Commercial Law: Disclaimer and Limitation of Liability Clause Denied Effect in Tort Action for Nonintentional Misrepresentation

Minn. L. Rev. Editorial Board

Follow this and additional works at: https://scholarship.law.umn.edu/mlr
Part of the Law Commons

Recommended Citation

This Article is brought to you for free and open access by the University of Minnesota Law School. It has been accepted for inclusion in Minnesota Law Review collection by an authorized administrator of the Scholarship Repository. For more information, please contact lenzx009@umn.edu.
Case Comments

Commercial Law: Disclaimer and Limitation of Liability Clause Denied Effect in Tort Action for Nonintentional Misrepresentation

In purchasing data processing services from defendant, plaintiff relied on defendant's nonintentional misrepresentation that an automated accounting system was the only way to obtain a desired inventory control system. The contract, which provided only that defendant would furnish plaintiff with an automated accounting system, disclaimed any express or implied warranties not included in the written contract, and limited defendant's liability to the contract price of approximately $200,000. In more than three years of use, the system failed to provide satisfactory inventory control, although it did perform its accounting function with a reasonable degree of success. The plaintiff sought recovery on the contract for breach of warranty and alternatively in tort for misrepresentation. In awarding damages of $481,000, an amount more than double the contract price, the court held that although the disclaimer and the clause limiting liability were effective to deny plaintiff any recovery in an action on the contract, they were ineffective in a tort action for misrepresentation. *Clements Auto Company v. Service Bureau Corporation*, 298 F. Supp. 115 (D. Minn. 1969).

A small majority of courts, following the leading English case of *Derry v. Peek*, hold that scienter is an essential element of misrepresentation. Those courts that do not require scienter have reached that result by gradually overstepping the boundaries of several theories. Historically, scienter has not been an essential element for rescission of a contract, breach of warranty, misrepresentation resulting in physical (as contrasted to economic) harm or ordinary negligence.

Many courts, proceeding on a negligence theory, came to regard the defendant's knowledge that he did not have a sufficient basis of information to make the representation as equivalent to

---

2. 14 App. Cas. 337 (1889). The court held that an action in deceit does not lie for any misrepresentation that is innocent or merely negligent.
3. Prosser, supra note 1, at 724.
lent to scienter.\textsuperscript{5} It was but a small step then to impose liability where defendant had a belief that the representation was true.\textsuperscript{6}

This final step, which imposes a type of strict liability for misrepresentation, has been recognized and approved since near the turn of the century.\textsuperscript{7} Minnesota is one of a sizable minority of jurisdictions\textsuperscript{8} which do not regard scienter as an essential element of misrepresentation.\textsuperscript{9} The Minnesota rule was stated in \textit{Schlechter v. Felton}:\textsuperscript{10}

[W]here defendant has made a false representation of a material fact, susceptible of knowledge and relating to a matter in which he has an interest, and as to which he may be expected to have knowledge, and makes such statement unqualifiedly and as of his own knowledge, and with intent to induce action, he cannot be heard to say, after the statement has been acted upon by the plaintiff to his damage, that he honestly believed that the statement he made was true.\textsuperscript{11}

Thus, imposition of liability for nonintentional misrepresentation is firmly entrenched in Minnesota law and is gaining acceptance in other jurisdictions. Minnesota makes no distinction between innocent, negligent and intentional misrepresentation.\textsuperscript{12}

---

\textsuperscript{5} Professer, \textit{supra} note 1, at 700.
\textsuperscript{6} "If, when a man thinks it highly probable that a thing exists, he chooses to say he knows the thing exists, that is really asserting what is false—it is positive fraud." Brownlie v. Campbell, 5 App. Cas. 925, 953 (1880), cited in \textit{Schlechter v. Felton}, 134 Minn. 143, 144, 158 N.W. 813, 814 (1916).
\textsuperscript{7} E.g., \textit{Williston, Liability for Innocent Misrepresentation}, 24 \textit{Harv. L. Rev.} 415, 437 (1911).
\textsuperscript{8} Professer, \textit{supra} note 1, at 726.
\textsuperscript{9} Hanson v. Ford Motor Co., 278 F.2d 586 (8th Cir. 1960); Davis v. Re-Trac Mfg. Corp., 276 Minn. 116, 149 N.W.2d 37 (1967).
\textsuperscript{10} 134 Minn. 143, 158 N.W. 813 (1916). \textit{See also} Hanson v. Ford Motor Co., 278 F.2d 586 (8th Cir. 1960).
\textsuperscript{11} 134 Minn. at 147, 158 N.W. at 815.
\textsuperscript{12} E.g., Dorsey Products Corp. v. United States Rubber Co., 21 App. Div. 2d 866, 251 N.Y.S.2d 311 (1964), \textit{aff'd} 16 N.Y.2d 925, 264 N.Y.S.2d 917, 212 N.E.2d 435 (1965). The denomination of misrepresentation seems to be somewhat unclear. Fraudulent misrepresentation exists where there is "scienter" or intent to deceive. "There is . . . no difficulty in finding the required intent to mislead where it appears that the speaker believes his statement to be false." Professer, \textit{supra} note 1, at 715. The difficulty arises in the denomination of those misrepresentations where an intent to deceive does not exist. \textit{Black's Law Dictionary} 752 (rev. 4th ed. 1968) defines \textit{negligent misrepresentation} as "a false representation made by a person who has no reasonable grounds for believing it to be true, though he does not know that it is untrue, or even believes it to be true," and \textit{innocent misrepresentation} as "where the person making the representation had reasonable grounds for believing it to be true." That this difference is difficult to distinguish is further demonstrated by Dean Prosser's statement that "A representation made with an honest belief in its truth may still be
The court considered five representations in *Clements*, primarily defendant's statement that the *only way* plaintiff would ever get an inventory control system was by automating its accounting.\(^\text{13}\) The court recognized that there was no proof that the defendant knew the statement was false "when it was uttered,"\(^\text{14}\) but found this fact immaterial because scienter is not required.\(^\text{15}\) The other four representations were subsidiary to the promise of inventory control and dealt with various aspects of implementing the system. Of all five representations, the court found that the defendant either knew them to be false or, "which is more likely, asserted [ther] as of its own knowledge without knowing whether they were true or false."\(^\text{16}\) On the basis of the court's finding of facts there seems to be little doubt that the Minnesota requirements for misrepresentation were satisfied.\(^\text{17}\)

Having found liability for misrepresentation, the court considered the effect of the warranties. Although the Uniform Commercial Code, which was adopted in Minnesota after

\[\text{negligent, because of lack of reasonable care in ascertaining the facts, or in the manner of expression, or absence of the skill and competence required by a particular business or profession.} \text{ Prosser, supra note 1, at 719.}\]

\(^{\text{13.}}\) 298 F. Supp. at 125.

\(^{\text{14.}}\) Id. at 126.

\(^{\text{15.}}\) Id., citing the following cases: Lack Indus., Inc. v. Ralston Purina Co., 327 F.2d 266, 277 (8th Cir. 1964); Hollerman v. F. H. Peavey & Co., 269 Minn. 221, 228, 130 N.W.2d 534, 539 (1964); Swanson v. Domning, 251 Minn. 110, 114, 86 N.W.2d 716, 720 (1957); Spiess v. Brandt, 230 Minn. 246, 252, 41 N.W.2d 561, 566 (1950).

\(^{\text{16.}}\) 298 F. Supp. at 131.

\(^{\text{17.}}\) The court summarized the requirements for misrepresentation as follows:

1. There must be a representation;
2. That representation must be false;
3. It must have to do with a past or present fact;
4. That fact must be material;
5. It must be susceptible of knowledge;
6. The representer must know it to be false, or in the alternative, must assert it as of his own knowledge without knowing whether it is true or false;
7. The representer must intend to have the other person induced to act, or justified in acting upon it;
8. That person must be so induced to act or so justified in acting;
9. That person's action must be in reliance upon the representation;
10. That person must suffer damage;
11. That damage must be attributable to the misrepresentation, that is, the statement must be the proximate cause of the injury.

Id. at 125.
contract in the present case had been made but before the litigation arose, does not specifically apply to contracts involving services, it should be considered an indication of modern policy in commercial law.

Express warranties may not be disclaimed under section 2-316 but may be excluded by the parol evidence rule in section 2-202. Section 2-202 provides that a writing intended by the parties as the final expression of their agreement cannot be contradicted by parol evidence but may be explained by evidence of consistent terms unless the court finds that the writing was to be an exclusive statement of the agreement. Most disclaimers, including the one in the present case, seek to present the contract as an integration and thus could be construed as exclusive agreements under section 2-202. This section is intended to allow sellers to prevent buyers from making false claims of oral warranties.

In addition, sections 2-718 and 2-719 of the Code expressly allow contracting parties to limit liability arising under Article 2 of the Code, as long as the stipulated amount is reasonable in light of the possible damages. Such a result gives force to the public policy sustaining the right of contract unless the contract violates a principle of greater importance.

Thus, in holding that the disclaimer sufficed to deny the plaintiff recovery on breach of express warranty and that the clause limiting liability was valid with respect to any contract claim, the court's decision was consistent with the provisions of the Code. However, the court reached a different result by applying the Minnesota law of misrepresentation. Unfortunately the court did not clearly present the rationale or authority for denying effect under the misrepresentation claim to both the disclaimer and the provision limiting liability, but merely stated that clauses limiting liability "do not limit the recovery for fraud or misrepresentation." The two cases on which the court relied to support this proposition hold that misrepresentation vitiates the contractual relationship of the parties, but in both cases the

19. Id. at 859.
21. 298 F. Supp. at 139.
22. Id. at 140.
23. Id.
misrepresentation, unlike that of the present case, was intentional.

The decision may, however, be partially reconciled with both the Code and Minnesota case law. While the Code is an attempt to codify the law applicable to most commercial transactions, the draftsmen realized that it could not possibly anticipate all situations. Thus, section 1-103 allows the principles of law and equity relative to fraud and misrepresentation to supplement the provisions of the Code unless specifically displaced by particular provisions thereof. This section is consistent with the Minnesota rule of statutory interpretation that a statute will not be construed as abrogating a well established principle of law unless such intention is clearly expressed in the statute.

The Minnesota rule regarding the treatment of disclaimers where there has been misrepresentation is best explained in National Equipment Corporation v. Volden where a buyer claimed that purchased equipment conformed to neither the seller's oral nor written representations. Although the contract contained both a disclaimer and an integration clause, the court held that parol evidence was admissible to show that the contract was procured through misrepresentation, whether intentional, negligent or innocent.

