered establishment, and (B) which holds itself out as serving patrons of such covered establishment.

The Civil Rights Act of 1964 § 201(C), 42 U.S.C. § 2000a(c) (1964), provides that:

The operations of an establishment affect commerce within the meaning of this title if (1) it is one of the establishments described in paragraph (1) of subsection (b); (2) in the case of an establishment described in paragraph (2) of subsection (b), it serves or offers to serve interstate travelers of a substantial portion of the food which it serves, or gasoline or other products which it sells, has moved in commerce; (3) in the case of an establishment described in paragraph (3) of subsection (b), it customarily presents films, performances, athletic teams, exhibitions, or other sources of entertainment which move in commerce; and (4) in the case of an establishment described in paragraph (4) of subsection (b), it is physically located within the premises of, or there is physically located within its premises, an establishment the operations of which affect commerce within the meaning of this subsection. For purposes of this section, "commerce" means travel, trade, traffic, commerce, transportation, or communication among the several States, or between the District of Columbia and any State, or between any foreign country or any territory or possession and any State or the District of Columbia, or between points in the same State but through any other State or the District of Columbia or a foreign country.


14. 379 U.S. at 258. The Court pointed out that the legislative history of the Civil Rights Act indicates that Congress based its power to enact such legislation on both the equal protection clause of the 14th amendment and article I, section 8, clause 3 of the Constitution (commerce clause), but since the commerce clause power was a
declared that the determinative test of the exercise of this power is simply whether the activity sought to be regulated is commerce which concerns more than one state and has a real and substantial relation to national interests. In the McClung case, the Court emphasized the pervasiveness of the commerce clause grant of power to Congress. It stated that the commerce clause, coupled with the necessary and proper clause, extended congressional power to those activities intrastate in nature which so affected interstate commerce, or the exertion of the power of Congress over it, as to make their regulation necessary for the proper execution of that grant of power.

With the affirmation of the constitutionality of the public accommodation provisions, the courts were actively summoned to interpret its broad language. Federal court application of this statute pivoted around two principle questions raised by sections 201(b) and 201(c): (1) is the establishment in question one of those covered under 201(b)?; and (2) if it is, then do its operations have the necessary nexus with interstate commerce?

As the status of various types of establishments was challenged under these sections, distinct patterns of response to the above questions emerged. In the section 201(b)(1) cases the key issue is whether the establishment provides lodging to transient guests. If a factual determination reveals that it does, then a per se nexus with interstate commerce exists. The question of whether the particular discriminatory activities being considered have a disruptive affect on commerce is moot since Congress has already asserted by the language of 201(c)(1) that it does.

In the eating establishment cases arising under section 201(b)(2), the first question to be answered is whether the facility is principally engaged in selling food for consumption on the premises. This is primarily

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sufficient basis for upholding its constitutionality, there was no need to consider the equal protection source of power.

15. Id. at 255.
16. 379 U.S. at 301-02.
17. Civil Rights Act of 1964 § 201(b), 42 U.S.C. § 2000a(b) (1964). For complete text of section 201(b) see note 11 supra.
19. Civil Rights Act of 1964 § 201(c)(1), 42 U.S.C. § 2000d(c)(1) (1964). For the complete text of section 201(c), see note 11 supra. In the McClung case the Court emphasized the fact that an act of Congress based on the commerce power does not have to provide for independent determination regarding the affect on commerce of the particular activity proscribed. Congress may say what activities affect commerce and the only question for the courts to decide is whether the particular activity regulated is within the reach of federal power. The fact that Congress has said a particular activity burdens interstate commerce does not preclude further examination by the courts, but when they find, in the light of the facts and testimony before them, that Congress has a rational basis for finding the chosen regulatory scheme necessary to the protection of commerce, the court's investigation is at an end. 379 U.S. at 297-98. For a discussion of the effects on interstate commerce of discrimination in the lodging of transient guests see supra supra note 11; Des Moines News, 88th Cong., 2d Sess. 2493-2501 (1964).
a factual determination and has presented little problem to the courts.\textsuperscript{20} Establishments which have been found to fall within this category include: restaurants,\textsuperscript{21} drive-in-restaurants,\textsuperscript{22} lunch counters,\textsuperscript{23} coffee shops,\textsuperscript{24} cafes\textsuperscript{25} and snack bars.\textsuperscript{26} Once this determination is made, the next question is whether the necessary nexus with interstate commerce exists. On this point, Congress has provided two controlling tests: (1) whether the establishment \textit{offers} to serve or does \textit{in fact} serve interstate travelers; or (2) whether a \textit{substantial portion} of the food served moves in interstate commerce.\textsuperscript{27}

In applying the first test — whether the establishment offers to serve interstate travelers — the courts have looked primarily to two signposts in making their determination: the sources and scope of advertising employed by the establishment and its propinquity to interstate highways.\textsuperscript{28} The rationale behind the courts’ reliance on the above two signposts is that notice and/or ease of accessibility tend to make it more probable than not that at least some interstate travelers will stop for services.\textsuperscript{29} Advertising media which have been determinative on this point have included: regional radio and television,\textsuperscript{30} daily and monthly newspapers,\textsuperscript{31} magazines,\textsuperscript{32} bill-

\textsuperscript{20} In Newman v. Piggie Park Enterprises, 377 F.2d 433 (4th Cir. 1967), the Fourth Circuit indicated that this question becomes somewhat problematical in drive-in-restaurant cases but held that the purpose of this determination has no bearing on the percentage of food consumed on the premises but is intended to exclude from coverage of the Act those places where food services are incidental to some other business.\textsuperscript{21} Restaurants are specifically mentioned in 42 U.S.C. § 2000a(b) (2) (1964). \textit{See, e.g.,} Blow v. North Carolina, 379 U.S. 684 (1968); Wooten v. Moore, 400 F.2d 239 (4th Cir. 1968); United States v. Beach Associates, Inc., 286 F. Supp. 801 (D. Md. 1968); Codogan v. Fox, 266 F. Supp. 866 (M.D. Fla. 1967); United States v. Jack Sabin's Private Club, 265 F. Supp. 90 (E.D. La. 1967); Willis v. Pickrick Restaurant, 231 F. Supp. 396 (N.D. Ga. 1964).


28. \textit{See the cases cited in note 27 supra.} These two signposts have been employed by the courts in 201(a) cases also.

29. \textit{See the cases cited in note 27 supra.} Mr. Justice Black in his dissenting opinion in the present case indicates that the absence of these factors make it more probable than not that interstate travelers did not frequent Lake Nixon.


boards along interstate highways, and brochures circulated to hotel guests. A covered establishment’s propinquity to an interstate highway has varied in each case. In those cases where the courts considered this signpost significant, the facility was located somewhere within the range of 60 feet to 5 miles. The “substantial portion” test, as an alternative to the service of interstate travelers test, has by application manifest its sweeping characteristics. It appears that the most that can be said on this point is that the amount of food which must move in interstate commerce is a relative one.

Under section 201(b)(3), motion picture houses, theatres, concert halls, sports arenas, and stadiums, which are specifically referred to therein, have created little difficulty. However, it has been otherwise with respect to the application of the “place of exhibition or entertainment” clause. Amusement parks, nightclubs or cabarets, and golf courses have all been held to fall within this category. The test for finding a nexus with interstate commerce under this section is whether the “sources of entertainment . . . move in commerce.” The courts have construed “sources of entertainment” to include: movie films, amusement park equipment, vocal groups, and tournament teams. Two fine distinctions have been made with respect to the application of this test. First, the determinative factor is not the source of entertainment presented at the time the cause of action arose, but the “customary” source of entertainment employed. Secondly, the word move found in the phrase “move in com-

35. In Blow v. North Carolina, 379 U.S. 684 (1965), the restaurant was sixty feet from an interstate highway. In Katzenbach v. McClung, 379 U.S. 294 (1964), the restaurant was eleven blocks away. In Gregory v. Meyers, 376 F.2d 509 (5th Cir. 1967), the distance was three blocks. In Codogan v. Fox, 266 F. Supp. 866 (M.D. Fla. 1967), the distance was three-fourths of a mile. In Evans v. Laurel Links, Inc., 261 F. Supp. 474 (E.D. Va. 1966), the golf course was five miles from two interstate highways.
36. In Gregory v. Meyers, 376 F.2d 509 (5th Cir. 1967), the court found that $5000 worth of coffee and tea that had moved in interstate commerce plus the fact that two-thirds of the $70,856 total sales of beef products were purchased from a meat packer who subsequently purchased 20-30% of his cattle out of state, constituted a substantial portion of the establishment’s total food sales. See also S. Rer. No. 872, 88th Cong. 2d Sess. 171-73, 212, 229 (1964). Compare the cases cited in note supra.
44. Miller v. Amusement Enterprises, Inc., 394 F.2d 342 (5th Cir. 1968).
47. See 42 U.S.C. § 2000a(c)(3) (1964). In Laurel Links the district court held that a golf team from Washington, D.C., playing on the course on a regularly scheduled annual basis was a “customary” source of entertainment. Id. at 427.
merce” is not to be strictly construed as meaning only the present tense of the verb. The past, past perfect, and present perfect tenses of moved, had moved and have or has moved are also to be controlling in its construction.48

The final category of establishments considered under the public accommodation provisions have been termed “dual establishments.”49 A more comprehensive understanding of this expression may be derived from a close examination of 201(b) and 201(c) language. These subsections have the pervasive feature of bringing the entire establishment within the scope of Title II if it (1) has located within its premises or it is located within the premises of an establishment covered by either section 201(b) or section 201(c); and (2) it holds itself out as serving patrons of the covered establishment.50 An illustration of the application of this provision is a department store that has within its premises a lunchroom which has acquired public accommodation status under 201(b)(2) and which serves the patrons of that store. Under this hypothetical, the facilities of both the lunchroom and the department store must be made available on a nondiscriminatory basis.51

When an establishment is being challenged under Title II, a frequent defense raised is that it is a “private club” under section 201(e) and therefore not subject to federal sanction.52 This section exempts from the Act a private club not in fact open to the public.53 In deciding whether a purported private club actually acquires this status, the courts look to two factors: the purposes for which the club was organized, as revealed by its by-laws, rules and regulations and its structure and operations.54 These

51. 42 U.S.C. § 2000a(b) (4) (1964); 42 U.S.C. § 2000a(c) (4) (1964). In Evans v. Laurel Links, Inc., 261 F. Supp. 474, 476 (1966), the district court held that the lunch counter located on the golf course, which it found to serve interstate travelers, brought the entire golf course under Title II. In Fazioz Real Estate Co. v. Adams, 396 F.2d 146 (5th Cir. 1968), an entire bowling alley was brought under Title II when the Fifth Circuit held that the refreshment counter sales, excluding beer, were 8-11% of total bowling alley sales and that a substantial portion of the refreshment counter food moved in commerce. Also, in United States v. Beach Associates, Inc., 286 F. Supp. 801 (D. Md. 1968), the district court held that the carry-out-shop, which served interstate travelers food, a substantial portion of which had moved in commerce, was located within the larger Beach Club premises and served its patrons, therefore bringing all the Beach Club facilities under the Act. Contra, Nesmith v. Y.M.C.A., 397 F.2d 96 (4th Cir. 1968), where the Fourth Circuit held that Y.M.C.A. facilities consisting of a community building and an athletic building joined together by a breezeway were separate and distinct operations, were not an integral unit therefore not necessary to invoke 201(b) (4).
52. 42 U.S.C. § 2000a(e) (1964), states in relevant part that:

The provisions of this title shall not apply to a private club or other establishment not in fact open to the public.

two factors are then juxtaposed and a conclusion drawn as to the club’s true nature. Some of the criteria utilized by the courts in this functional analysis include: the open ended character of its membership,\textsuperscript{55} size,\textsuperscript{56} genuineness of selectivity in membership,\textsuperscript{57} sources of financial assistance,\textsuperscript{58} utilization of club machinery,\textsuperscript{59} and the methods of membership recruitment.\textsuperscript{60}

Prior to the \textit{Paul} case, the scope of 201(b) and 201(c) had been primarily determined by the lower federal courts.\textsuperscript{61} But the facts in those cases did not require an extension of the statutory language as would be necessary to find Lake Nixon a public accommodation. The overriding national policy against discrimination in public accommodations and the necessity of a liberal construction of the Title II provisions to the facts in the \textit{Paul} case set the stage for Supreme Court action.

The Court’s finding that Lake Nixon is a public accommodation is grounded on two major arguments. The first argument is that the Lake Nixon snack bar is an establishment principally engaged in selling food for consumption on the premises under 201(b)(2) and its operations affect commerce as enumerated in 201(c)(2).\textsuperscript{62} The Court reasoned that because the sources of Paul’s advertising included a monthly magazine distributed to Little Rock hotel guests, the Little Rock Air Force Base monthly newspaper, and spot commercials on two local radio stations, they covered a broad-based market which had to include some interstate travelers under 201(c)(2).\textsuperscript{63} Furthermore, the Court reasoned that since

\begin{itemize}
  \item In \textit{Richberg}, the Fifth Circuit, after reviewing the stated purposes of the club, said: \textquotedblleft The Dixie Diner Club, is devoted, in the words of its by-laws, to \textquotedblleft "The creation of an atmosphere conducive to the development of connoisseurs of discriminating taste and epicurean pleasures". . . . [But] the record conclusively shows, that the club has maintained the same food, menu, prices and serving personnel as formerly characterized operations of Richberg’s Cafe, and as still characterize the cafe’s operations today.
  \item 398 F.2d 523, 527 (5th Cir. 1968).
  \item 55. See Nesmith v. Y.M.C.A., 397 F.2d 96, 101-02 (4th Cir. 1968).
  \item 56. Id.
  \item 58. Stout v. Y.M.C.A., 404 F.2d 687 (5th Cir. 1968); Nesmith v. Y.M.C.A., 397 F.2d 96 (4th Cir. 1968).
  \item 60. Nesmith v. Y.M.C.A., 397 F.2d 96 (4th Cir. 1968).
  \item 61. The only cases decided by the Supreme Court which reviewed the language of these sections are, Heart of Atlanta Motel v. United States, 379 U.S. 241 (1964) and Katzenbach v. McClung, 379 U.S. 294 (1964). In both of these cases the Court was clearly concerned with the question of the constitutionality of the Act. The other cases considered by the Court, relevant to the Act, concerned convictions under state trespass laws for civil rights activities, and the interpretation of sections 201(b) and 201(c) were incidental to those issues. See United States v. Johnson, 390 U.S. 563 (1968); Georgia v. Rachel, 384 U.S. 780 (1966); Blow v. United States, 379 U.S. 685 (1965); Hamm v. Rock Hill, 379 U.S. 306 (1964). \textit{Contra}, Adderly v. Florida, 385 U.S. 39 (1966).
  \item 63. \textit{Id.} at 304.
\end{itemize}
the Club actually served 100,000 patrons per season, it was unrealistic to assume that none of them were interstate travelers.64

To shore up their finding that the snack bar had the necessary nexus with interstate commerce, the Court decided that since the district court had taken judicial notice of the fact that the principal ingredients of the hamburger and hotdog rolls were produced out-of-state and that certain of the ingredients composing the soft drinks were “probably” obtained from out-of-state sources, there could be “no serious doubt” that a “substantial portion” of the food served moved in interstate commerce.65 Based on these findings, the Court concluded that since the snack bar is a covered establishment within the premises of the larger Lake Nixon facility and it serves those patrons, then subsections 201(b)(4) and 201(c)(4) are determinative and bring the entire facility within the compass of Title II.66

The second argument propounded by the Court is centered on subsections 201(b)(3) and 201(c)(3). Here, the majority asserted that Lake Nixon falls within the definition of a place of entertainment as provided for by 201(b)(3) since a reasonable construction of that term is not confined to establishments in which patrons are entertained as spectators, but also includes those involving direct participation.67 The 201(c)(3) requirement of a nexus with commerce was satisfied by the fact that the Club’s mechanical “sources of entertainment,” which included two juke boxes with the accompanying records, 15 paddle boats and a few surf boards, were manufactured outside of Arkansas and therefore moved in commerce.68

The Court also made passing mention of the private club defense raised by the defendant. It asserted that the lower courts were correct in their determination that Lake Nixon was not a private club because the membership device was no more than a “subterfuge” to avoid coverage of the Act and the Club did not have the self-government and member-ownership attributes traditionally associated with private clubs.69 This question is ultimately a factual one and the burden of proof rests with the party claiming the exemption.70

The primary question raised by the Paul decision is the Court’s extension of Congress’ regulatory power over interstate commerce to the Lake Nixon facility. In Heart of Atlanta Motel, Mr. Justice Clark, speaking for the entire Court, outlined the extent of this power:

[T]he power of Congress to promote interstate commerce also includes the power to regulate the local incidents thereof, including local

64. Id.
65. Id. at 305.
66. Id.
67. Id. at 306.
68. Id. at 308.
69. Id. at 301–02.
activities in both the States of origin and destination, which might have a substantial and harmful effect upon that commerce.\textsuperscript{71}

Here the Court underlines the basic scope of Congress’ regulatory power over interstate commerce and supports its legislative activity in the area of racial discrimination. Both houses of Congress carefully considered the harmful affects of racial discrimination upon interstate commerce and subsequently, through section 201(c), defined the parameters within which it wished to extend its power.\textsuperscript{72}

Congress has declared in 201(c)(2) that when a 201(b)(2) establishment serves or offers to serve interstate travelers, or when a substantial portion of the food it serves has moved in commerce, then its operations affect interstate commerce and it is subject to regulation. The Court, in deciding that the Lake Nixon Club is a public accommodation, declares that Congress’ power to regulate interstate commerce shall extend to this facility because the snack bar affects commerce by offering to serve and in fact serving interstate travelers. But the Court’s conclusions of fact on this point seem wanting. The district court found that the Pauls used the facilities of radio station KALO to advertise the Club’s weekly dances, but the record also reveals that these ads were addressed to members only.\textsuperscript{73} The fact of advertising in the “Little Rock Today” monthly magazine and the “Little Rock Air Force Base” monthly newspaper seems equally inconclusive since only one advertisement had been placed in each publication.\textsuperscript{74} These factors coupled with the fact that Lake Nixon is located 12 miles west of the city and only accessible by country roads seems to weaken the Court’s conclusion on this point.

The majority’s employment of the 201(c)(2) “substantial portion” test suffers from the same infirmities. The record of the trial court is silent on the question of where or how local suppliers obtained the soft drinks, but it did indicate that they were bottled locally.\textsuperscript{75} The Court’s treatment of the district court’s assertion that “[C]ertain ingredients were probably obtained by the bottlers from out-of-state sources”\textsuperscript{76} is to accept the reasonably possible as being conclusive. The district court’s finding that the meat may or may not have come from out-of-state and that the buns were baked and packaged locally, leaves the only substantially certain source

\textsuperscript{71} 379 U.S. at 258.

\textsuperscript{72} A careful analysis of section 201(c) will reveal that Congress has merged two distinct commerce doctrines: the “flow” and the “affectation” doctrines. The flow doctrine extends federal commerce power to all those “things” actually moving in commerce and the transactions, contracts, and other activities incidental to them. See, e.g., The Daniel Ball, 77 U.S. (10 Wall.) 557 (1871); Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1 (1824). The affectation doctrine extends federal commerce power to those activities adversely and injuriously affecting interstate commerce. See, e.g., Wickard v. Filburn, 317 U.S. 111 (1942); N.L.R.B. v. Jones & Laughlin Steel Corp., 301 U.S. 1 (1937); Houston, E.I.W.T.R. Co. v. United States, 234 U.S. 342 (1914).

\textsuperscript{73} Daniel v. Paul, 395 F.2d 118, 122-23 n.4 (8th Cir. 1968).


\textsuperscript{75} Id. at 418.

\textsuperscript{76} Id. (emphasis added).
of food moving in commerce to be the ingredients used in the rolls. They were judicially noticed by the district court as coming from out-of-state.\textsuperscript{77}

The application of the 201(c)(3) test for determining whether congressional regulatory power shall extend to a 201(b)(3) establishment seems also to be somewhat distorted. The only "sources of entertainment" that could be considered as having moved in commerce are the two juke boxes and records which were manufactured outside Arkansas and the 15 paddle boats which were leased from an Oklahoma firm.\textsuperscript{78} The band that performed at the weekly dances were found by the district court to be a purely local amateur group. The Court of Appeals also pointed out that thousands of paddle boats of the type used at Lake Nixon were manufactured locally, which leaves open the possibility that they were also purchased locally by the Oklahoma firm and hence never physically left the state of Arkansas.\textsuperscript{79}

Perhaps the Court's finding that the Lake Nixon facility is a public accommodation under the provisions of Title II is more readily understood when it is viewed as the result of something more than a statutory explication. What seems to be at the foundation of this decision is a recognition of a congressional policy to enforce the civil rights of American citizens through a regulatory scheme that is based on congressional power to regulate interstate commerce.\textsuperscript{80} The Court, recognizing that the commerce clause grant of power is sufficient to support the full realization of this policy, ultimately concludes that this realization will be best accomplished by a broad interpretation of this congressional mandate.\textsuperscript{81} The immediate impact of this broad interpretation seems to be twofold. First,

\textsuperscript{77} Id.

\textsuperscript{78} Daniel v. Paul, 395 F.2d 118, 125 (8th Cir. 1968). The Eighth Circuit concluded that:

There is not one shred of evidence that Lake Nixon customarily presented any activity or source of entertainment that moved in interstate commerce.

\textsuperscript{79} Id.

\textsuperscript{80} Mr. Justice Douglas in his concurring opinion agrees with the majority's application of Title II to the Lake Nixon facility. However, he also finds that the privileges and immunities and equal protection clauses of the Fourteenth Amendment are another source of prohibition against racial discrimination in public accommodations. 395 U.S. 308-09 (1969). In Bell v. Maryland, 378 U.S. 226 (1964), Mr. Justice Douglas (concurring) argued that the denial of equal rights to public accommodations is a "relic of slavery" that is prohibited by the Thirteenth Amendment. \textit{Id.} at 242-60. For a thorough analysis of the Thirteenth Amendment prohibition of "badges and incidents of slavery," see Jones v. Alfred H. Mayer Co., 392 U.S. 409 (1968); Brown v. Board of Education, 347 U.S. 483 (1954); Civil Rights Cases, 109 U.S. 3 (1883). \textit{See also} 14 VILL. L. REV. 116 (1968).

Mr. Justice Black in his dissenting opinion in Paul argues that if Congress had chosen to invoke the broad power of § 5 of the Fourteenth Amendment as the basis for enacting Title II, he could agree with the majority holding. However, since it based the Act on its commerce clause power, its protection against racial discrimination is limited to the extent of that power. The Lake Nixon facility is beyond Congressional reach and to hold otherwise:

[W]ould be stretching the Commerce Clause so as to give the Federal Government complete control over every little remote country place of recreation in every nook and cranny of every precinct and county in every one of the 50 states.

395 U.S. at 309, 312.

it emphasizes that congressional regulation of racial discrimination in public accommodations will extend to facilities whose operations have only a very minimal nexus with interstate commerce. Secondly, it emphasizes that even though Congress expressly provided for a private club exemption from the Title II provision, there is an overwhelming burden of proof on any party intending to claim it.

Howard D. Vensie, Jr.

CONSTITUTIONAL LAW — Aid To Parochial And Private Schools — Pennsylvania's Nonpublic Elementary and Secondary Education Act Held Not Violative of the Establishment and Free Exercise Clauses of the First Amendment.


Individual plaintiffs as taxpayers, nonprofit corporate plaintiffs, and unincorporated association plaintiffs jointly brought suit against Pennsylvania Secretary of Education Kurtzman and State Treasurer Sloan, as well as several nonpublic schools within the Commonwealth, to enjoin the alleged unconstitutional expenditure of state funds under the Nonpublic Elementary and Secondary Education Act. The specific allegations of unconstitutionality were that the Act provided for the establishment of religion, prohibited the free exercise of religion, and constituted a denial of equal protection of the laws. The defendants answered the allegations by moving to dismiss the complaint for lack of standing and failure to state a claim upon which relief could be granted. A three-judge district court granted defendant's motion to dismiss the complaint for failure of all plaintiffs to state a claim upon which relief could be granted, holding that since the purpose and primary effect of the Act neither advances nor inhibits religion, the Act does not infringe upon either the establishment or free-

1. Pa. Stat. tit. 24, §§ 5601-09 (Supp. 1969). The Act provides for the creation of a fund to finance the purchase of secular educational services from nonpublic schools which fulfill the compulsory school attendance requirements under Pennsylvania law including those schools administered by religious sects. The Superintendent of Public Instruction is to purchase these services of the nonpublic schools at the actual cost of teacher salaries, textbooks and instructional materials only in the courses of mathematics, modern foreign languages, physical science, and physical education. Funds for the operation and administration of the Act are to be drawn exclusively from the taxes collected from State horse and harness racing.

2. The complaint alleged the unconstitutionality of a statute of state-wide application, and sought injunctive relief against a state official, therefore the convening of a three-judge panel to hear the case was appropriate. 28 U.S.C. §§ 2281-84.

Prior to 1968, Everson v. Board of Education 4 was the principal Supreme Court case concerning aid to nonpublic schools. In Everson the Court upheld state reimbursement of bus fares for school children regardless of the school they attended. Mr. Justice Black, writing for the majority, concluded that the New Jersey legislation 6 did "no more than provide a general program to help parents get their children, regardless of their religion, safely and expeditiously to and from accredited schools" 96 and thereby was only extending its general public benefits to all its citizens. Thus, read narrowly, the Everson opinion supported a restricted view of aid to parochial and private schools. 7

For twenty-one years after Everson the Supreme Court did not clarify the question of whether or not the rationale of Everson would be confined to non-educational aid, such as transportation and fire protection, or whether the idea of a public benefit concept could be expanded to include a more direct form of aid for educational purposes as some authorities contended. 8

One of the reasons for the absence of Supreme Court guidance regarding public aid to nonpublic schools was caused by the inability of a taxpayer to acquire standing to challenge the constitutionality of such appropriations. 9 This inability was diminished somewhat in Flast v.

3. U.S. Const. amend. I, § 1, provides that:
Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof. . . .
This ban also represents a bar on State action since it has been judicially incorporated into the fourteenth amendment. Cantwell v. Connecticut, 310 U.S. 296 (1940).
5. N.J. Rev. Stat. § 18:14-8 (1941), reads in pertinent part:
Whenever in any district there are children living remote from any schoolhouse, the board of education of the district may make rules and contracts for the transportation of such children to and from school, including the transportation of school children to and from school other than a public school.
7. See, e.g., L. Pfeffer, Church State and Freedom 149 (1967), where the author states:
[A]ll the justices agreed that the First Amendment was to be given a broad interpretation, and that its intent was not merely to prohibit the establishment of a state church but to preclude any government aid to religious groups or dogmas. The language relied on in Everson to support this view is that neither a state nor the federal government can "pass laws which aid one religion, aid all religions, or prefer one religion over another." 330 U.S. at 15.
8. See, e.g., Drinan, The Constitutionality of Public Aid to Parochial Schools, in The Wall Between Church and State 71 (D. Oaks ed. 1963), where the author concludes:
Public welfare benefits surely include secular education, and by the rulings in . . . [Cochran v. Louisiana State Bd. of Educ., 281 U.S. 370 (1930)] and Everson the benefits extended by the state to all citizens may not be denied to anyone because of his religious faith or lack of it.
9. In this context, the doctrine of standing to sue in a federal court on a constitutional issue is concerned with whether there is a justifiable controversy between the complaining taxpayer and the governmental unit being sued which would give the court subject matter jurisdiction over the parties. In Frothingham v. Mellon, 262 U.S. 447 (1923), the court ruled that a federal taxpayer is without standing to
Cohen where the Court allowed the standing of a federal taxpayer to challenge a federal spending program if he could establish the required nexus between himself and the governmental expenditures. First, the taxpayer had to establish a logical link between his status as a taxpayer and the type of legislative enactment attacked, i.e., the taxpayer had to show that he "contributed" to the funds being distributed. Second, he had to establish a nexus between his taxpayer status and the precise nature of the constitutional infringement alleged, i.e., that the expenditure was in contravention of a specific constitutional limitation.\(^\text{11}\) In Flast, both elements were satisfied since it was alleged that the taxing and spending powers of the federal government were being used in excess of the specific constitutional limitations imposed upon their exercise by the establishment clause.\(^\text{12}\)

With the standing problem alleviated to an extent, the Court was able to turn its attention to the substantive issues presented in government aid to nonpublic schools. In Board of Education v. Allen,\(^\text{13}\) the Supreme Court held that a New York statute\(^\text{14}\) providing for a loan of secular textbooks to parochial school students did not violate the establishment clause in that the law had "a secular legislative purpose and primary effect that neither advances nor inhibits religion."\(^\text{15}\) The secular purpose and primary effect test was first clarified by the Court in a decision which struck down the practice of bible reading in public schools as violative of the establishment clause of the first amendment.\(^\text{16}\) In refusing to rely principally on Everson, the Allen Court signified its intention to allow a more direct form of aid to nonpublic schools without the use of the public welfare rationale used in Everson.\(^\text{17}\) It cannot be doubted that Allen goes further than Everson in that textbooks are considered as directly involved in challenge the constitutionality of a federal statute which authorized the spending of federal funds.