If the rule denying validity to disclaimers in cases of non-intentional misrepresentation seems to undercut the policy set out in section 2-202 of the Code, it must be remembered that liability may be escaped entirely if the seller qualifies his representation by stating that it is only an opinion or by indicating the source of the information on which the statement was based. The actual utility of this tool, however, is somewhat

26. 190 Minn. 596, 252 N.W. 444 (1934).
27. Id. at 598, 252 N.W. at 445. The court did not discuss whether there was scienter on the part of the seller, but adopted the definition of fraud set down in Helvetia Copper Co. v. Hart-Parr Co., 137 Minn. 321, 324, 163 N.W. 665, 667 (1917): "The representations were unqualified and must be treated as assertions of fact within the knowledge of the [seller], the falsity of which constitutes fraud as a matter of law."
28. In Schlechter v. Felton, 134 Minn. 143, 147, 158 N.W. 813, 815 (1916), the court said:
The rule [liability for misrepresentation without scienter] seems to us consonant with practical justice. It does the defendant no injustice. If his information is not absolute,
uncertain. There has been no indication as to how much specificity is required, and because of the nature of the problem, this question may be difficult to resolve. The validity of a specific disclaimer has also been questioned on the ground that it would allow a deliberate cheater to get away with fraud.\textsuperscript{29} This criticism, however, loses force where the misrepresentation is not deliberate.

No prior Minnesota case specifically deals with the effect of a misrepresentation on a clause limiting liability. There are, however, cases in Minnesota and in other jurisdictions that support the general rule that parties to a contract may "protect themselves against liability resulting from their own negligence."\textsuperscript{30} This general rule is reinforced by sections 2-718 and 2-719 of the Code which allow contracting parties to limit or alter the measure of damages under Article 2. While these provisions are not directly applicable because Article 2 does not define the damages recoverable for misrepresentation,\textsuperscript{31} the misrepresentations could be analogized to statements of fact which constitute express warranties under section 2-313. Although section 2-316 does not allow disclaimers of express warranties, section 2-316(4) provides that remedies for breach of warranty (express or implied) may be \textit{limited} in accordance with section 2-719.

A further analogy can be drawn to section 1-102(3) of the Code by comparing the obligations of a seller under the Minnesota law of misrepresentation to the obligations of good faith, diligence, reasonableness and care prescribed by the Code. These obligations cannot be disclaimed but the parties may agree upon reasonable standards for the performance of such obliga-

\begin{itemize}
\item \textsuperscript{29} Recent Developments, 59 \textit{COLUM. L. REV.} 525, 527 (1959).
\item \textsuperscript{31} Section 2-721 of the Code states that remedies for misrepresentation "include" all the remedies available under Article 2, but does not limit the remedies to those available thereunder.
\end{itemize}
tions. The policy suggested by this section would support a rule which allows the parties to avoid the high standards imposed by the Minnesota law of misrepresentation by specifically disclaiming, or at least limiting, liability for innocent misrepresentation.

There are also policy reasons which support the argument that to allow parties to limit liability is desirable. If the limiting clause is within the scope of permissible agreement and the intention of the parties is reasonably apparent, "public policy dictates that they be bound by the agreement made." If the agreement to limit liability was made when the parties were specifically thinking of the contingency of the failure of the contract, it would seem that their anticipated damages would not be dependent upon the reason for the failure. In addition, the degree of fault warrants a narrower liability for nonintentional than for intentional misrepresentation.

In denying validity to the disclaimer, Clements is in accord with section 1-103 of the Code and the treatment of disclaimers as exemplified by National Equipment Corporation v. Volden. The result may possibly be avoided by the use of a specific disclaimer. The court, however, should have given effect to the clause limiting liability. Such a result would fulfill the apparent intent of the parties, and give effect to the policy suggested by the Uniform Commercial Code.

While it is entirely proper for the court to generally ignore distinctions between the various types of misrepresentations, distinctions ought to be drawn when a specific disclaimer or limitation of liability clause is involved. Only when such clauses are evaluated with respect to the seller's degree of fault can the policies of the Code be given effect and a proper balance struck between protecting the buyer and maintaining freedom of contract.

33. See Lack Indus., Inc. v. Ralston Purina Co., 327 F.2d 266, 278 (8th Cir. 1964).
34. 190 Minn. 596, 252 N.W. 444 (1934).
35. See text accompanying note 30 supra.
Constitutional Law: Garnishment Without Notice
and Hearing is Denial of Due Process

Plaintiff instituted a garnishment action against defendant and her employer as garnishee. The Wisconsin garnishment statute did not specifically provide for any form of hearing prior to the freezing of the wages. The garnishee's answer stated that it controlled $63.18 of defendant's unpaid wages and that it would pay one-half to petitioner as a subsistence allowance and hold the other half subject to the order of the court. The Wisconsin Supreme Court sustained the lower court's holding that the garnishment procedure did not violate the due process requirement of the fourteenth amendment. The United States Supreme Court reversed, holding that absent notice and a prior hearing, such garnishment procedure amounted to a deprivation of property without due process of law, in violation of the fourteenth amendment. Sniadach v. Family Finance Corporation, 395 U.S. 337 (1969).

Garnishment is a statutory proceeding whereby property, money or credits controlled by a third party (the garnishee) are subjected to a judgment or potential judgment against the actual owner of the property. Thus, garnishment proceedings are not independent actions, but are ancillary to the action establishing the debt. Whoever prevails in the principal action obtains the right to proceed against the garnishee for the collection of the debt or ownership of the property. The most common form of garnishment occurs where the property consists of the

3. Wis. Stat. Ann. § 267.18(2)(a) (Supp. 1969) reads as follows: When wages or salary are the subject of garnishment action, the garnishee shall pay over to the principal defendant on the date when such wages or salary would normally be payable a subsistence allowance, out of the wages or salary then owing, in the sum of $25 in the case of an individual without dependents or $40 in the case of an individual with dependents; but in no event in excess of 50 per cent of the wages or salary owing. Said subsistence allowance shall be applied to the first wages or salary earned in the period subject to said garnishment action.
earned wages of the principal defendant while they are still in the hands of his garnishee-employer.

Traditionally, garnishment has been considered to be but a form of attachment, since the latter remedy can reach property controlled by the principal defendant in addition to that controlled by third parties. Attachment, however, is usually subject to more stringent controls than is garnishment, for attachment often requires a bond and is available only in limited circumstances. Even though the summary nature of the proceedings makes garnishment more easily available and results in stricter statutory construction, many states do not have separate garnishment statutes; rather, general attachment procedures are applied to garnishment actions.

Since garnishment is exclusively a statutory remedy, each state has separate and distinct laws and procedures relating to wage garnishment. Three general approaches may be discerned. One approach prohibits any form of wage garnishment. Pennsylvania, for example, statutorily exempts all unpaid wages and salaries from garnishment. Texas accomplishes the same result by constitutional provision. A second approach provides creditors with a readily accessible garnishment procedure. The former Minnesota statute is an example of this approach, requiring as a prerequisite for garnishment proceedings only the filing

---

7. See Wood v. Bangs, 199 Minn. 208, 210, 271 N.W. 447, 448 (1937). The court stated that garnishment is not subject to the same or similar safeguards as attachment proceedings; thus garnishment statutes should be more strictly construed. Note that, historically, attachment statutes are narrowly drawn and usually require a bond. See, e.g., Minn. Stat. §§ 570.02-03 (1967).
11. "No current wages for personal services shall ever be subject to garnishment." Tex. Const. art. 16, § 28 (1876).
of an action for the recovery of money. A third approach requires the same prerequisites to garnish wages as required by the typical attachment statute. The new Minnesota statute falls into this classification. The statute allows garnishment only after judgment or default except for the purpose of establishing quasi in rem jurisdiction or when the garnishee may be liable as guarantor or insurer for the claim asserted against the debtor in the principal action. If garnishment is allowed, the


plaintiff is restricted as to the amount of wages which may be reached, and under certain circumstances, the debtor's wages may be exempt from garnishment.

The results under prejudgment garnishment statutes have been characterized as vicious, allowing "loan sharks and collection agencies practically to blackmail a debtor by tying up his wages in advance of proving the validity of their claim, and without prior notice of intent to attach." Commentators have stated that such practices might well lead to bankruptcy and loss of the principal defendant's job. There are those, however, that believe in the necessity of a prejudgment garnishment procedure. Without prejudgment garnishment, the defendant in the principal suit could collect his wages, quit his job and either leave the jurisdiction or move—thus rendering the expenses of collection prohibitive.

Two state supreme courts had held that prejudgment garnishment or attachment was not violative of due process. In Byrd v. Rector, the West Virginia court held that due process was not violated because there had been no deprivation of property. The court reasoned that the property subject to garnishment is detained only temporarily and if judgment is later rendered before the entry of judgment the parties for the purposes of this act will be known as judgment debtor or judgment creditor respectively.

17. Minn. Stat. § 571.41 (1967), as amended, (Minn. Sess. L. Serv. ch. 1142 (1969)) limits garnishment to (1) an amount equal to eight times the number of business days and paid holidays (not to exceed five per calendar week) in the pay period, multiplied by the federal minimum hourly wage then in effect, or (2) 75 percent of the "disposable earnings" during the pay period, whichever is greater. Cf. 15 U.S.C. § 1673 (Supp. IV, 1969), discussed at note 41 infra.

18. Minn. Stat. § 571.41 (1967), as amended, (Minn. Sess. L. Serv. ch. 1142 (1969)) provides that one who has been a recipient of relief based upon need or an inmate of a state correctional institution shall, upon his return to private employment, be exempt from garnishment for six months.


20. See Brunn, supra note 10, at 1236.


23. 112 W. Va. 192, 163 S.E. 845 (1932).

24. Id. at 198, 163 S.E. at 848. The court could have decided the constitutional issue on the fact that defendants were nonresidents and in personam jurisdiction was unobtainable. Id. at 198, 163 S.E. at 848.
dered, the deprivation is the result of that judgment. Thus, the deprivation, if any, will occur only after defendant has had full opportunity to be heard in defense of the claim.

In *McInnes v. McKay*, the Maine court upheld the constitutionality of a prejudgment attachment procedure. Even though the court dealt with attachment rather than garnishment, the procedures involved are so similar that certain comparisons can be drawn. The court stated that it did not consider the attachment to be a deprivation of property within the meaning of the fourteenth amendment since the procedure was merely conditional and temporary. The court further stated that if there were a deprivation of property, it was not without due process since the attachment was merely a part of a process affording both notice and an opportunity to be heard before final deprivation could occur. The United States Supreme Court affirmed *McInnes* per curiam on the basis of two prior decisions, neither of which were factually similar to *McInnes*. It is apparent that the Court considered due process requirements in summary proceedings in general rather than specific terms. Prior to *Sniadach*, the Court had never addressed itself to the precise question of whether prejudgment wage garnishment—specifically, the interim freezing of wages without a hearing—violated the due process clause of the fourteenth amendment.