11. 392 U.S. at 102. The Flast Court noted that:

the emphasis in standing problems is on whether the party invoking the federal court jurisdiction has "a personal stake in the outcome of the controversy" . . . and whether the dispute touches upon "the legal relations of parties having adverse legal interests." . . .


15. 392 U.S. at 243.


17. However, it should be noted that the Court stated in Allen that the purpose and primary effect standard would sustain the aid allowed in Everson. Board of Education v. Allen, 392 U.S. 236, 243 (1968).
in the educational process while bussing is only a safety measure incidentally affecting education.

The extent to which the purpose and primary effect standard could be used to uphold public spending in support of nonpublic education remained a disputed question after Allen and therefore the Lemon Court concentrated its attention on the issue of whether or not the Pennsylvania Act came within the permissible limitations of the secular purpose and primary effect rationale.

Before considering the substantive issues, however, the Lemon Court had to determine whether the plaintiffs had standing to bring suit. The court gave summary treatment to the standing of the organizational plaintiffs, concluding that these plaintiffs, although possessing good motives, had "no personal stake or adverse interests which would demonstrate their standing as affected parties." The court next looked to whether or not Plaintiff Lemon fulfilled the required two nexuses established in Flast. Because Lemon alleged payment of an entrance fee into a Pennsylvania race track, the court found he established his status as a taxpayer whose money was being used by the legislature in funding its educational enactment, thus fulfilling the nexus between his taxpayer status and the type of legislation enacted. Lemon further alleged that the Act was in violation of the establishment clause, which is a specific limitation on the taxing and spending powers of the state legislature, thus establishing the second nexus.

The court turned its attention to the remaining two individual plaintiffs to determine whether they had established a sufficient interest to acquire standing on either establishment or free exercise grounds. Since these plaintiffs had failed to allege payment of any monies to a race track, the court concluded they lacked standing as affected taxpayers seeking redress for violation of the establishment clause. However, the court recognized as sufficient to establish their standing on free exercise grounds, regardless of the requirements of Flast, the plaintiffs' contention that


19. See note 11 supra and accompanying text. The court reasoned that since the first amendment applies to both Federal and State governmental powers, the exercise of State taxing and spending powers is also limited, and as such the requirements of standing as enunciated in Flast should apply. Lemon v. Kurtzman, ..... F. Supp. at ..... 20. Judge Hastie, dissenting, disagreed with this holding, explaining that "the plaintiffs should have an established monetary interest in the relief sought ..." and since "they do not contribute revenues disbursed under the Act ..." he concluded they "do not have standing to challenge ... under either of the religious clauses...." ..... F. Supp. at ..... This conclusion, however, is subject to criticism in that, "[t]here has never been any doubt about the clear right of a plaintiff to sue in a state or federal court if he can demonstrate that his free exercise of religion ... has been infringed." Drinan, Standing to Sue in Establishment Cases, in Religion and the Public Order 172-73 (D. Giannella ed. 1965). Strictly speaking, the complaint does fail to allege how the plaintiffs' free exercise of religion was infringed upon and perhaps, for this reason, standing could have been denied. But the lack of proper phrasing in an allegation appears to be little justification for declining to at least hear an argument based on such
they had not paid a race track fee because to do so would require them to pay a tax for the support of religion in violation of their rights of conscience, which is protected by the free exercise clause.

After having resolved the standing issue,\textsuperscript{21} the court considered the merits of the establishment and free exercise contentions of the plaintiffs. Viewing \textit{Allen} as the pertinent precedent, the court analyzed the Pennsylvania legislation to see whether it met the strictures of the purpose and primary effect test. The court refused to make an independent finding as to the purpose of Act,\textsuperscript{22} and accepted as controlling the purpose stated by the legislators which was the promotion of the secular education of children attending nonpublic schools within the state.\textsuperscript{23} The majority conceded that one of the effects of the Act is to confer incidental benefits to nonpublic schools, but because the Act restricts aid to strictly secular subjects,\textsuperscript{24} the court reasoned that neither the purpose nor the primary effect of the statute advanced or inhibited religion.

The plaintiff's second main contention — that the Act violates the free exercise clause by compulsory taxation for the support of religion — was summarily dismissed by the court. Reasoning from its previous conclusion that the Act does not support religion, the court explained that the plaintiffs would therefore not be supporting any religious institution by attending a Pennsylvania race track. The plaintiffs also alleged that the Act forces them against their religious conscience into contributing to the support of sectarian schools. The court again dismissed the plain-

\textsuperscript{21} The court rejected the standing of all plaintiffs under the equal protection clause noting the lack of any claim to the effect that the plaintiffs' children were denied admission to any of the defendant schools because of race or religion. \textit{Allen v. Board of Education of City of Philadelphia, 373 U.S. 65 (1963).}

\textsuperscript{22} The plaintiffs' contended that "[t]he doctrine of separation of powers requires the judiciary, following prescribed rules of statutory interpretation, to make its own determination of legislative purpose." Brief for Plaintiff at 40, \textit{Lemon v. Kurtzman, 311 U.S. 637 (1940).}

\textsuperscript{23} The court made specific note of the legislative policy underlying the Act. In its legislative findings and declaration of policy the Pennsylvania Legislature has determined that a crisis exists in elementary and secondary education in Pennsylvania due to rapid increases in costs and school population and consequent demands for more teachers and facilities. It was also found that twenty per cent of all elementary and secondary school children in Pennsylvania fulfill the requirements of the Commonwealth's compulsory school attendance laws in nonpublic schools. It has been further recognized that elementary and secondary education constitutes a public welfare purpose and that nonpublic education, by providing instruction in secular subjects, contributes significantly to the achievement of this public purpose. The Legislature, therefore, concluded that it is a governmental duty to support the achievement of this public welfare purpose by supporting the purely secular objectives of nonpublic education. \textit{Lemon v. Kurtzman, 311 U.S. 637 (1940), citing \textit{Pa. Stat. tit. 24, \textsection 5002 (Supp. 1969).}}

\textsuperscript{24} The court stated that "the statute is not only limited to secular subjects but to a limited number of \textit{specific} secular subjects peculiarly unconnected with and unrelated to the teaching of religious doctrines." \textit{Allen v. Board of Education of City of Philadelphia, 373 U.S. 65 (1963).} The legislature, it seems, also took pains to dispel the inference that the act would aid religion directly in defining secular subject to "mean any course which is presented in the curricula of the public schools of the Commonwealth and shall not include any subject matter expressing religious teaching, or the morals or forms of worship of any sect." \textit{Pa. Stat. tit. 24, \textsection 5003(3) (Supp. 1969).}
tiffs' allegation with little discussion, noting the plaintiffs' failure to allege what their "religious beliefs are nor how the . . . Act . . . coerces them in the practice of their religion." Consequently, the court concluded that defendant's motion to dismiss for failure to state a claim under both the establishment and free exercise clauses of the first amendment must be granted.

In reaching its decision the Lemon court followed the Allen precedent in rejecting the polar positions which have been posited by some authorities who have attempted to clarify the meaning of the first amendment religious clauses. One extreme position would deny all aid to nonpublic schools on the theory that the establishment clause must be strictly construed as forbidding aid, either directly or indirectly, to religion. In allowing the expenditure under the Act it is evident that the Lemon court does not take this position. This rejection is a recognition of the hardship such a stand would place on nonpublic schools; in fact, the no-aid position would actually penalize an educational institution because it followed a particular religious belief.

The other extreme contends that the first amendment requires aid to nonpublic schools. The proponents of this position argue that in order to be neutral, the state must give equally to public and nonpublic schools. The use of the secular purpose and primary effect standard is a step in this direction, but it is far from an adoption of this position. A com-

25. ___ F. Supp. at ___. The Lemon court relied on the Allen decision in reaching this conclusion. In Allen, the Supreme Court similarly dismissed the free exercise claim by stating that the "appellants have not contended that the . . . law in any way coerces them as individuals in the practice of their religion." Board of Education v. Allen, 322 U.S. 236, 249 (1968).

26. In attempting to draw its own conclusions on the meaning of the religious clauses, it should be noted that the Lemon court, as did the Allen Court, appears to advocate a unitary standard under both clauses. Thus, the purpose and primary effect rule is used to determine the permissibility of aid not only under the establishment clause, but also under the free exercise clause. See Valente, Aid To Church Related Education — New Directions Without Dogma, 55 VA. L. REV. 579, 585-87 (1969). See generally L. PFEFFER, supra note 7, at 138-59.

27. The clearest expression of this view can be found in L. PFEFFER, supra note 7, at 533, wherein the author reviewed the Everson decision as well as McCollum v. Board of Education, 333 U.S. 203 (1948) (which held that the use of public school facilities for religious teaching violated the first amendment) and Zorach v. Clauson, 345 U.S. 306 (1952) (where the Court permitted a program in which public schools released students early in order to receive religious instruction at religious centers). While reviewing these decisions Mr. Pfeffer concludes that "under the Everson, McCollum, and Zorach cases it is clear that the First Amendment bars the appropriation of government funds to sectarian schools." See also Everson v. Board of Education, 330 U.S. 1, 31-32 (1947) (Rutledge, J., dissenting).


29. Even before Allen, at least one authority viewed the Supreme Court's use of the secular purpose and primary effect test as a move in the direction of the so-called strict neutrality theory. Professor Donald A. Giannella has stated: "[a] shift from an absolute no-aid theory of nonestablishment to one of strict neutrality [was signaled by the occurrence of] . . . [T]he Supreme Court's recent adoption of the secular 'purpose and effect' test [in Schempp]." Giannella, Religious Liberty, Nonestablish-
complete agreement with the strict neutrality rule would have the same amount of financial support appropriated to nonpublic and public schools alike — something neither the Act nor the court's language advocates. It is suggested that adoption of this extreme position would create an impermissible constitutional result because it calls for the funding of religious teaching which the first amendment sought to prohibit.80

Assuming, therefore, that some aid to nonpublic schools is permissible, the constitutional discussion must focus on the proper limits to that aid. One theory widely regarded as expressing the limit of constitutional aid to nonpublic schools is the child-benefit doctrine.81 Under this theory, aid in support of education to nonpublic schools will be permissible if the student is the direct recipient of the aid, rather than giving the support directly to the schools. The schools are seen as only incidentally benefitting by the support to the students. This theory received its greatest impetus from a narrow reading of the Allen decision.82 However, it is doubtful that Allen should be so confined. One commentator has suggested a broader reading of Allen when he noted that “[t]he Court's extensive attention to identifying the secular education function of such schools suggests that the function aided, rather than the channel of such aid, is the critical constitutional factor.”83

This approach represents the position the Lemon majority adopted in rejecting the child-benefit approach,84 when it explained that: “[T]he constitutional result should not and cannot wholly depend upon the identity of the payee. The use to which the funds are put must be the primary

ment, and Doctrinal Development, Part II: The Nonestablishment Principle, 81 Harv. L. Rev. 513, 515 (1968). Professor Giannella further observed:

[H]owever, application of the secular “purpose and effect” test in the straightforward manner called for by the rule of strict neutrality would not properly serve the purposes underlying the Establishment Clause.

Id.


32. See Freund, Public Aid to Parochial Schools, 82 Harv. L. Rev. 1680, 1681 (1969), where the author states:

[The [Allen] opinion is a narrow one... in its stress on the formal aspects of the arrangements, namely, that the books were loaned, with title remaining in the state, and that the requests were made by and on behalf of the students, not the school.]

33. Valente, supra note 26, at 593. See also The Supreme Court, 1967 Term, 82 Harv. L. Rev. 63, 176 (1968), where the commentator, after reviewing the Allen decision, reasoned that:

[b]ecause of the illogic of differentiating aid to the child from aid to the institution, the Court may decide to abandon the distinction and rely instead only on the more general requirement that the aided functions be purely secular.

34. The dissent, on the other hand, considered Everson and Allen as merely standing for the proposition that a state may provide “public services directly to its people” and thereby “incidentally aid religious institutions” but, “that these cases do not suggest that the Constitution permits direct public financing of a religious enterprise.” — F. Supp., at —. Judge Hastie's use of the words “direct” and “incidentally” is in keeping with the child-benefit concept.
This position appears sound in that even supporters of the child-benefit theory agree that the sectarian schools receive an indirect benefit from the aid to the children. The court's realistic approach takes the issue out of a semantical dispute and allows the court to focus on the real question — whether or not the purpose and primary effect is to aid the secular aspect of a school's teaching.

The use of this latter test, however, does not resolve two additional problems that have been raised regarding aid to parochial schools. The first involves what has been popularly termed the permeation theory by opponents of aid to sectarian schools. Essentially, the theory is that a parochial school's education is so "permeated" with its own sectarian teachings and ideals that it cannot be separated from its secular educational function. Consequently, the dissent reasoned that the state cannot support the teaching of any subject in a sectarian school without supporting religion. In rejecting this thesis the majority was in agreement with the Supreme Court in Allen, when it explained that nonpublic schools have two goals — one religious and one secular — and that the state may provide aid to further the secular function without violating the establishment prohibition of the first amendment.