The Court, per Justice Douglas, reasoned that a procedure that might satisfy due process requirements for attachments in general does not necessarily satisfy procedural due process requirements in all cases. The Court pointed out the hardships

---

25. 127 Me. 110, 141 A. 699 (1928).
26. The *Sniadach* Court recognized such similarities. See 395 U.S. at 340.
27. 127 Me. at 116, 141 A. at 702.
28. *Id.* at 116, 141 A. at 702.
29. 279 U.S. 820 (1928).
30. *Coffin Bros.* v. *Bennett*, 277 U.S. 29 (1928); *Ownbey v. Morgan*, 256 U.S. 94 (1921). *Coffin Bros.* concerned the foreclosure of a lien on the value of the defendant's ownership in bank stock. *Ownbey* concerned foreign attachment and the requirement of special bail or surety's undertaking as a prerequisite before the defendant could appear and contest on the merits. The *McInnes* Court apparently felt that although the facts of *Ownbey* and *Coffin Bros.* were not similar to *McInnes*, the summary procedures involved concerned the same questions as to procedural due process and thus the cases were valid precedent. The *Sniadach* Court distinguished these cases because it determined that the end results of the procedure outweighed the procedure itself, and more importantly, that the procedure in the case could not be separated from the type of property involved.
that might result from prejudgment wage garnishment. The loss of income might well deprive the wage earner's family of adequate clothing and other necessities. In addition, the wage earner might face the loss of his job and other sources of income. Because of these severe hardships, the Court found an obvious deprivation of property. Since notice and prior hearing were not required by the statute, the Court held that fundamental principles of due process were violated.

The Court distinguished four decisions other than McInnes by briefly stating that the cases involved "special protection to a state or creditor interest" and thus due process could have been satisfied by a summary procedure.32 Coffin Brothers v. Bennett33 and Fahey v. Mallonee34 both concerned regulation of the banking business. Ownbey v. Morgan,35 which concerned foreign attachments and Ewing v. Mytinger & Casselberry, Incorporated,36 which concerned procedures under the Food and Drug Act, also presented special situations. There is no question that each of these cases can be easily distinguished from Sniadach in the sense that different assets and defendants were involved. The procedures involved, however, are similar and should not be distinguished so readily. All of the cases involve the prejudgment freezing of an asset without prior hearing, and regardless of the nature of the asset—whether it be stock in a corporation, money in a bank account or unearned wages of a defendant—a finding of lack of procedural due process in one would seem to require the same finding in another. The Court in Sniadach obviously disagreed, and felt that a balancing process should be utilized at least as far as wages are concerned. The Court balanced Wisconsin's legislative determination that creditors need garnishment protection with the possibly severe harm that might result from the procedure and determined that the latter outweighed the former.

It is apparent that prejudgment wage garnishment statutes "of the Wisconsin type" will be considered unconstitutional under Sniadach. The problem facing many state legislatures today is what exactly was meant by "prejudgment garnishment of the Wisconsin type?"37 Since the decision did not declare all

32. Id. at 339.
33. 277 U.S. 29 (1928).
34. 332 U.S. 245 (1947).
35. 256 U.S. 94 (1921).
37. 395 U.S. at 341. The Minnesota statute in effect before the recent amendments to the garnishment statutes was MINN. STAT. § 571.41
wage garnishment unconstitutional, it must be assumed that a statute could survive if the procedural defects were corrected by providing for notice and hearing. The problem of notice is merely a statutory formality which can easily be cured. The more difficult question is whether a full trial on the merits must precede garnishment or whether some proceeding short of a full trial will suffice. It is likely that a number of states will establish a procedure whereby prejudgment wage garnishment may be initiated upon a showing of probable cause. Such action would be initiated by the plaintiff, and the defendant would be notified and given an opportunity to be heard. This type of procedure would parallel the preliminary hearing in criminal law and might satisfy the objections raised by the Court but it is likely that many of these hearings would establish probable cause only by default—the defendant failing to appear. The Court determined only that prejudgment wage garnishment, or at least the threat of such, was the evil it had to eliminate. This has been the real club in the hands of creditors and it is thus far unclear what constitutional limits will be set.

Although the Court placed a great deal of emphasis upon the social and economic hardships caused by wage garnishment, it is unlikely that the Court would accept a statute merely providing greater exemptions for subsistence wages. Even though all states have some type of exemption from wage garnishment, no mention of this was made by the Supreme Court. Furthermore, the Court was well aware of the Truth in Lending Act since it cited section 1674, which forbids discharge from employment because of garnishment. The Court completely neglected, however, to mention section 1673 of the Act which will establish a minimum garnishment exemption for all state statutes. It seems certain, therefore, that providing higher exemptions will not correct the procedural problems involved.

(1967). This statute is certainly “of the Wisconsin type” as stated in Sniadach because of the total lack of protective standards and the ease with which the remedy is available.

38. See Comment, Wage Garnishment in Washington, supra note 21, at 749-54.
39. See Brunn, supra note 10, at 1250-53.
41. 15 U.S.C. § 1673 (Supp. IV, 1969) provides that the amount of an individual’s aggregate disposable earnings subject to garnishment may not exceed the lesser of (1) 25 percent of his disposable earnings, or (2) the amount by which his disposable earnings exceed 30 times the federal minimum hourly wage then in effect.
42. Following the same reasoning, it would seem that the elimination of other hardships, such as forcing new payment schedules or
Another question presented by Sniadach is the future validity of prejudgment attachment of personal property other than wages. The Court placed great emphasis upon socio-economic statements concerning wage garnishment. Consequently, it seems clear that the Court intended to limit the scope of the decision solely to wages. The opinion stated: “We deal here with wages—a specialized type of property presenting distinct problems in our economic system.” The Court indicated that wages were unique in presenting severe economic abuses when treated with a summary procedure. This might imply that similar garnishment of a different form of property, such as that involved in McInnes, would not be unconstitutional. The Court could, however, enlarge the scope of its decision and focus solely on the procedures provided by the statute. Sniadach established that a temporary freezing is a deprivation of property within the meaning of procedural due process. The only step remaining is to extend this rule to all forms of property, and McInnes will be overruled.

A similar result might follow where attachment or garnishment is used to establish quasi in rem jurisdiction. The recently passed Minnesota garnishment statute deserves attention here. Subdivision 2 not only permits garnishment before judgment but literally before commencement of the main action for the purpose of establishing quasi in rem jurisdiction. Subsections of this statute limit the use of the remedy, but at least one provision might prove unconstitutional. Subdivision 2(1)(c) allows garnishment before judgment if the defendant is a nonresident collection fees on the debtor, would not correct an otherwise unconstitutional statute under Sniadach. Danger of loss of job will be eliminated on July 1, 1970, under section 1674 of the Truth in Lending Act.  

43. See 395 U.S. at 341 n.6.  
44. Id. at 340.  
45. At least two state courts have taken this step, either anticipating an extension of Sniadach or ignoring the special emphasis placed upon wage garnishment in the decision. In Arnold v. Knettle, — Ariz. —, 460 P.2d 45 (1969), the court struck down two writs of garnishment. Only one of these writs garnished wages; the other was on a debt on accounts receivable. The Arizona court based its decision on the similarities between Ariz. Rev. Stat. Ann. § 12-1571 (1956) and the Wisconsin statute struck down in Sniadach. The court looked only to the similarities in procedures and did not mention the wage distinction. In Larson v. Fetherston, — Wis. —, 172 N.W.2d 20 (1969), the Wisconsin court noted the fact that Sniadach made reference only to wages, but stated that no valid distinction could be made between garnishment of wages and other property. The court decided that a due process violation should not depend upon the type of property but upon the procedure involved.  
46. See note 16 supra.
individual or a foreign corporation, partnership or association. *Sniadach* seemed to indicate that such a statute would be constitutional as to a nonresident only if in personam jurisdiction was not readily obtainable.\(^{47}\) The Minnesota statute makes no mention of this requirement and consequently could run into constitutional difficulty.

Subdivision 2(2) is of interest in a nonwage context. Prejudgment garnishment is allowed when the garnishee and the debtor are parties to a contract of suretyship, guarantee or insurance. An example of this might be a garnishment based on the obligation of the insurance carrier to defend the claim brought against the principal defendant. An extension of *Sniadach* would make this practice one of questionable constitutionality without proper notice and hearing.

There are other provisions of doubtful constitutionality within the statute. Subdivision 1 states that a garnishment summons may be issued before judgment if it “shall appear” that the defendant is about to take property which might be required to satisfy the potential judgment out of the state. To avoid abuse of this section, a court must clearly require more than a mere allegation that the debtor will abscond. The statute does not, however, indicate what showing is necessary.

Other sections have similar potentially abusive features. It is unclear what must be proved to show intent to defraud or avoid service under subdivision 2(1)(a). Another area of concern is the extent of the search the plaintiff must make before the court will decide that the defendant cannot be found within the state under subdivision 2(1)(b). Both of these sections are vague, and perhaps intentionally so. But since the Supreme Court has decided that wages and wage garnishment are special areas of constitutional concern, revision of the statute may be necessary.

One remaining problem surrounding the decision in *Sniadach* concerns the legal processes that were utilized to achieve the result. It might be argued that the determination of which creditor interests should receive special protection is a legislative rather than judicial function. On this basis, the decision is subject to attack as an unwarranted intrusion by the judiciary into legislative prerogatives. Although the Court stated that it does not sit as a “super-legislative body,”\(^{48}\) the decision appears to be based upon reasoning which Justice Black, in dissent, called a

---

\(^{47}\) 395 U.S. at 339.

\(^{48}\) *Id.*
usurpation of legislative power. In reaching its decision, the Court did not rely upon valid precedent or legal reasoning as such but rather upon what Justice Black termed "emotional rhetoric." The decision is concerned with the imposition of what the Court called "a most inhuman doctrine" that "may as a practical matter drive a wage-earning family to the wall." The Court emphasized the "tremendous hardship on wage-earners with families to support" and the fact that the "debtor will be under considerable pressure to pay the debt and collection charges in order to get his wages back."

_Sniadach_ will relieve many of the present hardships resulting from wage garnishment. The decision might, however, declare state laws unconstitutional in 40 or more states. Since Congress had recently acted in the field, and consumer protection measures had been drafted into the Uniform Consumer Credit Code, the Court would have been wise to hesitate before replacing Wisconsin's expressed legislative policy with its own. It has been over 60 years since the Court stated: "To what actions the remedy of attachment may be given is for the legislature of a State to determine and its courts to decide ..." Similarly, in 1941 the Court stated:

> We are not concerned ... with the wisdom, need or appropriateness of the legislation. Differences of opinion on that score suggest a choice which should be left where ... it was left by the Constitution—to the States and to Congress.