Certainly the permeation doctrine permits persuasive argument to those wishing to prohibit support for parochial schools. However, before one accepts the argument, the adherents of this position should come forth with more concrete evidence than mere verbal pronouncements on permeation. Without this added evidence, the court's rejection of the position is valid. Nevertheless, the permeation theory can not be ignored as a possible basis for denying aid to parochial schools if adequate facts can be produced substantiating the position.

The second difficulty posed by those opposing aid to parochial schools — that the granting of aid to these schools will lead to "the evils

35. _____ F. Supp. at _____ (emphasis added).
36. The dissent prefers the word "inculcate" to "permeate," but essentially agrees with the permeation theory in stating:

Through a total educational program offered in a separate religious environment, sectarian schools serve to inculcate and reinforce in children doctrine and moral precepts derived from the tenants of the church.

_____ F. Supp. at _____ (emphasis added).

37. Judge Hastie is not alone in this line of reasoning. See L. Preiser, supra note 7, at 511, where the author concludes: "Everything taught in the Catholic school is to be taught with the ultimate goal of education in mind — everything must be impregnated with God and religion." It appears that those accepting the permeation principle, including Judge Hastie, would advocate a return to the Everson rationale. See also 392 U.S. 236 (1968) (Douglas, J., dissenting).

38. The Lemon court, in relying on the Allen decision, stated:

[We] concur with the Supreme Court's statement in Allen, . . . that "we cannot agree . . . either that all teaching in a sectarian school is religious or that the processes of secular and religious training are . . . intertwined". . . .

_____ F. Supp. at _____

39. The majority also noted that the Act is further strengthened against an establishment clause attack by pointing out that the statute provides aid to all nonpublic schools, whether they teach a religious doctrine or not. _____ F. Supp. at _____.

40. The Court, in Allen, also failed to accept the permeation doctrine on its face, stressing that the plaintiffs had failed to come forward with any facts to disprove the legislative acceptance of secular educational programs in church related schools as complying with compulsory education laws. 392 U.S. at 247-48.
that attend a widespread and pervasive intermingling of politics and religion" — also poses a formidable obstacle to those advocating greater aid to sectarian schools. It is submitted, however, that the mere existence of this problem should not result in the end to all forms of aid to parochial schools. Realistically speaking, any amount of support to parochial schools will necessarily involve them politically. The extent of political involvement could possibly lead to some parochial schools emphasizing their secular objectives in an attempt to receive more aid and in the process neglect their sectarian teachings. Nevertheless, aid could still be given if the legislators make an honest attempt to limit such aid to the clear secular objectives of sectarian institutions, so that the purpose and primary effect is to aid the public directly and not religion. In this way, although political intermingling is not avoided entirely, the recognition of it as one factor in determining purpose and primary effect allows the legislators and courts to limit the adverse results of political intermingling.

Similarly, the consequences of religious and political intermingling should not be underestimated and the awareness of these consequences should lead to the avoidance of unconditional grants to parochial schools.

In the final analysis, the ultimate issue to be resolved is where the line should be drawn between what is primarily secular and what is primarily religious. In drawing that line one is immediately faced with a lack of consensus on any one approach or theory to resolve the

42. This consequence was recently noted by Professor Dallin Oaks when he expressed the fear "that the desire to qualify for government aid may lead some parochial schools to de-emphasize or debase their religious mission by secularizing some aspects of their teaching." _American Bar Association, Section of Individual Rights and Responsibilities_ No. 11, 12 (Monograph No. 2, August 1968).
43. It should be evident at this time that it is difficult to separate the permeation theory from the political involvement problem. Consequently if one espouses to the permeation doctrine he would not agree that aid could be limited to secular objectives. However, the evils of political intermingling can result even if one does not accept permeation. Thus, care should be taken to limit aid to secular subjects.
44. See note 42 supra, where the commentator notes some of these consequences.
45. Professor Paul Freund apparently misconstrued the Pennsylvania Act when he concluded that it calls for unconditional grants to the nonpublic schools. He also mistakenly described the Act as "appropriating a fixed annual amount to be derived so far as possible from the public proceeds of horseracing . . . [and that] the funds could presumably be used for . . . buildings . . . in the discretion of the schools." Freund, supra note 32, at 1681-82. But see Brief for Defendant at 14, Lemon v. Kurtzman, _ F. Supp. _ (E.D. Pa. 1969), where counsel correctly indicates that the Act "provides for no fixed annual amount, [and] the source of the funds consists solely of proceeds from harness and horse racing" (emphasis added). Nor does the Act provide for funds to construct or maintain buildings. PA. STAT. tit. 24, § 5604 (Supp. 1969).
46. Consider, for example, the observation made by Professor Oaks. Everyone who has made an objective examination of the practices and precedents before attempting to state an argument for or against the constitutionality of indirect aid to parochial schools has experienced the inconvenience of apparently contradictory authority.
47. See L. PFEFFER, supra note 7, at 521-26, listing the various arguments for and against state aid to nonpublic schools.
48. See Giannella, supra note 29, at 516-22, representing the various principles which can be advanced as underlying the establishment clause.
issue. Whatever line of reasoning one adopts, it cannot be seriously doubted that nonpublic schools serve a public purpose. It is submitted that the extent to which this public service is distinct from its religious ends can be better determined by the legislature, which is better equipped to recognize the extent of the benefit to the public through its committee system, and other fact finding facilities. It is suggested, therefore, that courts give greater weight to legislative findings not only in determining the purpose of particular legislation but also in its determination of primary effect.

Joseph T. Sebastianelli

CORPORATIONS — PUNITIVE DAMAGES NOT AVAILABLE IN ACTION UNDER SECTION 17(a) OF THE SECURITIES ACT OF 1933 — UNDERWRITERS INDEMNIFICATION AGREEMENT INVALID.

Globus v. Law Research Service, Inc. (2d Cir. 1969)

Law Research Service, Inc. (LRS) prepared and distributed an offering circular signed by its underwriter, Blair & Co., Granbery Marache, Inc. (Blair) in connection with a public offering under Regulation A of the Securities and Exchange Commission. The circular prominently mentioned an attractive “Sperry-Rand Contract” while failing to mention that

49. The majority in the instant decision took note of this service when it concluded:
The increasing national concern for education in our society, coupled with the public awareness that private schools are performing a significant public service in educating great numbers of school-age children, necessarily makes the State interested in private education.

F. Supp. at See also Jones, supra note 30, at 193. It is equally manifest that public school expenditures would have to be higher than they are, if financial difficulties compelled an abandonment of the parochial school system or a severe cutback in the number of students now being educated in the parochial schools and their Protestant and Jewish equivalents.

50. But see Freund, supra note 32, at 1692, where, without denying that the legislature can better determine the needs of the public, Professor Freund concludes that: Although great issues of constitutional law are never settled until they are settled right, still as between open-ended, ongoing political warfare and such binding quality as judicial decisions possess, I would choose the latter in the field of God and Caesar and the public treasury.

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Sperry Rand Corp. had terminated some of its services in a dispute over the contract and that LRS had filed suit against Sperry Rand Corp. 2

Morton Globus and twelve other purchasers of the LRS stock filed suit in the Southern District of New York charging LRS, its president Ellias C. Hoppenfeld and Blair with having violated section 17(a) of the Securities Act of 1933, 8 section 10(b) of the Securities Exchange Act of 1934, 4 and with having committed common law fraud 6 in the publication of the misleading circular. 6 Blair brought cross-claims against LRS based on an indemnity agreement in the underwriting contract. 7 Plaintiffs asked for compensatory damages and punitive damages against all defendants. The jury found for the defendants on the charge of common law fraud but awarded compensatory damages against all defendants for violations of the federal securities acts and punitive damages against Hoppenfeld and Blair for violations of section 17(a). On all the indemnity cross-claims the jury found for Blair. LRS and its officers then moved successfully to set aside the verdicts on the cross-claims for indemnity, but Blair and Hoppenfeld were unsuccessful in their motion to set aside the award

2. LRS had entered into a contract on June 5, 1963, with Sperry Rand Corp. to provide LRS with vital computer services. On January 29, 1965, with four days notice, Sperry Rand Corp. terminated the contract and refused to perform certain of these vital services for failure by LRS to pay $28,000 in debts accumulated over the previous year. On the same day LRS instituted a suit against Sperry Rand Corp. based on breach of contract and fraud. Globus v. Law Research Service, Inc., 418 F.2d 1276, 1280-82 (2d Cir. 1969).

3. 15 U.S.C. § 77(q) (2) (1964), provides: It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any devise, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

4. 15 U.S.C. § 78(j) (1964), reads in part: It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentalities of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.


6. The offering circular became effective March 15, 1965, and mentioned only that LRS was indebted to Sperry Rand Corp. and hoped that payment of the indebtedness could be deferred. The stock was completely sold within a few days while the dispute was not settled until April 21, 1965. Blair was also charged with violations of § 12(b) of the 1933 Act, 15 U.S.C. § 77(1) (1964), and § 15(c) of the 1934 Act, 15 U.S.C. § 78(o) (1964). Globus v. Law Research Service, Inc., 418 F.2d 1276, 1281-82 (2d Cir. 1969).

7. Cross-claims were also brought by Blair against Hoppenfeld and a third-party defendant, Paul Wiener, Secretary-Treasurer of LRS, based on the tortious conduct of those officers. The court determined that this question raised the same issues and necessitated the same reasoning as used in the LRS cross-claim on the indemnity agreement. 418 F.2d 1276, 1279 (2d Cir. 1969).
of punitive damages. The Court of Appeals for the Second Circuit affirmed the decision as to the cross-claims for indemnification but reversed as to the award of punitive damages under section 17(a), holding that punitive damages are not desirable for the effective enforcement of the 1933 Act and therefore section 17(a) does not support such an award. Globus v. Law Research Service, Inc., 418 F.2d 1276 (2d Cir. 1969).

Created to provide greater protection for the investing public, the Securities Act of 1933 and the Securities Exchange Act of 1934, generally, and section 17(a) of the former and 10(b) of the latter, more specifically, prohibit the use of misleading information, whether through devise or omission, in the issuance or sale of securities. The provisions in section 17(a), however, apply only to misrepresentations by an issuer or seller, while the provisions of section 10(b), through its accompanying Rule 10b-5 apply to misrepresentations by both purchasers and sellers. In addition, section 17(a) deals with schemes to defraud, material omissions of fact, and fraud or deceit, while section 10(b) is so broad as to cover any "manipulative or deceptive device or contrivance." Therefore, section 10(b) usually provides a broader base upon which to ground an action.

Unlike some other sections of the federal securities acts of 1933 and 1934, neither section 17(a) nor section 10(b) nor Rule 10b-5 expressly provide a private right of action for violations of their respective provisions. The courts, nevertheless, have constantly implied the existence of civil liability under these sections.

Throughout, its patent concern was primarily with the flow of securities from the issuer through underwriters to the public rather than with the subsequent buying and selling of these securities by the public.
11. One of the major concerns of the Securities Exchange Act of 1934 was the regulation of post-issuance trading. 1 L. Loss, supra note 9, at 130.
12. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1969), extends the coverage of section 10(b) to fraud by purchasers.
15. Implied liability under section 10(b) has been upheld in seven circuits: Boone v. Baugh, 308 F.2d 711 (8th Cir. 1962); Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962); Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527 (10th Cir. 1962); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961); Errion v. Connell, 236 F.2d 447 (9th Cir. 1956); Speed v. Transamerica Corp., 235 F.2d 369 (3rd Cir. 1956); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951). See also Ruder, Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?, 57 Nw. U.L. Rev. 627, 687-90 (1963). As concerns implied liability under section 17(a), most often, courts have either stated that it was unnecessary to determine whether an action was maintainable under § 17(a) when one was maintainable under
The creation of an implied remedy under section 10(b) has raised the question of whether such an action would be subject to the limitation of section 28(a) of the Securities Exchange Act which prohibits a recovery greater than actual damages in an action under that Act16 thereby prohibiting punitive damages. Even though several courts have held that section 28(a) only applies to expressed statutory actions and does not prohibit punitive damages in an implied action under section 10(b),17 the Second Circuit has previously held that punitive damages may not be awarded in a civil action under section 10(b).18 The instant case is significant, therefore, in that it explores the possibility of awarding punitive damages where warranted19 solely on the basis of the implied civil action under section 17(a).20

The conflicting conclusions reached by the appellate and district courts result mainly from conflicting assessments of the “desirability” of punitive damages under section 17(a). Where remedies are not expressly provided

section 10(b), Dauphin Corp. v. Redwall Corp., 201 F. Supp. 466, 469 (D. Del. 1962), or they have taken for granted that an action is maintainable under section 17(a) since section 10(b) is also involved. See 6 L. Loss, Securities Regulation 3913-14 (Supp. 1969). In the Second Circuit, however, where section 17(a) may apply where section 10(b) is explicitly restricted by § 28(a), an action under § 17(a) has been expressly recognized. Katz v. Amos Treat & Co., 411 F.2d 1046 (2d Cir. 1969); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968), (dictum), cert. denied, 394 U.S. 976 (1969); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Dack v. Shanman, 227 F. Supp. 26 (S.D.N.Y. 1964); Pfeffer v. Cressaty, 223 F. Supp. 756 (S.D.N.Y. 1963). But cf. 6 L. Loss, Securities Regulation 3911-12 (Supp. 1969).

(a) The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.
17. In de Haas v. Empire Petroleum Co., —— F. Supp. ——, —— (D. Colo. 1969), the court in holding that a private action for damages resting on tort principles is not limited by section 28(a), stated:

In light of the nature of a private action for damages under 10b-5, and in view of the fact that Congress did not contemplate this implied remedy based on federal common law, we conclude that it is reasonable to rule that punitive damages are allowable in a case such as the instant one.


19. This discussion assumes that in any instance under section 17(a) in which an award of punitive damages is considered, the correct standard for determining conduct meritng such an award is used. The court here used the state standard. Walker v. Sheldon, 10 N.Y.2d 401, 179 N.E.2d 497, 223 N.Y.S.2d 488 (1961). There is controversy over whether such a standard should be a federal one. At least one commentator believes that to use state standards would have the disadvantage of fragmenting an area of federal securities regulation. Note, 82 Harv. L. Rev. 951, 956 (1969). Another contends that use of state standards would bring the question of damage awards for securities violations closer to the community attitudes of the localities involved. 44 N.Y.U.L. Rev. 226, 234 (1969). See also Basista v. Weir, 340 F.2d 74, 86 n.11, 87 (3d Cir. 1965).