As stated by Justice Harlan in his concurring opinion, the

49. *Id.* at 345.
50. *Id.* at 344.
52. *Id.* at 341-42.
53. *Id.* at 340.
54. *Id.* at 341, citing Comment, _Wage Garnishment in Washington_, supra note 21, at 753.
55. See statutes cited in notes 13 & 15 supra.
57. Section 5.104 prohibits garnishment prior to judgment and section 5.106 prohibits discharge from employment for reason of employee garnishment. Section 5.105, which sets maximum amounts subject to garnishment, provides that the aggregate disposable earnings of an individual for any workweek subject to garnishment arising from a consumer credit sale, consumer lease or consumer loan shall not exceed the lesser of (1) 25 percent of his disposable earnings for that week, or (2) the amount by which his disposable earnings exceed 40 times the then existing federal minimum hourly wage.
60. 395 U.S. at 343.
thrust of past cases dealing with procedural due process has centered about the notice and hearing required before any deprivation of property can occur. Upon examination of the cases cited, it becomes apparent that the Court in Sniadach is using a constitutional amendment aimed at curing procedural defects to alleviate socio-economic hardships. The most important issue to arise out of Sniadach may prove to be what Justice Black described as the "... plain, judicial usurpation of state legislative power to decide what the State laws shall be."
Constitutional Law: Property Ownership Requirement in School Board Election Is Denial of Equal Protection

Petitioner, a bachelor living with his parents, was denied the right to vote in a local school board election because he did not satisfy the voting requirements imposed by section 2012 of the New York Education Law. This statute provides that, in certain New York school districts, residents who satisfy the necessary age, citizenship and residency requirements may vote in the local school district election only if they also (1) own or lease taxable real property within the district or (2) are parents or have custody of children enrolled in the local public schools. Asserting that he was affected by and interested in the results of these school district elections, petitioner brought suit in federal district court, alleging that section 2012 denied him equal protection of the law in violation of the fourteenth amendment. A three-judge court held section 2012 constitutional and dismissed the complaint. On direct appeal, the United States Supreme Court reversed, holding that section 2012 denied petitioner equal protection of the law in violation of the fourteenth amendment. Kramer v. Union Free School District Number 15, 395 U.S. 621 (1969).

The concept of classification is inherent in the nature of statutory law. Since the very idea of classification is unequal treatment, laws will affect different classes of people in different ways. The Supreme Court has evolved a "traditional test" under which a legislative classification is unconstitutional only if

2. The school board, like all school boards where section 2012 is applicable, not only prescribes textbooks and courses of study, but also formulates the school budget which is then submitted for approval to the qualified district voters in the same annual local election in which petitioner was denied the right to vote. N.Y. Educ. Law §§ 1709, 2021, 2022 (McKinney 1953).
it is based on grounds completely irrelevant to the purpose of the classification.³

In the area of voting rights, however, the Court has recently departed from the use of the "traditional test" in determining the constitutionality of a legislative classification. The departure began when a stricter test of equal protection was applied by the Supreme Court in the 1964 apportionment case of Reynolds v. Sims.⁷ The Court announced that the equal protection clause demanded that a statute denying the exercise of the franchise to some and granting its exercise to others "must be carefully and meticulously scrutinized" to determine whether it furthers a valid state interest.⁸ The extent of the departure was in doubt for one year however, for the Court refused to extend the stricter test to a voting case not involving apportionment in Carrington v. Rash.⁹ The Court refused to explicitly apply either test and merely ruled that the particular classification was not

⁶ See, e.g., McGowan v. Maryland, 366 U.S. 420, 425-26 (1961), where the Court concluded that Maryland's Sunday Closing Laws did not violate the equal protection clause. McGowan is typical of the application of the "traditional test." Generally, the test has been that a legislative classification does not violate the equal protection clause so long as its relationship to the state's purpose is not "irrational," "irrelevant," "unreasonable," "arbitrary" or "invidious." Harper v. Virginia Bd. of Elections, 383 U.S. 663, 673-74 (1966) (Black, J. dissenting). Lassiter v. Northampton County Bd. of Elections, 360 U.S. 45, 51 (1959), applied the "traditional test."⁷ 377 U.S. 533 (1964). In this case the voters in several Alabama counties brought suit, alleging that malapportionment of the Alabama legislature deprived them of equal protection of the law under both the United States and Alabama constitutions. The Court held that the representatives of both houses must be apportioned by population. See Note, The Supreme Court, 1963 Term, 78 Harv. L. Rev. 179, 248 (1964) and Note, Apportionment, 43 Tex. L. Rev. 236 (1964). Among the other reapportionment cases which were decided similarly and on the same day as Reynolds are WMVMCA, Inc. v. Lomenzo, 377 U.S. 633 (1964); Maryland Comm. for Fair Representation v. Tawes, 377 U.S. 656 (1964), and Lucas v. Forty-Fourth Gen. Assembly, 377 U.S. 713 (1964).⁸ Reynolds v. Sims, 377 U.S. 533, 562 (1964). This same test, however, had been previously applied by the Court when the basis of classification was inherently suspect (such as race) regardless of the subject matter of the statute (i.e., these cases are exceptions to the general equal protection case where the "traditional test" is applied). See, e.g., McLaughlin v. Florida, 379 U.S. 184, 192 (1964) (race); Takahashi v. Fish & Game Comm'n, 384 U.S. 410, 420 (1968) (alienage); Oyama v. California, 332 U.S. 633, 640 (1948) (nationality).⁹ 390 U.S. 59 (1968). The case involved a provision of the Texas constitution which barred all servicemen who had moved to Texas during their military service from voting in any state election while they remained members of the armed forces.
“reasonable.”

The Court's reluctance to extend the use of the stricter test to a nonapportionment voting rights case ended with the 1966 case of Harper v. Virginia Board of Elections, invalidating a poll tax requirement in an election of state representatives. The Court, applying the stricter test, concluded that "where fundamental rights and liberties are asserted under the Equal Protection Clause, classifications which might invade or restrain them must be closely scrutinized and carefully confined." Thus, prior to Kramer, the Court had applied the stricter test of equal protection only in the apportionment cases and in a case involving a state legislative election.

The Court in Kramer, applying the stricter test, held that the additional voting requirements of the New York statute deprived an otherwise qualified voter of equal protection guaranteed by the fourteenth amendment. The Court justified its application of the stricter test by reasoning that the close scrutiny given to state apportionment statutes which merely dilute the citizen's vote should a fortiori require close scrutiny of a statute which denies the franchise. The close examination of the statute would, in turn, reveal whether the classification is in fact necessary to promote a valid state interest.

The Court concluded that the traditional test was inappropriate by reasoning first that Harper is controlling and second, 380 U.S. 89, 91-96 (1965).


12. 383 U.S. at 670. The majority rejected the dissenters' arguments that the traditional test should be applied and that the poll tax should be upheld because there exists a rational relationship between the tax and the voting right—namely, that those who pay poll taxes are more interested in furthering the well-being of the state.

13. See note 1 supra.

14. 395 U.S. at 626.

15. Id. at 628. As the dissent notes, however, Harper dealt with a state legislative election while Kramer dealt with a "special-purpose" type of election. Id. at 640 n.10.
that the traditional test rests on the assumption that "the institutions of state government are structured so as to represent fairly all the people." Thus, when the "challenge to the statute is in effect a challenge of this basic assumption, the assumption can no longer serve as the basis for presuming constitutionality."17

The Court then considered the issue of whether section 2012 was necessary to promote a legitimate state interest. The state argued that the purpose of the classification was to limit the vote to those citizens who were "primarily interested" in school affairs. The Court, without reaching the question of whether or not the state's purpose was a "compelling" one, held that the classification did not accomplish this purpose with sufficient precision to justify denying appellant the franchise.18 The Court concluded that section 2012 would permit people who are disinterested in the outcome to vote, while disenfranchising persons such as petitioner who are sincerely and directly interested in the outcome of such elections.19

The dissent20 maintained that the traditional test should have been applied since the majority's justification for the application of the stricter test was erroneous in two respects—Harper was not controlling21 and the "state government" was fairly structured. It responded to the majority's assertion that the assumption upon which the traditional test rests was in effect being challenged by petitioner's arguments, by stating that there is "no claim whatever here that the state government is not structured so as to represent fairly all the people."22 In support of this statement, they reasoned that since section 2012 was promulgated by the state legislature and not the school district and since petitioner could still vote in the state legislative election,

---

16. Id. at 628. The dissent used the words "state government" instead of "the institutions of state government" when it attacked the majority's reasoning. Id. at 639. See text accompanying note 32 infra.
17. Id. at 628.
18. Id. at 633.
19. For example, appellant resides with his parents in the school district, pays state and federal taxes and is interested in and affected by school board decisions; however, he has no vote. On the other hand, an uninterested unemployed young man who pays no state or federal taxes, but who rents an apartment in the district, can participate in the election. Id. at 632 n.15.
20. The dissenting opinion was written by Justice Stewart, joined by Justices Black and Harlan.
21. See note 15 supra.
22. 395 U.S. at 639.
he was not being “locked into any self-perpetuating status of exclusion from the electoral process.” The dissent concluded that section 2012 should be upheld under the traditional test since it was as rational a classification as those admittedly valid—age, residency and literacy.

While the dissent’s reasoning may at first appear to be plausible, a closer examination indicates its weaknesses. First, the analogy of the section 2012 classification to age, residency and literacy qualifications is without solid support. For example, the requirement of a reasonable voting age is clearly different from the requirements of owning or leasing real property or having children enrolled in local schools. A minor will come of voting age through a natural process, but a voter in appellant’s position must take affirmative action to satisfy the additional voting requirements of section 2012. Hence, the minor is excluded only temporarily whereas appellant is excluded for an indefinite period of time and perhaps a lifetime. The dissent’s analogy of the section 2012 requirements to residency and literacy requirements is weakened by the fact that the cases involving residency and literacy requirements were decided before the stricter standard was extended to nonapportionment voting rights cases. If those cases were now to come before the Supreme Court, it is quite probable that the newer standard of equal protection would be applied. This is not to say that different results would be reached—only that a different method

23. Id. at 640.
24. Id. at 637.
25. Id. at 637-41.
28. Harper v. Virginia Bd. of Elections, 383 U.S. 663 (1966) was the first case to apply the stricter test of equal protection to state voting requirements.
29. The stricter standard was first announced in 1964 in Reynolds v. Sims, 377 U.S. 533 (1964), an apportionment case. Its first application outside the apportionment field came in Harper v. Virginia Bd. of Elections, 383 U.S. 663 (1966), where it was applied to state voting requirements in a state election. The Court had had the opportunity to apply the new standard in Carrington v. Rash, 380 U.S. 89 (1965) but, as previously discussed (see text accompanying note 10 supra), the Court declined to explicitly use either the traditional or the stricter test and instead hedged the question—deferring the question for one year until Harper. That hedging in Carrington, together with the explicit use of the stricter test one year later in Harper, is a strong indication that the Court will not use the traditional test in future voting rights cases.
would be applied to decide each of the cases.