20. But see Nagel v. Prescott & Co., 36 F.R.D. 445 (N.D. Ohio 1964) (denying motion to strike interrogatories on ground that punitive damages are available under

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by the statute in question, as they are not in an implied statutory action, the court must find the remedy both permissible under the statute and necessary to the overall regulatory scheme in terms of furthering the legislative policy of the statute.\textsuperscript{21} The appellate court’s reversal of the district court was not based on a finding that the remedy was impermissible under federal statutes.\textsuperscript{22} Although the court recited numerous possible grounds for finding punitive damages statutorily excluded,\textsuperscript{23} it decided that it was unnecessary to answer these inquiries in that it found punitive damages to be unnecessary in the overall regulatory scheme.\textsuperscript{24}

The question of necessity was posed by the lower court as an assessment of whether punitive damages were in “accord with the overall purpose” of the Act and would serve a “desirable function.”\textsuperscript{25} This decision was based solely on an analysis of the ability of punitive damages to serve as a deterrent. The important question of whether existing remedies could also serve this function was not raised by that court.\textsuperscript{26} The appellate court, however, expressly attempted to analyze whether or not punitive damages are “necessary for the effective enforcement of the Act.”\textsuperscript{27}

Both courts found that any implied civil action under section 17(a) would presumably have as its purpose the deterrence of improper performance in the issuance of securities.\textsuperscript{28} The appellate court, however, determined the overall deterrent effect of punitive damages under section 17(a) by weighing the need for the additional deterrent of punitive damages\textsuperscript{29} as against the already existing “arsenal of weapons” for deterrence and retribution.\textsuperscript{30} While the deterrent and retributive ability of

\begin{itemize}
\item \textsuperscript{23} See p. 493 infra.
\item \textsuperscript{26} The language of J.I. Case Co. v. Borak, 377 U.S. 426 (1964), would infer that any implied remedy must be needed in order to effectuate the statutory purpose and not that it merely be an alternative remedy. But cf. Bell v. Hood, 327 U.S. 678, 684 (1946), supporting the use of any available remedy in an implied action for violation of rights protected by the fourth and fifth amendments.
\item \textsuperscript{27} Globus v. Law Research Service, Inc., 418 F.2d 1276, 1284 (2d Cir. 1969).
\item \textsuperscript{28} See Landis, supra note 10, at 35, where the author states:
- We were particularly anxious through the imposition of adequate civil liabilities to assure the performance by corporate directors and officers of their fiduciary obligations. . . .
- 30. This arsenal consists of criminal sanctions under the Act, 15 U.S.C. § 77(x) (1964); suspension or expulsion by the SEC; recovery of actual damages in implied civil actions under section 17(a); class actions under Fed. R. Civ. P. 23; the desire
\end{itemize}
some of the weapons in the “arsenal” is questionable.\(^{31}\) the court’s calculus does provide us with the additional deterrent. The positive effect of punitive damages was then weighed against its potential harmful effects.

The harmful effects are twofold. First, courts have been unable to control the size of punitive damage awards,\(^{32}\) a problem which is amplified in a section 17(a) violation where there are a potentially large number of plaintiffs and individual suits which could arise from a single violation.\(^{33}\)

This could result in both bankrupting “an otherwise honest underwriter or issuer who egregiously erred in one instance which affected many [purchasers]”\(^{34}\) and depleting the amount of funds available to injured plaintiffs so that recovery would be limited to a first come first serve basis. Second, the court desired to avoid an unnecessary inconsistency between the two securities acts. Section 17(a) only provides protection to purchasers of original issues who are damaged by fraud.\(^{35}\) Defrauded sellers would have to obtain relief under section 10(b).\(^{36}\) For this reason courts have attempted to create a uniform remedy for defrauded parties by keeping sections 10(b) and 17(a) consistent.\(^ {37}\) To permit punitive damages under section 17(a) when section 10(b) has been found not to support such an award would create an inconsistency between the remedies of the parties to retain a good name — the psychological deterrent. Globus v. Law Research Service, Inc., 418 F.2d 1276, 1285 (2d Cir. 1969).

31. See Comment, Remedies for Private Parties Under Rule 10b-5, 10 B.C. IND. & COM. L. REV. 337 (1969). For example, the use of class actions has still to reach full use as a part of the arsenal. See Eisen v. Carlisle & Joquelin, 391 F.2d 555 (2d Cir. 1968); Richland v. Cheatham, 272 F. Supp. 148 (S.D.N.Y. 1967). In this regard, there exists the question of whether different measurements of damages resulting from different post-issuance holding periods by plaintiffs would destroy the common issue of the class action. See Comment, Measurement of Damages in Private Actions Under Rule 10b-5, 1968 WASH. L.Q. 165.


33. The court in Roginsky v. Richardson-Merrell, Inc., 378 F.2d 832, 839 (2d Cir. 1967), concerned itself with the problem that there is “no principal whereby the first punitive award exhausts all claims for punitive damages and would thus preclude future judgments.” See Morris, Punitive Damages in Tort Cases, 44 HARV. L. REV. 1173, 1194-95 (1931).


35. Section 17(a) is expressly limited to fraud in the “offer or sale” of securities. See note 3 supra.


37. Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961). For a good discussion of this issue, see 3 L. Loss, SECURITIES REGULATION 1424 (2d ed. 1961) ; Comment, Punitive Damages Under Section 17(a) of the Securities Act: A Myopic View of Congressional Intent, 15 WAYNE L. REV. 792, 803-11 (1969). But see Green v. Wolf Corp., 406 F.2d 291, 303 (2d Cir. 1968), cert. denied, 395 U.S. 977 (1969), where the presiding appellate court judge in the instant case analyzed the need for consistent interpretation of the two acts:

It is true that punitive damages are permitted under the Securities Act of 1933, but that Act does not contain language similar to § 28(a) of the 1934 Act. Congress might well have intended to impose different liabilities under each of the two Acts since at the time of its enactment the requirements of the 1934 Act could have been avoided if corporations simply refused to register on the exchanges. The provisions of the 1933 Act were less easily evaded. Hence lighter penalties under the 1934 Act would have been an inducement for corporations to comply with its terms and not “go on strike.” Globus v. Law Research Service, 287 F. Supp. 188 (S.D.N.Y. 1968).
available to defrauded purchasers and those available to defrauded sellers. In light of their marginal deterrent effect and their potential harmful effects, the court concluded that punitive damages are not “desirable” for the effective enforcement of the Securities Act.

A finding of the necessity for allowing punitive damages would imply that the existing deterrents are not sufficient to fulfill the purpose of the Act.\(^{38}\) Only if additional deterrents are needed would a discussion of whether punitive damages are desirable under section 17(a) be relevant. The court points out that the existing remedies “serve to perform the functions of retribution and deterrence.”\(^{39}\) Such a finding would in itself have been sufficient to support a holding that punitive damages are not available under section 17(a).\(^{40}\) In that the court does infer that the existing remedies are sufficient, the decision to discuss the desirability of punitive damages indicates that the appellate court did not limit its decision to the measurement of necessity for a particular remedy but instead applied its own method for measuring desirability instead of that used by the lower court.

The method for measuring desirability as applied in the instant decision is based on questionable foundations as to the harmful effects of punitive damages. In regard to the fear of overkill in the instance of one egregious error by an otherwise honest issuer or underwriter, the standard for conduct permitting punitive damages as applied in the instant case is “moral turpitude or dishonesty and a wanton indifference to one’s obligations.”\(^{41}\) While there has been debate as to whether \textit{scienter} is necessary to the maintenance of a fraud action under the securities acts\(^{42}\) and the trend is clearly away from enforcing a requirement equal to intent to defraud,\(^{43}\) there has not been such debate over lessening the standard for punitive damages.\(^{44}\) Therefore, as long as punitive damages are available only in those instances of fraud where the defendant evinces “moral turpitude or dishonesty and a wanton indifference to his obligations,”\(^{45}\) it will never be a question of egregious error.

The only underwriters or issuers threatened with bankruptcy through the recovery of punitive damages would be those who have displayed the requisite wanton or reckless conduct so as to permit the recovery of

\(^{38}\) See Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 445 (N.D. Cal. 1968), where punitive damages were not permitted because available remedies were adequate.

\(^{39}\) 418 F.2d 1276, at 1285.


\(^{43}\) Heit v. Weitzen, 402 F.2d 909, 914 (2d Cir. 1968). See Note, supra note 42, at 1109 n.19.

\(^{44}\) See note 19 supra, suggesting that a debate exists only as to whether the standard should be state or federal.

\(^{45}\) 418 F.2d 1276, at 1283.
punitive damages against them. The elimination of existing parties who have displayed such disregard for the investing public and the deterrence of such conduct by others in the future would be a positive result of the awarding of punitive damages in keeping with the purposes of the securities acts. Therefore, this threat of bankruptcy raised by the court should have been used to measure the effectiveness of punitive damages and not as a negative effect of such an award.

The desire to avoid inconsistency between the remedies provided by section 17(a) and those provided by section 10(b) is a valid point of concern for the court. However, it should be noted that the Second Circuit is the only one so far to prohibit punitive damages under section 10(b), relying on section 28(a) of the 1934 Act. It would be inconsistent to hold that section 17(a) does not support punitive damages in those jurisdictions which hold that section 28(a) is not applicable to implied causes of action thereby permitting punitive damages under section 10(b). The tenability of the court's assessment as to desirability may rest upon the resolution of the conflicting interpretations of section 28(a) of the 1934 Act. Without these harmful effects, and query as to whether both are necessary to the instant decision, the court concedes that there is a marginal deterrent effect gained by adding punitive damages to the existing remedies, and thus would apparently concede that punitive damages are desirable. The court would then have to base its exclusion of punitive damages on the lack of statutory permissibility or on the lack of necessity for allowing such an award as it originally announced that it intended to do, but on which it failed to follow through.

The inference given by the court's opinion is that punitive damages are not statutorily impermissible. Five possible theories for exclusion of punitive damages are discussed by the court: 1) the non-existence of a civil action under section 17(a); 2) the impermissibility of punitive damages without express Congressional intent; 3) the propriety of importing the aspects of common law fraud into the statutory action; 4) the original intention of Congress to have section 17(a) serve as a basis for only criminal or injunctive actions; and 5) the express restriction against other than compensatory damages in those sections of the 1933 Act which expressly provide for civil liability. The first of these is denied by the court as a practical point in light of the great weight of authority on the side of implying a civil action. The next two theories are discarded as

46. See Landis, supra note 10, at 30-35.
47. See note 18 supra. See also Reynolds v. Texas Gulf Sulphur Co., ______ F. Supp. ______ (D. Utah 1969), where punitive damages were disallowed by the district court in the Tenth Circuit under section 10(b) relying on section 28(a).
48. See note 17 supra.
50. See note 15 supra.
“conflicting generalities.” Only in the final two points could there be a basis for excluding punitive damages. However, it is recognized that the action under section 17(a) is more difficult to prove than those under the express liability provisions. For this reason a court would not have to be bound by the restraints in these sections, and the court admits that neither theory provides a firm basis for decision.

The future applicability of the instant decision as a prohibition against punitive damages under section 17(a) would have been strengthened if the decision had rested on the lack of necessity for punitive damages, since punitive damages could be prohibited under both sections 17(a) and 10(b) on that basis. As the decision stands, however, its applicability would seem to rest on the resolution of the conflict as to the permissibility of punitive damages under section 10(b). A reversal of the Second Circuit’s opinion on section 10(b) would leave this decision open to direct attack. However, if the Second Circuit is upheld on section 10(b) this decision will probably stand as a possible interpretation of the criterion for measuring necessity in the overall regulatory scheme.

The second issue before the court was that of indemnification of underwriters. The Securities Act of 1933 generally prohibits most forms of indemnifications — attempts to avoid, through contract, the burden of liability by parties to the issuance of securities. For example, under section 14 of the 1933 Act any issuer or underwriter is prohibited from contracting for indemnification with a purchaser of the securities. Rule 460 of the Securities and Exchange Commission further stated that indemnification agreements between the issuer and a director or officer of the issuer would be void as contrary to the purpose of the Act. There is, however, no expressed sanction against an indemnification agreement between underwriters and the issuers — a practice of widespread use.

In Globus, the underwriter, Blair, had such an indemnity contract with LRS. Despite the fact that the agreement contained an escape

53. See notes 21, 24, 26 and 40 supra.
54. See generally 3 L. Loss, Securities Regulation 1829-36 (2d ed. 1961).
   Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commissioner shall be void.
57. 17 C.F.R. § 230.460 (1969), provides that the SEC may refuse to accelerate the effective date of a registration where there is indemnification of a director, officer, or controlling person by the issuer.
59. 3 L. Loss, Securities Regulation 1834 (2d ed. 1961).
60. The agreement between Blair and LRS reads in part:
   (a) The Company will indemnify and hold you harmless . . . against any losses, claims, damages or liabilities, joint or several, to which you . . . may become subject under the Securities Act or otherwise, insofar as such losses, claims, damages or liabilities are, or may arise out of or are based upon any untrue
clause for LRS in the case of Blair’s "wilful misfeasance, bad faith or gross negligence" or if Blair were liable "by reason of its reckless disregard of its obligations and duties," to the court refused to find that the actual knowledge of the misstatements of Blair constituted the requisite conduct to bar recovery under the agreement. Instead it chose to find the agreement invalid under the securities acts. It was emphasized at the outset that the only consideration before the court was the indemnification of an underwriter who "has committed a sin graver than ordinary negligence," thereby limiting the ban on indemnification agreements.

The first argument advanced against such an agreement is that it would encourage the "flaunting of the policy of the common law and the securities acts." At common law, one cannot insure himself against his own reckless, wilful or criminal acts. To permit an underwriter to do so would be inconsistent with such a policy. As stated earlier, neither an insurer nor director of the issuer is permitted to indemnify himself in the same manner as an underwriter. Since section 11 of the Securities Act of 1933 makes underwriters, directors, issuers and signers jointly liable, to permit only one of these parties to indemnify himself would be contrary to the purpose of section 11.