The dissent's second argument—that the majority's justification for applying the stricter standard of equal protection was erroneous—is also open to rebuttal, even though it may be true, as the dissent observes, that Harper is not necessarily controlling. The majority stated that "the institutions of state government" were structured unfairly. In support of its claim, the majority reasoned that although section 2012 was enacted by the state legislature, it nevertheless delegated decision-making to people who are elected by only a portion of those eligible to vote in the legislative elections. The majority considered such a delegation to be tantamount to a denial of the franchise at the legislative level. Thus, the dissent did not address itself to the issue discussed by the majority.

Moreover, two important rationales, unmentioned in the opinion, can be advanced to refute the minority's assertions. First, to deprive petitioner and others similarly situated from voting in school district elections is tantamount to depriving such persons of control over the matters which the school board decides. Thus a very important state institution becomes unfairly structured. The minority's second argument—that the state government is fairly structured since petitioner can still vote in the state legislative elections—is open to a further objection. The minority's view overlooks the fact that if a voter is denied the vote in school district elections, he is also denied a significant degree of control over government as a whole. Local school boards exercise a considerable part of that political power which has been diffused among the various levels of government. For example, since state and federal governments are major sources of revenue for local schools, a denial to petitioner of his vote in school district elections is equivalent to a denial of equal control over the expenditure of tax money col-

31. See note 15 supra.
32. 395 U.S. at 828.
33. Legislation which delegates decision making to bodies elected by only a portion of those eligible to vote for the legislature can cause unfair representation. Such legislation can exclude a minority of voters from any voice in the decisions just as effectively as if the decisions were made by legislators the minority had no voice in selecting.
35. Id.
lected by the state and federal governments. 36

While the majority's holding is justified on the basis of the foregoing analysis, the Court leaves a number of crucial questions unanswered. For example, the Court gives no indication of what constitutes a "state institution" which now must be fairly structured so as to represent all the people. Further, it is unclear in what other types of "special elections" Kramer would be controlling. The fact that the Court did not utilize available arguments 37 relating specifically to the nature of the educational system tends to indicate that it did not wish to limit the precedential value of this case to an education election. Moreover, the companion case of Cipriano v. City of Houma 38 makes it quite clear that Kramer will be applied in future cases dealing with other types of special elections. 39

Another question Kramer leaves unanswered is whether the state's purpose in limiting the franchise to those "primarily interested" 40 is itself a "compelling state interest." Since the Court did not reach the issue of the nature of a "compelling state interest," Kramer does not indicate what voter requirements a state may legitimately impose. It only indicates that if a state does impose restrictions those restrictions must be tailored with "sufficient precision" to justify the denial of the franchise. 41

Finally, it is unclear how precise the statute must be in order to meet the Court's standard of "sufficiently tailored." The Court's only indication of the degree of precision required under the stricter test is its statement that "the classifications of section 2012 permit inclusion of many persons who have, at best, a remote and indirect interest in school affairs and on the other

36. Id. at 77.
37. The Court never discussed the importance of our educational system nor did it utilize any of the arguments of the dissenting judge in the district court. See text accompanying note 34 supra.
38. 395 U.S. 701 (1969). In Cipriano the Court, citing Kramer for the application of the stricter test of equal protection, found that a Louisiana statute which gave only "property taxpayers" the right to vote in elections called to approve the issuance of revenue bonds by a municipal utility violated the fourteenth amendment. Justices Black and Stewart concurred in the result but applied the traditional test and concluded that "this case involves a voting classification 'wholly irrelevant to achievement' of the State's objective."
39. Cipriano involved a bond election, and like Kramer, the Court never reached the issue whether the state's purpose in limiting the vote to those property owners who had a "special pecuniary interest" was itself a compelling state interest. 395 U.S. 701, 703 (1969).
40. 395 U.S. at 632.
41. Id. at 633.
hand, exclude others who have a distinct and direct interest in
the school meeting decisions."  

These unanswered questions illustrate the weakness of the
stricter test for equal protection. It is very difficult to apply
and thus prediction of which legislative classifications, if any,
could meet the requirements of this test is hazardous. Under
the traditional test the Court had merely to find some rational
relationship between the classification and the state's purpose in
order to uphold the statute. Under the stricter test, the Court
will have to find that the relationship is not only rational but
also that it is so precise and the statute's purpose so compelling
as to justify denial of the franchise.

The result reached in Kramer is justified because of the im-
portance of our educational system to the very functioning of
our society. Further, Kramer makes it clear that the stricter
test of equal protection will be applied in future voting rights
cases. However, since this decision fails to indicate what is
meant by "sufficiently tailored" and thereby fails to mark the
limits of this stricter test, the decisions will likely lead to further
uncertainty and unpredictability in the results of future voting
rights cases.

42. Id. at 632.
43. See note 39 supra.
Patent Law: Licensee Not Estopped From Asserting Invalidity of His Licensor's Patent

Petitioner, Adkins, was hired by respondent, Lear, Incorporated, to invent an improved gyroscope for use in the aviation industry. Adkins subsequently invented a gyroscope and applied for a patent on it. Pursuant to their employment contract, Adkins granted an exclusive license to Lear for patent use and production "know-how." Prior to patent issuance, Lear stopped making royalty payments and Adkins promptly brought suit to collect royalties allegedly due. Lear defended on the ground that the patent was invalid. The trial court directed a verdict for Adkins holding that by its licensing agreement Lear was estopped from asserting the invalidity of the patent. The California Court of Appeals ruled that petitioner should recover royalties based on the license agreement up to the date that respondent announced its intention to terminate payments, regardless of the patent's validity. Any damages after that date, according to the court, must be obtained through an action for infringement. The California Supreme Court affirmed the trial court's use of licensee estoppel and held that royalties were to be paid. The United States Supreme Court reversed, holding that in a licensor's suit to collect agreed-upon royalties, a licensee will not be estopped from attacking the validity of his licensor's patent, and may avoid payment of royalties by proving the patent is invalid. Lear, Incorporated v. Adkins, 395 U.S. 653 (1969).

1. Although the trial court invoked the doctrine of licensee estoppel in regard to gyros manufactured in Lear's California plant, a different approach was used for the gyros manufactured in Lear's Michigan plant. Noting Lear's claim that it had developed its Michigan designs independently of Adkins' ideas, the court instructed the jury to find for the inventor only if it was satisfied that Adkins' invention was novel within the meaning of the federal patent laws. The jury so found and returned a verdict for Adkins on the Michigan gyros. The court, however, having found that it was not novel, granted Lear's motion for judgment notwithstanding the verdict. Adkins v. Lear, Inc., 52 Cal. Rptr. 795, 801 (Dist. Ct. App. 1966).

2. Id. Under the contract principles applied by this court, no distinction was made between the California gyros and the Michigan gyros.

3. Adkins v. Lear, Inc., 67 Cal. 2d 882, 435 P.2d 321, 64 Cal. Rptr. 545 (1967). The court applied the same test as the trial court in regard to the Michigan gyros, but overruled that court's finding that Adkins' invention was not novel, and awarded Adkins royalties for their manufacture.

4. The Court remanded the question of the liability of Lear on the Michigan gyros to the California Supreme Court to be determined in conjunction with the ruling on the patent's validity. 395 U.S. at 676.
The doctrine of licensee estoppel was born in 1846 when the Circuit Court of Massachusetts analogized a licensing agreement to a land lease agreement. The court ruled that the long established principles of the landlord-tenant relationship were equally applicable to licensing, and thus the licensee must pay royalties as long as he obtains the quiet enjoyment of the benefits of the patent, notwithstanding its invalidity. The United States Supreme Court ruled on the licensee estoppel doctrine 10 years later, and also held that a licensee who manufactured under the license was estopped from questioning the validity of the patent.

Thereafter, the doctrine was progressively weakened. While reaffirming the doctrine in United States v. Harvey Steel Company and more recently in Automatic Radio Manufacturing Company v. Hazeltine Research Incorporated the Court, in other cases, has found it necessary to make numerous exceptions and to narrow its limits.

The Court in Lear addressed itself to the issue of whether the doctrine of licensee estoppel should be invoked to prevent Lear from challenging Adkins' patent. The Court emphasized the numerous exceptions which had been made to the general rule, concluded that the decision reached in Hazeltine in 1950 could no longer be considered the general rule, and therefore expressly overruled that decision. The Court conceded that under contract principles, the mere receipt of some benefit is sufficient to require the enforcement of the contract, regardless of the validity of the underlying patent.

---

7. 196 U.S. 310 (1905).
9. See Scott Paper Co. v. Marcalus Co., 326 U.S. 249 (1945) (licensee may introduce prior art taught by an expired patent to determine parties' obligations under current patent); Westinghouse Co. v. Formica Co., 266 U.S. 342 (1924) (licensee may introduce prior state of the art to construe and narrow the claims of the patent).
12. Id. at 671.
13. Id. at 669.
ever, emphasized the fact that the Patent Office reaches its decision as to whether an invention is patentable in an *ex parte* proceeding, without the aid of argument by parties interested in patent validity. When the licensor's equities based on contract law were balanced against the public interest in the free use of ideas which are a part of the public domain, the doctrine of licensee estoppel was given a "decent public burial."  

To effectuate the decision, the Court ruled that if the patent is found to be invalid, the licensee's release from the duty to make royalty payments is retroactive to the *date of issue* of the patent, not merely to the date of patent invalidation or the date of royalty payment stoppage. Noting that often the licensee is the only one in a position to benefit materially from invalidation, the Court sought to give him a real incentive to challenge the patent. The Court also attempted to avoid dilatory court tactics that might be devised by the licensor if the licensee was obligated until the date of invalidation.

In balancing the parties' equities, the *Lear* Court neglected to mention the public policy which encourages licensing as an efficient means of utilizing discoveries. Conceivably *Lear* could have a stifling effect upon inventors entering into licensing agreements. But when consideration is given to the fact that the Patent Office is extremely overworked and that the process of determining novelty is at best difficult,  the policy of protecting only those inventions that actually are novel outweights contract principles and dictates repudiation of the licensee estoppel doctrine. In the aftermath of the *Lear* decision, however, several questions remain unanswered and thus create uncertainty as to future licensing procedures.

First, the incentive given licensees to challenge patent validity could lead to abuse if proper restrictions are not established. After *Lear* the licensee would appear to be strongly tempted to

---

14. *Id.* at 670.

15. The Court reasoned that strict compliance with contract law would permit a licensor to procure a patent by fraud and then by agreement prevent the licensee from challenging the patent. *Id.* at 670.


17. 395 U.S. at 674.