The second argument of the court is that such an agreement would cause underwriters to neglect their high standards of care imposed by the acts. Since an underwriter could avoid liability by showing that he was less liable for the misstatement than the issuer he would have the tendency to be lax in his duty of independent investigation. This argu-

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ment can also be tied into the first argument since any event that would cause the lessening of diligence by underwriters would be contrary to the legislative purpose of the Securities Act of 1933.67

Third, the court considers the parties upon whom the cost of indemnity will fall — the stockholders of the issuer. Since many of these stockholders will be the purchasers injured by the misstatements, they will be indemnifying the underwriter for injury incurred by them personally and caused by the indemnified party. This situation is similar to the indemnification agreement between a party to an offering and a purchaser thereof under section 14.68 It is an evil that the Act was designed to avoid.

Some of the arguments posed by the court are open to rebuttal. The desire of the securities industry to attract and retain qualified underwriters in light of the risks involved for them would explain the inconsistent treatment of underwriters in the area of indemnification.69 Such an intent would also be in keeping with the policy of the Securities Act. Also, the argument that the ultimate burden will fall on the stockholder who is also the injured party is weakened by both the requirement of shareholder approval prior to the offering70 and the threat of a derivative suit based upon the misstatements.71 The analogy to an agreement between the underwriter and the innocent purchaser is weakened by tying the share-

holder/purchaser to the issuer.

However, from these three arguments, the court concludes that such an agreement, at least where the actions of the underwriter amount to more than mere negligence, conflicts with the proper purpose of the Act — the encouragement of diligence by exposing underwriters to liability for damages. In doing so, the court has created the situation where the actions and knowledge of the underwriter must be classified by degree. For now the courts must define ordinary negligence to determine what exceeds that standard. This is the very practice that courts have moved away from in the area of tort law.72 It must also be noted that the jury in the instant case had trouble classifying the actions of Blair, finding the requisite conduct for punitive damages but not that required to find the indemnifica-
tion agreement inapplicable. Since the basic arguments brought forth by the court would also apply to indemnification of underwriters in the situa-

67. Landis, supra note 10, at 35.
69. See 3 L. LOSS, SECURITIES REGULATION 1835 (2d ed. 1961):
This special treatment of underwriters apparently has a historical explanation in the fears expressed during the early days of the act that underwriters would be unwilling to assume the full risks of § 11...
71. For a discussion of the use of Rule 10b-5 as a remedy in a derivative suit for mismanagement, see Lowenfels, Rule 10b-5 and the Stockholder's Derivative Action, 18 Vand. L. Rev. 893 (1965); Susman, Use of Rule 10b-5 as a Remedy for Minority Shareholders of Close Corporations, 22 BUS. LAW. 1193 (1967).
tion of ordinary negligence, and since the courts would be required to
determine the relative negligence of the underwriters under the principles
of the instant case, this decision would appear to be the first step in the
elimination of indemnification for underwriters.

John C. Snyder

DIVERSITY JURISDICTION — CIVIL PROCEDURE — PARTIAL
ASSIGNMENT OF A PLAINTIFF'S CLAIM IS INEFFECTIVE TO PREVENT
REMOVAL TO FEDERAL COURT.

Gentle v. Lamb-Weston, Inc. (D. Me. 1969)

Nine Maine citizens originally instituted an action for breach of con-
tact in Maine state court against Snow Flake Canning Co., a Maine
corporation. After it became known that Snow Flake had earlier merged
with, and was survived by Lamb-Weston, Inc., an Oregon corporation, a
second action naming Lamb-Weston as defendant was brought in state
court. While the same relief was sought, three additional plaintiffs were
added, one of whom was an Oregon citizen who had no previous connec-
tion with the matter, but who had taken a partial assignment of one
one-hundredth (1/100) of each of the other plaintiffs' claims. It was
conceded that the partial assignment had been made for the sole purpose
of defeating an anticipated removal to federal court by destroying the
diversity of citizenship that would have existed between the plaintiffs and
defendant if no assignment had been made. After the defendant had
removed the action to federal district court the plaintiffs moved to remand
the case to a state court on the ground that there was no diversity of

1. As consideration for the assignments, the Oregon citizen, who was a law
school classmate of an attorney in the law firm representing plaintiffs, paid each of
the original plaintiffs one dollar. Gentle v. Lamb-Weston, Inc., 302 F. Supp. 161, 162
(D. Me. 1969).

   (a) The district courts shall have original jurisdiction of all civil actions
   where the matter in controversy exceeds the sum or value of $10,000, exclusive
   of interests and costs, and is between—
   (1) citizens of different States;
   (2) citizens of a State, and foreign states or citizens or subjects thereof; and
   (3) citizens of different States and in which foreign states or citizens or
   subjects thereof are additional parties.

3. 28 U.S.C. § 1441(a) provides:
   [A]ny civil action brought in a State court of which the district courts of the
   United States have original jurisdiction, may be removed by the defendant . . .
   to the district court of the United States . . . where such action is pending.
citizenship by reason of the addition of the Oregon plaintiff. The district court denied the plaintiffs' motion to remand holding, the partial assignment for the admitted purpose of defeating federal diversity jurisdiction did not destroy the essential diversity of citizenship or defeat federal jurisdiction. Gentle v. Lamb-Weston, Inc., 302 F. Supp. 161 (D. Me. 1969).

The grant of diversity jurisdiction to the federal courts has both a constitutional and statutory basis. It has been argued that the reason for its inclusion in the Constitution and the Judiciary Act of 1789 was to counteract the fear that a nonresident might incur local prejudice in a state court. In interpreting the legislative mandate, courts have read it to require complete diversity of citizenship — all of the parties on one side of the suit must be citizens of different states from all of the parties on the other side. Concomitant with the grant of diversity jurisdiction, Congress has provided defendants with a right to remove to federal court a cause of action which might have originally been brought there. Accordingly, since the ability to sue in federal court or to remove a state court suit based on diversity jurisdiction is dependent upon the citizenship of the parties, the parties have been manipulated, i.e., added and subtracted, in order to take advantage of the rules of diversity and thereby manufacture or destroy diversity through assignment or appointment.

In the instant case several Maine citizens sued an Oregon corporation and thus would have met all the requisites of complete diversity but for


5. [T]he circuit courts shall have original cognizance, concurrent with the courts of the several States, of all suits of a civil nature at common law or in equity, where the matter in dispute exceeds, exclusive of costs, the sum of five hundred dollars, and the United States are plaintiffs, or petitioners; or an alien is a party, or the suit is between a citizen of the State where the suit is brought, and a citizen of another State. Judiciary Act of 1789, ch. 20, § 11, 1 Stat. 78.


9. 28 U.S.C. § 1359 (1964), provides:

A district court shall not have jurisdiction of a civil action in which any party, by assignment or otherwise, has been improperly or collusively made or joined to invoke the jurisdiction of such court.

The manufacture of diversity jurisdiction is the corollary to the precise issue of destruction of diversity involved in Gentle. For an analysis of the judicial and legislative history of this area, see Comment, Manufacturing Diversity Jurisdiction,
the fact that one one-hundredth of each Maine plaintiff's claim was assigned to an Oregon citizen. Further, the court quickly found that the plaintiffs had complied with both the state and federal law of assignments and thus the validity of the assignment was not at issue.\textsuperscript{10} Both state "real party in interest" statutes\textsuperscript{11} and rule 17(a) of the Federal Rules of Civil Procedure\textsuperscript{12} essentially require that, "[a]n action shall be prosecuted in the name of the party who, by the substantive law, has the right sought to be enforced."\textsuperscript{13} Today the great weight of authority holds that an assignee of a cause of action is a real party in interest and possesses "the right sought to be enforced;"\textsuperscript{14} and, the same is true with respect to a partial assignee.\textsuperscript{15} The court in \textit{Gentle} was thus able to frame the precise issue to be, "whether this Court is powerless to protect its jurisdiction and the constitutional and statutory right of a defendant of diverse citizenship to have a federal forum free from the potentiality of local bias."\textsuperscript{16}

Early Supreme Court cases found two rationales upon which to sanction a total assignment as a means of preventing removal. Firstly, a colorable assignment — one which appeared to be bona fide — was viewed as maintaining the assignee's identity as a real party in interest. Thus, in \textit{Provident Savings Life Assurance Soc'y v. Ford,}\textsuperscript{17} the Supreme Court

\begin{itemize}
\item[10.] In this area, the initial inquiry into federal jurisdiction involves an examination of the state substantive law of assignments. The validity of the assignment is governed by local law which the federal court is required to follow under \textit{Erie R.R. v. Tompkins}, 304 U.S. 64 (1938). If the assignment is invalid, diversity jurisdiction cannot possibly attach. One of the issues in the present case was whether the assignment was void as violative of the Maine champerty statute. \textit{Me. Rev. Stat. Ann. tit. 17, § 801 (1964)}, provides:
\begin{quote}
Whoever . . . gives . . . any valuable consideration . . . with intent thereby to procure any account, note or other demand for the profit arising from its collection by a civil action shall be punished . . .
\end{quote}
The court concluded that the assignment was not champertous. 302 F. Supp. at 163 n.4. But the court correctly adds that finding a valid assignment does not automatically mean that federal diversity jurisdiction is present. The court cites to the language of Mr. Justice Harlan in \textit{Kramer v. Caribbean Mills, Inc.}, 394 U.S. 823, 829 (1969), "[t]he existence of federal jurisdiction is a matter of federal, not state law." 302 F. Supp. at 166. This reasoning is noteworthy for otherwise state law could be used to exploit the jurisdiction of the federal courts. The ease with which this assignment device could manipulate federal jurisdiction through state law indicates that the expansion and limitation of diversity jurisdiction should be a matter handled by the federal courts and not state law.

\item[11.] See \textit{3A J. Moore, Federal Practice} \textsuperscript{\textit{¶} 17.02, at 53 n.13 (2d ed. 1968)}, for a list of state real party in interest (and related) statutes.

\item[12.] \textit{Fed. R. Civ. P. 17(a)} provides: "Every action shall be prosecuted in the name of the real party in interest."

\item[13.] \textit{3A J. Moore, supra} note 11, \textsuperscript{¶} 17.07, at 221. See \textit{generally} \textit{Clark & Hutchins, The Real Party in Interest, 34 Yale L.J. 259 (1925)}.

\item[14.] \textit{3A J. Moore, supra} note 11, \textsuperscript{¶} 17.09, at 272-73.

\item[15.] \textit{3A J. Moore, supra} note 11, \textsuperscript{¶} 17.09, at 279-82. The argument that a party having one one-hundredth of a claim is not a valid plaintiff because of the doctrine of \textit{de minimis non curat lex} has been held invalid. Ridgeland Box Mfg. Co. v. Sinclair Refining Co., 82 F. Supp. 274, 280 (E.D.S.C. 1949).

\item[16.] 302 F. Supp. at 163. While \textit{Erie R.R. v. Tompkins}, 304 U.S. 64 (1938), made substantive law no longer a factor in an attorney's choice of forum, there remain several reasons for favoring a state court rather than a federal court: lower litigation costs, greater familiarity with judges, local prejudice against the opponent, and the tendency of federal judges to participate more than state judges in the trial. See Comment, \textit{The Choice Between State and Federal Court in Diversity Cases in Vir- ginia, 31 Wash. U.L.Q. 1, 32 (1953)}.

\item[17.] 114 U.S. 635 (1885).
held that the assignment of an entire claim to a plaintiff for the purpose of preventing removal from the state to the federal courts left the federal court with no basis to assume jurisdiction.\textsuperscript{18}

[I]t may perhaps, be a good defence to an action in a state court to show that a colorable assignment has been made to deprive the United States court of jurisdiction; but, as before said, it would be a defence to the action, and not a ground of removing that cause into the federal court.\textsuperscript{19}

The Court reasoned that the assignment was not fraudulent, but colorable. As such, the assignee was a real party in interest whose interest was determinative in respect to the diversity of the parties; and therefore there could be no removal to the federal courts since diversity of citizenship was now absent.\textsuperscript{20}

Secondly, the lack of a uniform federal statutory scheme covering both the creation and the destruction of diversity left the Court with no basis upon which to take jurisdiction when a colorable assignment was made to destroy diversity. In Oakley v. Goodnow,\textsuperscript{21} the Court approved the use of the assignment device to evade federal jurisdiction, reasoning that as dismissal or remand was required by federal statute where an assignment was made to create diversity, congressional failure to proscribe assignments made to destroy federal jurisdiction meant that federal courts had no authority to take jurisdiction of a case by removal from a state court.\textsuperscript{22} Thus, the lower federal courts had almost unanimously held that a total assignment was effective to frustrate federal jurisdiction.\textsuperscript{23}

While the Supreme Court has not spoken on the effectiveness of a partial assignment to defeat diversity jurisdiction, such a question has been considered by the federal and state courts of South Carolina. Ridgeland Box Mfg. Co. v. Sinclair Refining Co.\textsuperscript{24} was the first case involving an assignment of one one-hundredth of a claim in order to defeat federal jurisdiction. It was held that an action may not be removed to a federal

\begin{footnotesize}
\begin{enumerate}
\item[19] Id. at 641.
\item[20] Id. at 640-41.
\item[21] 118 U.S. 43 (1886).
\item[22] \emph{Id.} at 45. \textit{See} Act of March 3, 1875, ch. 137, § 5, 18 Stat. 472.
\end{enumerate}
\end{footnotesize}
court when a partial assignee, as an additional plaintiff, is a citizen of the same state as the defendant. That the only purpose of the assignment was to defeat diversity was found inconsequential.\textsuperscript{25} Later, in \textit{Lisenby v. Pats},\textsuperscript{26} a visiting judge construed South Carolina law to prohibit the assignment, either total or partial, of a personal injury claim prior to judgment. While the effect of the assignment itself need not have been discussed, the court did not forego the opportunity to criticize it. However, \textit{Lisenby} was later denounced in \textit{Hair v. Savannah Steel Drum Corp.}\textsuperscript{27} for having misconstrued the state law on the validity of assignments. As the partial assignment was valid, \textit{Hair} remanded the action to the state court.

To reinforce their position these cases have relied upon \textit{Mecom v. Fitzsimmons Drilling Co.}\textsuperscript{28} for the proposition that the motive or purpose prompting the assignment is of no consequence. In \textit{Mecom} the Supreme Court considered the situation of an administrator selected for the sole purpose of defeating diversity jurisdiction and held that, “it is clear that the motive or purpose that actuated any or all of these parties in procuring a lawful and valid appointment is immaterial upon the question of identity or diversity of citizenship.”\textsuperscript{29} Relying on \textit{Provident} and \textit{Mecom}, the plaintiffs in \textit{Gentle} contended that “federal courts must unquestioningly honor the most colorable attempts to deprive them of their jurisdiction, at least until Congress provides otherwise.”\textsuperscript{30} The \textit{Gentle} court was not persuaded, however, and found \textit{Provident} and \textit{Mecom} distinguishable on separate grounds.

\textit{Provident}, in the court’s view, was immediately distinguishable from the instant case since it involved a total assignment rather than a partial assignment. But the court does not rest on this mere distinction. Incisively analyzing and comparing the end result of a total assignment and a partial assignment, it concludes that “a fractional assignment, where the assignor remains a party for the purpose of profiting from local prejudice, is manifestly less defensible [than a total assignment].”\textsuperscript{31} The key to the court’s reasoning is thus the practical difference between total and partial assignments. Where there is a total assignment, the assignor does not appear in the courts of his state, divesting himself completely of all interest in the outcome of the suit including, most importantly, all interest in a money judgment that might be awarded. On the other hand, where there is a partial assignment the assignor retains a very definite interest in the suit.
and can literally "profit" from any local prejudice that might exist against
the nonresident defendant.

In distinguishing plaintiffs' contention based on *Mecom* — that plain-
tiffs' motive to defeat diversity is immaterial — the court noted that
*Mecom* involved the appointment of an administrator and not the assign-
ment of a claim. This distinction had been recognized clearly by the
Supreme Court two months earlier in *Kramer v. Caribbean Mills, Inc.*, which
held that a partial assignment could not be used to create federal
diversity jurisdiction.

Cases involving representatives vary in several respects from those
in which jurisdiction is based on assignments: (1) in the former situa-
tion, some representative must be appointed before suit can be
brought, while in the latter the assignor normally is himself capable of
suing in state court; (2) under state law, different kinds of guardians
and administrators may possess discrete sorts of powers; and (3) all
such representatives owe their appointment to the decree of a state
court, rather than solely to an action of the parties.

To buttress its reasoning in the instant case the court discerns a
movement in Supreme Court decisions toward greater protection of the
jurisdiction of the federal courts. As evidence of this movement it looks
to *Ex parte Nebraska*, wherein an injunction was sought against a non-
resident railroad for charging rates above those set by the Nebraska
railroad commission, the State of Nebraska being joined as a plaintiff in
order to destroy federal jurisdiction. The Supreme Court affirmed the
decision of the circuit court that since the State had no interest in the con-
troversy, it was to be viewed as a nominal party plaintiff whose citizenship
is not determinative for purposes of diversity jurisdiction. This reliance
on *Ex parte Nebraska* is perhaps the weakest point in the court's decision.
It is doubtful whether such an old case can be considered to show such a
movement toward protection of diversity jurisdiction; and further the
Supreme Court's disposition of the matter was more clearly concerned
with the propriety of reviewing the circuit court's decision by using a
writ of mandamus rather than the merits of the joinder.

As further evidence of the movement toward greater protection of the
federal forum, the *Gentle* court cites *Wecker v. National Enameling
Stamping Co.*, a tort case which involved the joinder of a co-defendant
for the express purpose of destroying diversity. The Supreme Court
affirmed the circuit court's refusal to remand to the state court holding
the joinder ineffective to prevent removal because it was clearly a "sham"
joinder where it was not conceivable that the co-defendant could be held

33. Id. at 828 n.9. For an extensive analysis of *Caribbean Mills* and its effect
on prior precedent, see Comment, *Manufacturing Diversity Jurisdiction*, 14 *Vill. L.
34. 209 U.S. 436 (1908).
35. 201 U.S. 156 (1906).
liable. While Wecker might be distinguished on the basis that it concerned the joinder of defendants rather than the assignment of a claim, the court's reliance of Wecker clearly shows that it views the destruction of diversity through the use of a partial assignment as being in the nature of a fraud upon the court.\textsuperscript{36} It is upon this characterization that the court's holding perhaps truly best lies.

The result reached in the instant case is commendable as it cures a problem the federal courts had not heretofore fully resolved. Provident suggested that if the purpose of the assignment was to prevent removal, it may be a defense against the assignee in the state courts. Oakley reaffirmed this language by noting, "resort can only be had to the state courts for protection against the consequences of such encroachment on the rights of the defendant."\textsuperscript{37} However, the state courts have not provided this protection.\textsuperscript{38} Thus Gentle rectifies this situation by actually offering the defendant the protection which the other federal courts had incorrectly presumed the state courts would do.

This result would also be accomplished by section 1307(b) of the ALI's proposed federal legislation:

Whenever an object of a sale, assignment, or other transfer of the whole or any part of any interest is a claim or any other property has been to enable or to prevent the invoking of federal jurisdiction under this chapter or chapter 158 of this title, jurisdiction of a civil action shall be determined as if such sale, assignment, or other transfer had not occurred.\textsuperscript{39}

A cursory examination reveals that the ALI is clearly proposing a motive test for assignments. Thus if the transaction had "an object" of creating or defeating diversity — and the Gentle plaintiffs expressly stated this to be the reason for their assignment — the assignment will not be considered determinative for purposes of diversity jurisdiction. While this motive test presents additional complications,\textsuperscript{40} the Gentle court enunciates no test

\textsuperscript{36} In further support of the proposition that the federal courts must guard their jurisdiction against such devices, see 3A J. Moore, supra note 11, \S 17.05[2], at 156; American Law Institute, Study of the Division of Jurisdiction Between the State and Federal Courts 160 (1969); Field, Proposals on Federal Diversity Jurisdiction, 17 S.C.L. Rev. 669, 671 (1965); Note, The Assignment Device in Diversity Cases: The Illusory Right of Removal, 35 U. Cin. L. Rev. 33 (1966); 44 Harv. L. Rev. 97, 100 (1930); 34 Texas L. Rev. 476, 477 (1956); 40 Va. L. Rev. 803, 804 (1954).

\textsuperscript{37} Oakley v. Goodnow, 118 U.S. 43, 45 (1886).

\textsuperscript{38} See Hayday v. Hammermill Paper Co., 176 Minn. 315, 223 N.W. 614 (1929) (lack of a state statute making an assignment for the purpose of defeating removal a defense to an action in a state court, resulted in the assignee maintaining his real party in interest status); Schepman v. Mutual Benefit Health & Acc. Ass'n, 231 Mo. App. 651, 104 S.W.2d 777 (1937) (no state statute making such assignment a defense); Heape v. Sullivan, 246 S.C. 218, 143 S.E.2d 366 (1965) (partial assignment made to extinguish diversity and preclude removal of action found to be no defense to the cause in state court).

\textsuperscript{39} ALI, Study of the Division of Jurisdiction Between the State and Federal Courts 22 (1969).

\textsuperscript{40} For a discussion of the problems involved in the motive test, see Comment, Manufacturers, Diversity Jurisdiction, 14 Vill. L. Rev. 728, 744-45 (1969).
and merely discards altogether the notion that a partial assignment will defeat diversity.

Apart from the actual holding in the case, Gentle never satisfactorily answers the basis of the plaintiffs' question: May the federal judiciary itself limit its jurisdiction, or is legislative action necessary? As there is no existing counterpart to section 1359,41 which prohibits the creation of diversity, it can be argued there is no federal policy against the destruction of federal jurisdiction.42 In respect to this problem, the court advances the sentiment of Professor James W. Moore: "The proposals [of the ALI] in this respect are good ones. But we respectfully suggest that the federal courts should not await legislative action to cure an erroneous doctrine which had been evolved by the federal courts."43 This solution can, however, be rebutted by the rationale of Oakley which asserts that the congressional failure to halt destruction of diversity while prohibiting manufacture of diversity left the courts no basis for jurisdiction.44 However, while there may be no true congressional policy against the destruction of diversity, the instant court clearly makes it a federal judicial policy.

While Gentle broke from precedent, it does augment the well-considered proposals of the ALI which noted:

So long as federal diversity jurisdiction exists, however, the need for its assertion may well be greatest when the plaintiff tries hardest to defeat it. The plaintiff who chooses to sue a non-citizen defendant in a state court may be motivated by the hope that the out-of-state defendant will be at a substantial disadvantage in that court, and the likelihood of such motivation increases with the lengths to which the plaintiffs will go to prevent removal to a federal forum.45

If the reason for the grant of diversity jurisdiction and the right of removal is to eliminate prejudice, any other result would endanger the nonresident defendant to prejudice. The plaintiff does have the initial choice of forum. But, the assignment device has the practical effect of leaving the choice of forum entirely up to the plaintiff as it thwarts the defendant's right of removal. This result would foster the very abuses which diversity jurisdiction was meant to prevent.

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42. It has also been argued that there is a policy favoring devices restricting federal jurisdiction as demonstrated by the increased amount of the claim necessary for federal court jurisdiction. Comment, Manufactured Diversity Jurisdiction and Section 1359, 69 COLUM. L. REV. 706, 723 (1969).
43. 3A J. MOORE, supra note 11, ¶ 17.05[2], at 156.
44. See notes 21–22 supra and accompanying text.
INSURANCE — EQUITABLE ESTOPPEL — DOCTRINE OF EQUITABLE
ESTOPPEL USED TO BAR THE DEFENSE OF NONCOVERAGE BY THE
INSURER AND TO EXTEND COVERAGE TO RISKS NOT PROVIDED FOR
OR EXPRESSLY EXCLUDED IN THE POLICY.


Plaintiff, the insured, brought an action against the defendant insurance company to recover for water damage to certain business merchandise which was allegedly covered by a fire insurance policy issued by the defendant. At trial the insured contended that certain representations made by the defendant's agent as to the scope of the policy’s coverage estopped the insurer from now denying that coverage even though it was expressly excluded by the terms of the policy. The trial court, however, granted the defendant’s motion for involuntary dismissal. The Appellate Division affirmed the trial court’s dismissal of the action on other grounds, finding that the insured had failed to establish all the essential elements for an action of equitable estoppel to lie. The New Jersey supreme court reversed, however, holding, inter alia that: (1) equitable estoppel is

1. Plaintiff also made a claim for recovery under a homeowner’s policy on the theory that certain language as to personal property coverage should be deemed, under the circumstances, to include the business merchandise as well. The trial court held to the contrary and the point was not pursued on appeal. 54 N.J. 287, 292, 255 A.2d 208, 212 n.2 (1969).

2. The trial court granted the defendants motion for involuntary dismissal at the conclusion of the plaintiff’s case on the ground that statements by the insurer’s agent at the inception of the contract could not, under the parol evidence rule, broaden the coverage of the policy. 54 N.J. 287, 290, 255 A.2d 208, 210 (1969).


4. The Appellate Division took the position that equitable estoppel is available, under appropriate circumstances, to bring within insurance coverage risks not provided for or expressly excluded under the policy. 54 N.J. 287, 290, 255 A.2d 208, 210 (1969).

5. To have an equitable estoppel in New Jersey certain elements, enunciated in Feldman v. Urban Commercial, Inc., 70 N.J. Super. 463, 474, 175 A.2d 683, 688 (Chancery Div. 1961), are required:

(1) there must be conduct... amounting to a representation or a concealment of material facts; (2) these facts must be known to the party estopped at the time of his said conduct... or knowledge of them is necessarily imputed to him; (3) the truth concerning these facts must be unknown to the other party claiming the benefit of the estoppel, at the time when such conduct was done, and at the time when it was acted upon by him; (4) the conduct must be done with the intention or at least with the expectation, that it will be acted upon by the other party; (5) the conduct must be relied upon by the other party, and, thus relying, he must be led to act upon it; (6) he must in fact act upon it in such a manner to change his position for the worse...

6. The court reversed the trial court's granting of the motion for involuntary dismissal, affirmed the Appellate Division's ruling on the availability of equitable estoppel and remanded the case to the Law Division for retrial.

7. A second issue in the case dealt with an amended pleading filed by the plaintiff. The appellee claimed that it was accepted by the court in violation of New Jersey state law, N.J. Rev. Stat. § 17:36-5.20 (1954), which provides in part that:

[n]o suit or action on this policy for the recovery of any claim shall be sustainable in any court of law or equity unless all the requirements of this policy shall have been complied with, and unless commenced within twelve months next after inception of the loss.

The supreme court affirmed the lower court's ruling that the amended pleadings were

in substance no different than the original and that the doctrine of relation back
available to bar a defense in actions on insurance policies even where the estopping conduct arose before or at the inception of the contract;\textsuperscript{8} (2) the parol evidence rule\textsuperscript{9} does not apply in such situations;\textsuperscript{10} and (3) equitable estoppel is available under appropriate circumstances to extend coverage to risks not provided for or expressly excluded in the insurance policy.\textsuperscript{11} \textit{Harr v. Allstate Ins. Co.}, 54 N.J. 287, 255 A.2d 208 (1969).

Prior to the decision in the instant case, only three jurisdictions, New Jersey,\textsuperscript{12} Nebraska,\textsuperscript{13} and Massachusetts,\textsuperscript{14} would not permit equitable estoppel to be raised in actions \textit{at law} if the conduct complained of occurred \textit{prior to} or \textit{concurrent with} the formulation of the written contract. In contrast, the vast majority of American jurisdictions adhered to the guidelines\textsuperscript{15} laid down by the United States Supreme Court in \textit{Union Mut. Life Ins. Co. v. Wilkinson},\textsuperscript{16} which provided that “any words or acts raising an equitable estoppel may be shown by parol testimony, and it is immaterial whether they appeared before or after the making of the formal contract.”\textsuperscript{17}

In aligning themselves with the majority of jurisdictions, however, the New Jersey supreme court abandoned one extreme of the equitable estoppel spectrum and took station at the other. Consequently, New Jersey law now not only endorses the use of equitable estoppel to bar a defense in actions on an insurance policy where the estopping conduct arose before or at the inception of the contract, but also allows the use of equitable estoppel, \textit{under appropriate circumstances}, to bring within insurance coverage risks and perils not provided for or expressly excluded in the policy.\textsuperscript{18} While some courts\textsuperscript{19} concur with the New Jersey high court on this latter point, others\textsuperscript{20} are skeptical as to the equity and wisdom of the court’s declaration.