18. *Id.* at 673. The question of the amount of royalties that had accrued prior to patent issuance was remanded to the trial court for determination along with the issue of the validity of the patent.


terminate royalty payments while continuing to manufacture the licensed product or to use the licensed process. Even if a suit to recover unpaid royalties is initiated by the licensor, the licensee would appear to be in an advantageous position. If the patent is declared valid, the licensee must pay only that which he is already obligated under the contract to pay.\footnote{But see text accompanying note 23 infra.} If the patent is adjudged invalid, the licensee may use the former patent free from the threat of an infringement suit, and no royalties after the date of the patent issuance must be paid. The licensee may also be able to use dilatory court tactics, precisely what the Court sought to bar the licensor from using.\footnote{See text accompanying note 18 supra.} If the patent is held valid, the delay has cost the licensee nothing in additional royalties. If invalid, he has extended the period during which he has enjoyed a market monopoly without cost since a competitor would be unlikely to risk infringement and injunction while the patent's validity is undetermined.

The licensee, however, when considering whether or not to terminate his royalty payments, must also evaluate the possibility of other consequences. After the licensee breaches the contract by stopping royalty payments, the licensor has the option of suing for expectation damages in the form of unpaid royalties or of considering the contract obligations to be at an end and bringing an action for patent infringement. If the latter is chosen and if the court finds that the repudiation of the license agreement was undertaken maliciously or only to oppress the licensor, the court may award treble damages to the licensor if the patent is declared to be valid.\footnote{35 U.S.C. § 284 (1964).} It is likely that treble damages would seriously alter the profit picture of the licensed product or process. Liberal use of this safeguard would assure that a licensee seriously consider the outcome of the trial before initiating the suit. Furthermore, the licensee must realize that if the patent is declared valid, the bitterness and antagonism generated between the parties during the course of litigation is likely to make relicensing a distasteful or impossible task.

The Court's reasoning in determining the date of issue of the patent, rather than the date of royalty payment termination or date of patent invalidation, as the cut-off for licensee liability creates further uncertainty. Although in \textit{Lear} royalty payments were stopped before patent issuance, the Court should have realized that in many cases the date of payment termination will...
be long after the date of patent issuance. Clearly, the licensor should not be liable for the return of all payments received subsequent to the date of patent issue due to the obvious inequity that would arise. The licensor would likely find himself in a desperate situation when suddenly required to produce a sum of money which had been received over a number of years and which had long since been spent.

By remanding the question of the parties' pre-patent issue rights to the California Supreme Court,\textsuperscript{24} the Court avoided the question of the disposition of related license agreements for trade secrets and production "know-how." Often a single license agreement specifies both a right to produce the patented invention, and a right to use trade secret or "know-how" information which is conveyed at the same time. If liability for payment for this information is terminated when a patent is held invalid, inequities would appear to result. A licensee could get a head start on his competitors and after obtaining enough trade secret information to secure his efficient production and entrench his market position, he could terminate payment and retain the knowledge without cost. If the Court intended a finding of patent invalidity to affect only the obligations of the patent use, licensors would undoubtedly price the secure "know-how" agreement at a high rate as compared to the insecure obligations under the patent-use agreement. How the courts would police this practice leads to further uncertainty.

Similarly, the Court did not address itself to the question of the inclusion of trade secret information in the patent agreement. In a concurring opinion, however, Justice Black, joined by Chief Justice Warren and Justice Douglas, expressed strong disapproval of the practice of licensing the use of information contained in patent applications.\textsuperscript{25} It appears that Black would pre-empt the states' allowance of any trade secret information licensing on the ground that licenses of this nature restrict free competition by promoting monopolies in that specific field. It is obvious, however, that access to the information contained in undisclosed patent applications is a major incentive to a licensee to enter into such an agreement. If these agreements with their attendant disclosure were eliminated, much of the licensing would no longer be attractive. The result is that the incentive of licensees, relied on by the majority, to challenge the validity

\begin{flushright}
\textsuperscript{24} Prior to patent issuance, the license agreement conveyed only the right to production "know-how."
\end{flushright}

\begin{flushright}
\textsuperscript{25} 395 U.S. at 674, 677.
\end{flushright}
of patents would be lacking and public policy would not be served.

*Lear* strengthens the spirit of the patent laws by assuring protection only to those inventors who deserve it. It does this, however, by encouraging licensees to breach their license agreements and to take a chance on the outcome of litigation. The courts should make liberal use of infringement remedies by issuing injunctions to cease manufacturing and by awarding treble damages where there is deliberate overreaching by the licensee. In addition, the courts should clarify whether, upon a finding of patent invalidity, a licensor is liable for the return of royalty payments made to him after the date of patent issuance, and whether related agreements for trade secrets and production "know-how" are to be terminated along with patent-use agreements.
Securities Regulation: Tipster Not Liable To Tippee Under Rule 10b-5

In January, 1965, the president of the Texstar Corporation, William Rhame, informed his friend, Albert Kuehnert, that Texstar had negotiated a deal to drill two oil wells as “farmouts” on land belonging to an oil company which Texstar was about to acquire. He also told Kuehnert that Texstar’s dividends would be $3.00 per share for the fiscal year. Rhame suggested that Kuehnert purchase enough stock to enable the two of them to obtain control of Texstar. At that time Texstar was selling for $4.25 per share on the American Stock Exchange. As a result of this confidential information Kuehnert began purchasing Texstar stock and by May 1965, owned 94,600 shares. The dividend prediction proved to be excessive and the “farmout” contract a fabrication. Kuehnert was forced by successive margin calls to sell his stock at a loss. Kuehnert sued Rhame under Rule 10b-5 to recover what he had lost by relying on Rhame’s fraudulent representations. The federal district court gave summary judgment for defendants Texstar and Rhame. In affirming, the Fifth Circuit Court of Appeals, one judge dissenting, held that Kuehnert, being a “tippee,” was under the same obligations of Rule 10b-5 to disclose material information as is a corporate insider and was therefore barred by his own illegal conduct from seeking recovery from his “tipster.” Kuehnert v. Texstar Corporation, 412 F.2d 700 (5th Cir. 1969).

Since its promulgation, the scope of Rule 10b-5 has been gradually expanded until at present it is one of the major instruments of securities regulation. Although not expressly authorizing private enforcement of its provisions, Rule 10b-5 has been construed to permit private initiation in accordance with its broad objective of protecting individual investors from

1. Also in May, Rhame resigned as president of Texstar “to devote his time to personal business interests.” The Wall Street Journal, May 14, 1965, at 17, col. 2.
2. 17 C.F.R. § 240.10b-5 (1969). While the complaint also alleged that Rhame had violated 15 U.S.C. § 78j(b) (1964), it did not allege deceit. Kuehnert may have anticipated that in pari delicto would easily be accepted as a defense to a common law action.
fraudulent practices.\(^5\) It is generally conceded that the role of these “private attorneys general” has contributed substantially to the rule's development\(^6\) and most courts have therefore decided upon extensive private recovery.\(^7\)

With the recent decisions of *In re Cady, Roberts & Company*\(^8\) and *Texas Gulf Sulphur*,\(^9\) the antifraud restrictions of the Rule have been extended to encompass not only high corporate officials but also lesser employees and even nonemployees. Included within the last category is the tippee, the one to whom the corporate insider has given the information.\(^10\) Thus, the tippee who fails either to adequately disseminate inside information or to await its adequate dissemination before acting upon it violates Rule 10b-5 and, like the tipster, is liable to a vendor or vendee of stock who is injured in the ensuing transactions.\(^11\) While an innocent third party may recover from one who violates Rule 10b-5, it was not clear whether a tippee was entitled to recover his losses from his tipster when both were admitted violators of the Rule.

Courts have often invoked the doctrines of *in pari delicto* and unclean hands to bar recovery by persons who have themselves participated in illegal conduct.\(^12\) *In pari delicto* denies recovery on the basis that the plaintiff has knowingly participated as an equal in the illegal act which caused the loss.\(^13\) Unclean hands denies recovery because of the more general equitable notion that a court of conscience should not grant relief to one who has himself engaged in either illegal or unfair practices.\(^14\) The relevance of these defenses in modern judicial procedure is in dispute and at least one prominent authority has concluded that “insofar as [unclean hands] is a principle it is not very helpful but is at times capable of causing considerable harm.”\(^15\)

---

5. Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961).
11. 412 F.2d at 702 and cases cited therein.
13. Comment, 53 Minn. L. Rev. 827, 828 n.16 (1969) and cases cited therein.
14. Id.
15. Chafee, supra note 12, at 878.
There does seem to be general agreement that the defenses of *in pari delicto* and unclean hands should be viewed less favorably when the plaintiff is asserting a right to recovery based on remedial legislation. In fact, the United States Supreme Court recently held that *in pari delicto* is not available as a defense in a treble-damage antitrust action, reasoning that its allowance would inhibit private suits, which the Court believed to be essential to the constructive development of the antitrust prohibitions.

These defenses have not often been a factor in securities regulation cases. While the unclean hands doctrine has been recognized in the proxy solicitation area, the extent of its acceptance is somewhat unclear. Prior to the *Kuehnert* decision, courts confronted with these defenses in securities fraud litigation, other than in proxy solicitation violations, adopted a comparative analysis approach. Instead of ascertaining only whether the plaintiff had contaminated his own cause, the courts made the defense dependent upon a comparison of the degree of culpability.

---

16. 412 F.2d at 704. See also Shinssaku Nagano v. McGrath, 187 F.2d 753, 759 (7th Cir. 1951). Besides serving the public interest by enforcing statutory prohibitions, an additional reason for not allowing these defenses is that the legislature has expressed its belief that plaintiffs are incapable of protecting themselves and thus their involvement in the misconduct should not be decisive. Remar v. Clayton Sec. Corp., 81 F. Supp. 1014, 1017 (D.C. Mass. 1949).

17. *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968). The Supreme Court, nevertheless, indicated that the defense would be allowed if the plaintiff was "actively supporting the entire restrictive program as such, participating in its formulation and encouraging its continuation." *Id.* at 140. For a discussion of this case, see Comment, supra note 13.


19. In *Gaudiosi v. Mellon*, 269 F.2d 873, 879 (3rd Cir.), cert. denied, 361 U.S. 902 (1959), the leading case, the court had already found the defendants not guilty before it spoke of the plaintiff's own unclean hands. In *Studebaker Corp. v. Allied Products Corp.*, 256 F. Supp. 173 (W.D. Mich. 1966), the unclean hands defense was allowed, but arguably it was more directed to the plaintiff's forum shopping than to any definite violations of the securities acts. And in *Union Pac. R.R. v. Chicago & Nw. Ry.*, 226 F. Supp. 400 (N.D. Ill. 1964), the court actually rejected the defense, finding that the purpose of the proxy solicitation requirements in the securities acts would be defeated if it were allowed.

20. Thus in *Can-Am Petroleum Co. v. Beck*, 331 F.2d 371 (10th Cir. 1964), the court, in analyzing the plaintiff's role, noted that:

   Her relationship as a pure investor became adulterated when she actively assisted in selling others but she at no time had the degree of culpability attributed to defendants and should not be considered as *in pari delicto*.