With respect to the time of the estopping conduct and the parol evidence issues, the court felt that it was necessary to overrule nearly

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8. \textit{Id.} at 304, 255 A.2d at 218.
9. The parol evidence rule has commonly been phrased as follows:
When two parties have made a contract and have expressed it in a writing to which they have both assented to as the complete and accurate interpretation of the contract, evidence, whether parol or otherwise, of antecedent understandings and negotiations will not be admitted for the purpose of varying or contradicting the writing.
10. 54 N.J. at 304, 255 A.2d at 218.
16. 80 U.S. (13 Wall.) 222 (1871).
17. See W. Vance, supra note 15, § 90, at 541.
19. See note 29 infra.
20. See supra note 15, § 90, at 541. For a list of the courts taking exception to the broad rule announced in the instant case.
100 years of case law and align itself with the majority of jurisdictions because of the current state of affairs in the insurance field. When the old law was established in 1872,\textsuperscript{21} insurance was not the universally purchased commodity that it has developed into today. The contemporary insurance policy is a complex adhesion contract which is written in so awkward and intricate a fashion that it is beyond the comprehension of the average purchaser.\textsuperscript{22} As a consequence of this complexity and unintelligibility, the purchaser relies almost exclusively on the representations of the selling agent to determine the nature and extent of the coverage his policy will provide.\textsuperscript{23} In light of these facts it became obvious that utilization of the minority view resulted in severe prejudice to those misled prior to the contract’s formation, since they were compelled to seek redress by way of the far more demanding remedy of reformation.\textsuperscript{24} The New Jersey court was not the first, however, to note that neither equity nor logic could be called upon to support a rule that made so prejudicial a distinction on such an arbitrary basis. For example, in \textit{Employer’s Liab. Assur. Corp. v. Madric},\textsuperscript{25} Judge Story stated:

I am at a complete loss to understand why coverage can be extended because of an estoppel founded upon insurer’s assumption of the defense of an action against insured [a post-contract action] and can not be extended on an estoppel founded on such facts as we have at bar [a pre-contract action], when the prejudice to the insured is even greater than in the defense-in-action cases. I take the position that any rule which presumes to advance such an anomaly is clearly without foundation.\textsuperscript{26}

While the \textit{Harr} decision drastically modified the law in New Jersey, it did not mark a change in the supreme court’s disposition toward insurance policies in general. As indicated by a string of decisions over the past ten years,\textsuperscript{27} the court has for some time had the general objective of providing greater protection for the ordinary insured who is untutored in the complexities of insurance policies. The court continued this objective in the case under discussion by removing an obvious inequity and binding

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\textsuperscript{24} Reformation is a form of remedy, afforded by courts of equity to the parties, to written instruments which import a legal obligation, to reform or rectify such instruments whenever they fail, through fraud or mutual mistake, to express the real agreement or intention of the parties. \textit{Black’s Law Dictionary} 1446 (4th ed. 1951). The burden of proof in gaining reformation of a written contract is far greater than that required to establish an equitable estoppel. “The mistake must be established to the satisfaction of the court or the relief will be refused.” H. McCLINTOCK, EQUITY § 104 (2), at 279 (2d ed. 1948).
\textsuperscript{25} 54 Del. 146, 174 A.2d 809 (1961).
\textsuperscript{26} Id. at 161, 174 A.2d at 816.
\textsuperscript{27} \textit{See} Kiev v. Loyal Protective Life Ins. Co., 34 N.J. 475, 482, 170 A.2d 22 (1960), in which the court stated that those who are insured “should not be subjected to technical incumbrances or to hidden pitfalls and their policies should be construed liberally in their favor to the end that any fair interpretation will allow.” \textit{See also} Bowler v. Fidelity & Cas. Co., 53 N.J. 313, 250 A.2d 580 (1969); Allen v. Metropolitan Life Ins. Co., 44 N.J. 294, 288 A.2d 24 (1963); Merchants Indem. Corp. v. Eggleston, 37 N.J. 114, 179 A.2d 503 (1962).
\end{flushleft}
the insurer to all the selling agent’s representations relied upon by the insured. General principles of insurance\textsuperscript{28} as well as the similar holdings of several other jurisdictions\textsuperscript{29} bear witness to the propriety of this legal position.

Having so concluded, it clearly followed that the parol evidence rule could not apply to equitable estoppel situations where the conduct arose prior to or at the time the contract was formed. Such a use of estoppel does not contravene the parol evidence rule for it in no way affects the terms of the written contract or in any way attempts to change them. In essence, it merely permits proof of an action or representation by the insurer whose denial of it now would virtually defraud the insured who justifiably relied on it. The compatibility of the user of equitable estoppel and the parol evidence rule was early rationalized by Mr. Justice Miller in \textit{Union Mut. Life Ins. Co. v. Wilkinson},\textsuperscript{80} where he stated that:

\begin{quote}
[T]his principle [equitable estoppel] does not admit oral testimony to vary or contradict that which is in writing, but it goes upon the idea that the writing offered in evidence was not the instrument of the party whose name is signed to it; that it was procured under such circumstances by the other side as estop that side from using it or relying on its contents; not that it may be contradicted by oral testimony but that it can not be lawfully used against the party whose name is signed to it.
\end{quote}

While the Harr court’s rulings with respect to the time the estopping conduct arose and the admissibility of parol evidence appear to be consistent with settled principles of law, its holding with respect to the use of equitable estoppel to expand the policy coverage is widely rejected because it contravenes some time honored doctrines of contract law.\textsuperscript{81} The possible implications of this new standard are both far reaching and of considerable import, and for these reasons most jurisdictions refuse to permit the use of estoppel to broaden the coverage of an insurance policy. The overwhelming majority of American jurisdictions adhere to

\textsuperscript{28} 16A J. Appleman, \textit{Insurance Law \& Practice} § 9166, at 471 (1968), where the author states that:

An insurer may by its authorized agents, make representations which will estop it from denying the fact so represented. Generally, an insurer may rely upon information from the insurer’s agent in procuring a policy, and the company would be bound by the acts, conduct, and representations of its agents irrespective of the inclusiveness of the policy terms.

\textit{See also} 29A A.M. Jur. \textit{Insurance} § 1049 (1960), which states that:

In an action on a contract of insurance, the insurance company is generally considered estopped to deny liability on any matter arising out of fraud, misconduct, or negligence of an agent of the company. If either party must suffer from an insurance agent’s mistake it must be the insurance company, his principle.


\textsuperscript{80} 80 S.D. 237, 122 N.W.2d 86 (1963).

\textsuperscript{81} See p. 509 infra.
the view that "a loss not within the coverage of a policy can not be brought within such coverage by invoking the principle of waiver or estoppel."32

A number of courts feel that "the effect in such a case . . . would be to create a new contract without a new consideration."33 Other courts so hold because they deem equitable estoppel to be solely a defensive weapon to be used only to prevent injustice, and therefore can not be used affirmatively to create a duty.34 The most common reason urged is that such a use of equitable estoppel results in the court creating a new contract which actually contradicts the written contract of the parties.35

Although these objections to the expansive use of equitable estoppel seem formidable, upon examination some fail to hold up and others are seemingly outweighed by the equitable results that the new rule may provide. The argument which asserts that the court is creating a new contract without new consideration fails to completely recognize the effect of the equitable estoppel doctrine, i.e., the insurance company is precluded from denying coverage which the insured was led to believe was part of the policy and for which he advanced his consideration. Thus, the consideration rendered was intended to be applied to the coverage represented by the agent as part of the policy, and no new consideration is needed.

The argument that equitable estoppel can only be used as a defensive weapon appears to be no more than custom left over from the days when law and equity were separate; and since this segregation of justice has been eliminated in New Jersey36 there was no compelling reason for the Harr court to be impressed by such an argument. Furthermore, a consideration of both the general definition37 and the essential elements38 of equitable estoppel clearly show that there is nothing inherent in the doctrine which relegates it to merely a defensive posture. Just as collateral estoppel, which was originally a purely defensive doctrine of law, is now

36. N.J. Const. art. VI, § IV (1947), provides that:
The county courts, in civil cases including probate causes, within their jurisdiction, and subject to law, may grant legal and equitable relief so that all matters in controversy between the parties may be completely determined.
37. The court in In re Beier's Estate, 205 Minn. 43, 48, 284 N.W. 833, 838 (1939), defined equitable estoppel as the:
   [E]ffect of voluntary conduct of one party whereby he is precluded, at law and in equity, from asserting rights which might perhaps have otherwise existed, either of property, of contract, or of remedy, as against another person, who has in good faith relied on such conduct, and has been thereby led to change his position for the worse, and who on his part acquires some corresponding right either of property, of contract, or of remedy.
accorded equal standing as an offensive argument in some jurisdictions,\textsuperscript{39} so to should equitable estoppel be accorded the same recognition.\textsuperscript{40}

With respect to the argument that such a use of equitable estoppel cannot be sustained because it contravenes time honored doctrines of contract law, it should be noted that the California supreme court in \textit{Rault v. Northwestern Nat'l Ins. Co.}\textsuperscript{41} stated that an insurance policy was so unique a contract, with all its "traps for the unwary,"\textsuperscript{42} that it could not be enforced as an ordinary contract with the same strict compliance to contract law.\textsuperscript{48} The New Jersey court has long recognized the same fact\textsuperscript{44} and therefore was not constrained to follow basic contract law in enunciating this new rule.

The most tenable argument advanced in opposition to the broad rule announced in \textit{Harr} is that, while tending to alleviate the inequities under the old rule, it will result in fraudulent claims and even greater inequities to the insurance companies. Most jurisdictions which follow the broad rule attempt to overcome this argument by placing a heavy burden of proof on the plaintiff.\textsuperscript{45} The \textit{Harr} court, however, required only "that the insured has met his burden by a preponderance of the evidence."\textsuperscript{46} This could mean a verdict for the plaintiff if the jury believed the insured's words only slightly more than the agent's testimony, a result easily arrived at considering the innate bias of the jury against the insurance company.\textsuperscript{47} While the requirement of this relatively light burden of proof is consistent with the supreme court's objective of providing a more easily acquired remedy, it contains an inherent shortcoming in that it renders the court more susceptible to fraudulent claims.

There are also other points with respect to the equitable estoppel issue which have been left unanswered by the court in the instant case, and the manner in which they are answered will greatly determine the effect of the court's ruling in \textit{Harr}. For example, in determining justifi-

\textsuperscript{40} The New Jersey court is not alone in condoning this affirmative use of estoppel in extending the coverage of insurance policies. For example, in Employees' Liab. Assur., Ltd. v. Madric, 54 Del. 146, 174 A.2d 809 (1961), \textit{reversed on other grounds}, 54 Del. 593, 183 A.2d 182 (1962), the Delaware superior court ruled that estoppel is available to bring within the policy coverage risks not covered by its terms or excluded therefrom when an agent misrepresents to insured that the risk is within policy terms, and the insured relies thereon to his detriment.
\textsuperscript{41} 157 Cal. 213, 107 P. 292 (1910).
\textsuperscript{42} Id. at 230, 107 P. at 298.
\textsuperscript{43} Id.
\textsuperscript{44} See note 27 supra.
\textsuperscript{46} 54 N.J. at 307, 255 A.2d at 219.
\textsuperscript{47} Appleman, \textit{Jouner of Policy Holder and Insurer as Parties Defendant}, 22 Modern Law Rev. 75, 81 (1958); \textit{Note}, The Liability Insurer as a Real Party in Interest, 41 MINN. L. REV. 784, 786 (1957).
able reliance, the question of whether the court will ignore entirely the
written policy or view the insured's claim in light of the clarity and
definiteness of the policy on that point remains to be answered. Nor has
the court indicated whether the determination of justifiable reliance is to
be a subjective test as to each individual or an objective standard as to
what the ordinary man would be justified in inferring from the agent's
conduct. Other courts have virtually ignored the written contract when
its terms would deny coverage the insured had been led to believe, by agent
or company action, that he possessed. An additional ambiguity exists
in that the court has in no way clarified what it considers to be the
"appropriate circumstances" it requires to allow the extension of the
policy coverage. Those other jurisdictions abiding by the same rule have
permitted it in all circumstances where equity requires that the policy
be so construed.

One further point that must be taken into account is the effect that
the instant decision will have on insurance companies doing business in
New Jersey. These companies will now be faced with unexpected and
unanticipated claims arising out of representations made by their agents
and unknown to them. Since these claims were not considered in arriving
at the present premium schedules, the added burden on the companies
will almost certainly necessitate a rise in insurance rates. In essence the
insured in New Jersey will be paying for his new protection by way of
higher insurance costs, as the insurance companies distribute the costs to
those receiving the benefit of this greater protection.

It is submitted that the New Jersey supreme court's ruling in Harr
provides for as great a degree of protection for the unwary purchaser of
insurance in New Jersey as can be found anywhere in the nation. It is
conceded that this new position, allowing equitable estoppel to be used
under appropriate circumstances to extend coverage to risks not provided
for or expressly excluded in the insurance policy, has some possible short-
comings. Yet it must be concluded that making equitable estoppel available
to bar a defense in actions on insurance policies even where the estopping
conduct arose before or at the inception of the contract, has wrought
upon New Jersey law a worthwhile reform long overdue. Whether in
implementing this ruling the courts will create the inequities some have
prophetized remains to be seen, but for the present, at least, it has removed
others which have persisted for many years.

Dennis W. Alexander

where the Massachusetts court refused to permit the company to rely on a policy
provision as to the amount of coverage after it had issued a certificate for a greater
amount; California in Ames v. Employer's Cas. Co., 16 Cal. App. 2d 255, 60 P.2d 347
(1936), ruled the insurer was estopped from enforcing a clause contrary to the policy
ordered by the insured; South Dakota in Craig v. Nat'l Farmers Union Auto. Ins. Co.,
76 S.D. 349, 78 N.W.2d 464 (1956), stated that an insured is not barred recovery
because he failed to read the policy, stating the exclusion of the very coverage the
agent represented as being included.

49. 54 N.J. at 307, 255 A.2d at 219.