*Id.* at 373, 374. See also *Katz v. Amos Treat & Co.*, 411 F.2d 1046, 1054 (2d Cir. 1969).
of the plaintiff with that of the defendant. The courts invariably stressed the successful fraud of the tipster rather than dwelling on the tippee's participation. Thus, despite the plaintiff's active assistance in the fraudulent scheme, his degree of culpability was never found sufficient to deny recovery.

In the *Kuehnert* factual context, the Fifth Circuit therefore had to resolve the problem of whether to allow a tippee to recover from his tipster when both were in violation of Rule 10b-5. The court took notice that the unclean hands defense had been allowed to deny relief for a proxy solicitation violation. The court then distinguished the antitrust violation situation on the ground that the degree of public interest served by private enforcement is greater in the antitrust area. If the tippee is permitted to recover from his tipster, the court reasoned that he will then be insured against loss in his transactions. If the information is true he will profit from his financial maneuvers and if it is untrue he can recover from his informant. Believing that the corporate insider is already subjected to adequate restraints by the *Texas Gulf Sulphur* decision, the majority decided it best to give "appropriate discouragement" to the tippee. If the tippee is faced with the prospect of irretrievable loss, he will be less likely to act on unpublicized information. The court therefore concluded that neither the equities of the situation nor the policy considerations of the securities laws justified the further extension of recovery "when the only question is one of accounting between joint conspirators."

The court apparently excluded all tippees from the prote-

---

21. *See Stockwell v. Reynolds & Co.*, 252 F. Supp. 215 (S.D.N.Y. 1965), in which the court was confronted with a clear case of a tippee being injured by acting on inside information which he received from his brokerage firm. Nevertheless, the court consistently spoke of the plaintiff only as a misled investor and continually dwelt on the fraud alleged against the defendants. The court did not even consider the plaintiff's obligations as a tippee.

22. These cases may be distinguishable from the *Kuehnert* situation in that the plaintiffs apparently had not been motivated by an equally fraudulent intent towards the third party vendees.


24. *See note 19 supra.*

25. 412 F.2d at 703.

26. "Apparently" since the majority does refer to *Kuehnert* and *Rhame* as "joint conspirators," possibly implying that a plaintiff who is not a joint conspirator may be entitled to recovery. If this is so, the majority reasoning would more closely approximate that of the Supreme Court in *Perma Life*. 
tion of Rule 10b-5, making no distinction between different types of tippees.²⁷ Thus, once a plaintiff is categorized as a tippee, he is a fortiori considered in pari delicto and denied recovery. Although the court did not analyze the definitional significance of the term “tippee,” it appears to have adopted the broad, unqualified definition of “persons given information by insiders in breach of trust,”²⁸ thereby placing a significant limitation on the extent of potential recovery under Rule 10b-5.

Judge Godbold, in dissent, questioned the wisdom of allowing the in pari delicto defense at all in securities fraud cases.²⁹ He maintained that the public interest in the private enforcement of the securities laws is as great as that served by private antitrust suits. He argued that the dissemination of inside information could be more effectively stopped at its source, the tipster, than at its destination, the tippee. Also, since the tipster is likely to be an important corporate official with access to legal counsel, he can be expected to be better informed of the extent of Rule 10b-5 restrictions.

In analyzing the court’s decision, the first aspect to consider is whether the majority properly applied the in pari delicto defense to the present situation. In pari delicto is usually translated as “in equal fault,”³⁰ and, in accordance with its purpose, the stress should be on “equal” rather than on “fault.” It appears at least questionable whether the defrauded plaintiff’s guilt or fault would ever “equal” that of the fraudulent defendant. As the court aptly stated, Kuehnert was “in fact a dupe,” and “in actuality, Kuehnert knowing nothing, concealed nothing, and hence did not defraud his vendors.”³¹ The tippee is merely the instrumentality or device through which the tipster-initiator accomplishes his fraudulent purpose.³² It is usually the tipster

²⁷ See text accompanying note 35 infra.
²⁹ Judge Godbold in fact explicitly rejects the allowance of the defense in a co-conspirator context, thus going even further than the Perma Life exception. 412 F.2d at 706 n.3. See note 17 supra.
³¹ 412 F.2d at 703-04. Judge Aldrich, however, footnoted this assumption with a caveat that, “[s]trictly speaking, this may have not been so . . . .” Id. at 703 n.5. Of course, once a tippee has entered the market, he has theoretically contaminated any subsequent transaction. But in this context the third party vendors or vendees may be assumed to have actually benefited from the tippee’s misinformation since the market obviously went in the opposite direction from that anticipated by the tippee.
³² Although the court never examines Rhame’s actual motives for misleading Kuehnert, they should also be a component of the deter-
who creates the tippee and who conceives of and induces the fraudulent activities. From either an equitable or a comparative point of view, it would seem that the tippee's degree of culpability would not be as great as that of the fraudulent tipster. Thus, the court's acceptance of in pari delicto as a defense may not be justified on the facts of the case. A more technically correct application would seem to necessitate the comparative approach adopted in the earlier securities regulation cases. Moreover, the court would deny recovery to any party to whom Kuehnert gave the fabricated information, even though as the information passed farther outward from the fraudulent initiator, the degree of complicity and guilt would seem to diminish. All would be categorized as tippees and thus would be in pari delicto with the tipster. Since there are potentially infinite combinations of tippees and tipsters, the court's inflexible and arbitrary classification appears unwise.

The second aspect to consider is whether the majority's decision best fulfills the objectives of Rule 10b-5. The only time a tippee will sue a tipster is when the information is either purposely or accidentally false and the tippee sustains a loss by acting on it. Thus, the real problem is how most effectively to advance the purposes of the securities laws in this limited situation. One of the main purposes of Rule 10b-5 is to prevent the opportunistic dissemination or utilization of inside corporate information. Although the court concluded that the denial of recovery will exert a deterrent influence on tippees, it appears rather wistful to believe that a person given information on a
corporation's prospects by a high corporate official will be inhibited from acting upon it by what legal remedies he may or may not have if the tipster is misleading him. It seems more plausible to assume that a corporate official will be deterred from deceiving potential tippees by the realization that they will be able to invoke statutory assistance to recover their losses from his fraudulent information. Attacking the prepublication dissemination of inside information after it has been communicated and then only by punishing the one to whom it is communicated seems less efficient than applying every possible discouragement to the one who controls this dissemination and who is actually the one who gains from its misuse.37

The court also appears unduly optimistic in its belief that publication of the inside information will expose the tipster's intended fraud on the tippee. The practical obstacles facing the tippee in adequately publicizing the information would seem to warrant placing this burden on one better situated to fulfill its requirements.38 And even if the tippee is able to gain some attention for his predictions, it is nevertheless difficult to agree with the court that disclosure would allow "the free market to probe and evaluate his information."39 It seems more likely that the free market would ignore his information.

What the Kuehnert decision has done is to tell the corporate insider that if he gives out false information to induce action on the part of his tippee, he need not fear private enforcement of Rule 10b-5. The tipster will only be liable when his information is true and a third party vendor or vendee is actually injured. If the tipster restrains himself to defrauding only his tippee, he is free from any potential tippee recovery. On the other hand, if his tippee, given accurate information, defrauds a third party, then the tipster is also liable to the third party. Thus Kuehnert presents the paradoxical situation that the tipster is not liable for his own successful fraudulent actions, but is liable for the successful fraudulent actions of another. This problem can be resolved by looking at each fraudulent relationship separately.

37. See Note, 22 VAND. L. REV. 359, 366 n.36 (1969), which states that the "public interest might be better served by cutting off illicit tips at their source, and one method of realizing this objective would be the disallowance of the in pari delicto defense in a suit by a tippee."

38. But see In re Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961), where the S.E.C. decided that, "If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transac-

39. 412 F.2d at 704.
If the tipster intends to defraud his tippee, he should be made to account for his own fraud. If the tippee intends to defraud the third party vendor or vendee, he should be made to account to the third party. In this way each is held responsible for his own misdeeds and is accountable to those he has injured. There is then a symmetrical recoupment of loss and no one escapes unpenalized. There is deterrence of both the tipster and the tippee, for whatever harm each has caused. This solution would fulfill the statutory intention of the securities laws in protecting the investor in each relationship from fraudulent conduct. The court would merely be putting each party in statu quo ante, so that neither would be receiving any profit from his own violation of Rule 10b-5.

Whether one approaches the decision in terms of the technical application of the in pari delicto defense or in terms of the policy considerations underlying the securities laws, the tippee should be allowed to seek judicial relief. The majority's rigid denial of any tippee recovery will likely have little inhibitive effect on the tippee, while providing unwarranted protection for the tipster. Although it is perhaps unpleasant to allow one wrongdoer to recover his losses from another, in the securities regulation instance this would better accomplish the objective of investor protection. The tipster would thereby be forced to account for his fraud and the tippee, though compensated for his own loss, would be liable for any damage his own actions had caused.

40. Of course, there may be unusual instances where both parties have so involved themselves in the fraudulent undertaking that neither should be allowed to seek recovery from the other. An example of this might be where the tipster secures no advantage from giving the tip and the tippee becomes such an active participant in the scheme as to qualify as the motivating force. Then it may be that neither party would actually be a tippee in the submissive sense of one who receives inside information but both would be active co-conspirators to an unsuccessful fraud. This exception would be consistent with the Perma Life decision. See notes 17 & 26 supra.
Securities Regulation: Corporation Held Liable
Under 16b for Deputy's Short-Swing Sale
After His Resignation as Director

Defendant Martin Marietta Corporation (Martin) purchased 801,300 shares of Sperry Rand Corporation's (Sperry) common stock between December 14, 1962, and July 24, 1963, and subsequently sold them between August 29 and September 6, 1963. Plaintiff, a stockholder of Sperry, brought suit against Martin on behalf of Sperry alleging that defendant had violated section 16b of the Securities Exchange Act of 1934.1 The allegation was based on the fact that George M. Bunker, the president and chief executive officer of Martin, had also been a director of Sperry from April 29 until August 31, 1963. Plaintiff sought recovery of the profits realized by Martin on the sale of the 101,300 shares of Sperry stock which had been purchased while Bunker served on Sperry's board. The Second Circuit Court of Appeals, reversing the district court,2 held that Martin had "deputized" Bunker to act on its behalf and the corporation was therefore liable, as if it were a director, under section 16b of the Act for profits realized on securities bought while the deputy was a director and sold within six months, even though the deputy's resignation had become effective before the sale. Feder

1. For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

The reasons underlying the enactment of 16b are related to the activities of investors prior to 1929 when trading by insiders was an accepted practice of businessmen. A stockholder who felt he had been wronged by such dealings had his sole recourse in the common law doctrine of special circumstances, which required him to prove that all relevant circumstances indicated that the insider had taken an inequitable advantage. This placed an almost insurmountable burden of proof upon the plaintiff stockholder. But the stock crash of 1929 demonstrated, among other things, that the stock markets were sorely in need of more rigorous regulation than that provided by common law. The result was the enactment of the Securities Act of 1933 and the Securities and Exchange Act of 1934.

Section 16b of the Exchange Act was designed to prevent corporate insiders from profiting by the use of inside information in transactions involving the corporation's stock. Due to the difficulty of proving a causal relationship between the transaction and the inside information, 16b allowed recovery on any transaction occurring within a six month period. The assumption underlying 16b is that to allow the insider to profit from his inherent advantage vis-a-vis ordinary investors, would harm the stock market in general. Although some writers have questioned the validity of this assumption, section 16b's vitality as

---

4. 10 S.E.C. Ann. Rep. 50 (1944): "[P]rofits from 'sure thing' speculation in the stocks of their corporations were more or less generally accepted by the financial community as part of the emolument for serving as a corporate officer or director notwithstanding the flagrantly inequitable character of such trading."
5. See McDowell, Director's Liability in Securities Transactions, 22 Bus. Law 76, 77 (1966): "The 1933 Act . . . was really the first statute to impose liability on directors for material false statements or omissions in securities selling literature."
7. See Strong v. Repide, 213 U.S. 419 (1909), for an example of the problems faced by a stockholder who felt himself wronged by a corporate insider.
10. Section 10b and rule 10b-5 are designed to prevent the fraudulent use of inside information by anyone, whether or not the transactions occur within a six month period. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).
a security regulation has not been diminished, and in fact has increased since its inception.

Section 16b, upon first reading, appears to be a fairly direct and uncomplicated piece of legislative draftsmanship. This is understandable because its framers intended that it be objective and simple, thereby making compliance with it relatively easy. Ironically, the attributes which the section's framers felt to be one of its virtues have probably caused it to be the focus of much litigation and private settlement. The key to interpreting the myriad cases that have arisen under 16b lies in the opening clause of the section, which has been read by the courts to be a clear statement of legislative intent. The courts have followed the framers' intent in treating section 16b as nothing more than a "crude rule of thumb" and have reached decisions by looking to this intent rather than a literal interpretation of the statute.

12. Hamilton, Convertible Securities and Section 16(b): The End of an Era, 44 Texas L. Rev. 1447, 1449 (1966). Examples are numerous. The statute does not define the point at which an owner becomes a "beneficial owner." Blau v. Osgbury, 210 F.2d 426, 427 (2d Cir. 1954). Nor does it say whether a partnership can be considered a "director." Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959). The term "officer" is extremely ambiguous and had to be further defined. 17 C.F.R. § 240.36-2 (1969). The terms "purchase" and "sale" do not clearly delineate what transactions were comprehended. Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958); SEC Securities Act Release No. 34-7826, Feb. 17, 1966; Hamilton, supra. The phrase, "within any period of less than six months" does not say precisely when the period begins or ends. Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959). The section does not differentiate a "class" from a "series" of equity securities. Ellerin v. Massachusetts Mut. Life Ins. Co., 270 F.2d 259 (2d Cir. 1959). Finally, the Commissioner's power to grant exemptions does not give that body as much latitude as was once thought. Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir. 1943).


14. This view of the section was derived from a statement made by Thomas G. Corcoran, the principal draftsman of the 1934 Act during hearings before the Senate Committee on Banking and Currency:

You hold the director, irrespective of any intention or expectation to sell the security within 6 months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing.


15. It has been said, "[the question of the definition of terms] ... is not in any event primarily a semantic one, but must be resolved in
Feder presented two primary issues, one of first impression and one which added new insights on a more familiar problem. The latter was whether Bunker, as president and chief executive officer of Martin, had been deputized to act on behalf of Martin on the Sperry board of directors. According to what the court called a “legal fiction,” developed through a series of cases, if he were deputized, the Martin Marietta Corporation would be considered a director under section 16b and thereby would be subject to its requirements and sanctions.

Rattner v. Lehman has often been referred to as the case in which the seeds of the deputization theory were planted. The case involved stock transactions by a partnership, with one of the partners serving on the corporation’s board of directors. The Second Circuit held that the partner-director must give up his share of the profits, but that since he had not caused the partnership to engage in the transactions the other partners would not have to release theirs. The court added a significant caveat, however; “[w]hether the result might be different had he caused the firm to make [the purchase] we need not now determine.” Judge Learned Hand raised this question in his concurrence with a statement that has often been referred to as the origin of the deputization theory. The theory moved to the brink of judicial acceptance in 1962 when the Supreme Court, in Blau v. Lehman, indicated, without so holding, that a partnership could be considered a director under 16b. Subsequently, the theory was given full acceptance in Marquette Cement Manufacturing Company v. Andreas, where the federal

---

16. 406 F.2d at 262.
17. 193 F.2d 564 (2d Cir. 1952).
18. Id. at 565.
19. Id. at 566-567 (concurring opinion).
21. Id. at 409.
22. 239 F. Supp. 962 (S.D.N.Y. 1965). In Marquette, defendant was the sole trustee for 19 trusts. Together these trusts owned all shares of a certain corporation. Defendant sold all of that corporation's
district court said: "That such a deputization is possible seems clear after Blau v. Lehman, ... but its existence is a question of fact to be settled case by case." However, the court then held that the mere fact that a stockholder in a corporation has engaged in a short swing transaction from which the corporation has also benefited was an insufficient basis upon which to find deputization. Thus the court in Fedex could say, "the validity of the deputization theory, presumed to be valid here by the parties and by the district court, is unquestionable." Even so, the finding of such deputization is based on the facts of each case. It was on this consideration that the court of appeals reversed the district court decision in Fedex.

The district court made several findings of fact in support of its conclusion that Bunker had not been deputized by Martin: (1) Sperry initially invited Bunker to join its board two and a half months before Martin began its accumulation of Sperry stock; (2) Bunker turned down a second offer by Sperry at a time when Martin already held 400,000 shares of Sperry stock; (3) Sperry, not Martin, took the initiative to encourage Bunker to accept the directorship; (4) No other Martin employee was ever mentioned for the position in the event Bunker absolutely declined, and (5) Bunker's fine reputation and engineering expertise was the prime motivation for Sperry's interest in him. The court of appeals, however, found additional, more germane and uncontradicted evidence which was either overlooked or ignored by the district court: (1) Bunker's own testimony concerned his extensive responsibilities and authority within his corporation; (2) Bunker's testimony revealed that several Sperry officials had discussed their company's "short range outlook" with Bunker while he was a Sperry director; (3) An unsigned document, allegedly originating in Martin's assets to the plaintiff in return for some of the latter's stock and then sold this stock one month later. Defendant, subsequently, was held liable only for the profits earned by the two trusts of which he was the beneficiary. The plaintiff claimed that all of the trusts should be held liable based on the deputization theory.

23. Id. at 967.
24. Id.
25. 406 F.2d at 263.
26. Id. at 264.
27. Bunker's position was such that he could have received information and, without disclosing it to other Martin men, could have used it to the corporation's advantage. Thus, the court held that a finding of a lack of disclosure on Bunker's part was irrelevant. All that was necessary was the possibility of informational misuse. Id.
files, contained descriptions and evaluations of Sperry's management and future outlook; (4) Bunker's letter of resignation to General MacArthur, then chairman of the Sperry board of directors, which gave strong indications that at least MacArthur and Bunker were under the impression that the latter was representing Martin on Sperry's board; (5) The fact that Martin's Board of Directors formally consented to and approved Bunker's acceptance of the Sperry directorship before Bunker had accepted the position, and (6) Martin made a practice of placing representatives on the board of directors of other firms and Bunker's directorship differed from the others in only minor ways.

In balancing these facts, Feder was as imprecise as its predecessors in its appraisal of what factors must be present to reach a finding that a director has been deputized by his corporation. Although the Feder court pointed out several broadly defined factors which it felt were significant, it failed to point out the relative importance it placed on each of them or how they would affect a decision in a slightly different factual setting. One fact is certain, however. No lawyer can accurately advise his client on the basis of this court record.

The second major issue of Feder was whether a director (in this case, Martin Marietta Corporation) could be held liable for the profits realized on securities bought while a director and sold within six months, but not until after the director's resignation had become effective. Although the issue is one of first impression, an earlier decision held that section 16b imposes liability upon a person who is not a director at the date of pur-

28. Its title may be explanatory of the document's contents. It was entitled "Notes on Exploratory Investment in Sperry Rand Corpora-
tion." The court said that these three findings alone raised a strong presumption that Bunker had been deputized, although they declined to so hold without further evidence. Id.

29. The letter of resignation stated:

When I became a member of the Board in April, it appeared to your associates that the Martin Marietta ownership of a sub-
stantial number of shares of Sperry Rand should have represen-
tation on your Board. This representation does not seem to me really necessary and I prefer not to be involved in the affairs of Sperry Rand when there are so many other demands on my time.

Id. at 265.

30. The court stated, for example, that to be deputized, a director who does not disclose information to his company must have a great deal of authority and responsibility within the corporation he repre-
sents. "Authority" and "responsibility" are terms whose ambiguity can only further obscure the definition of a deputy.
chase, but becomes one before selling his stock. In Adler v. Klawans, the court reached this decision by reading the Congressional intent of section 16b as prohibiting the purchase and sale of a security, "by someone within one of the proscribed categories, i.e., one who was a director, officer, or beneficial owner at some time." By reading the words "at some time" into the statute, the court clearly went beyond the statutory language itself and rested its decision primarily upon legislative intent. The court also pointed out that while a "beneficial owner" must be such at both the time of the purchase and the sale in dispute, similar provision is not made in regard to directors and officers. The court inferred that Congress did not intend that officers and directors be such at both ends of the transaction.

Although Adler did not mention it, some additional statutory basis can be found for its decision. Section 16a provides: "Every person . . . who is a director . . . shall file, at the time of the registration of such security or within ten days after he becomes such . . . director . . . a statement with the exchange . . . ." Thus it could be argued that an individual who buys securities and sells them after becoming a director was meant to come under section 16b sanctions on the theory that if a person must file under section 16a then he is automatically subject to section 16b.

This statutory support for the rationale of Adler has significance in the Feder decision. No similar specific provisions of section 16a can be interpreted to imply that Congress intended that officers and directors must file after they have left their position. This fact would have meant that Martin had no duty to file and therefore incurred no liability if Rule 16a-10 of the Securities and Exchange Commission had been upheld. In essence, this rule says that if an individual is exempted from the requirements of 16a, he is exempted from 16b. The Commissioner's power to grant exemptions pursuant to the last sentence of section 16b, however, is not beyond the purview of judicial intervention, since the Commission's powers to grant exemptions

31. 267 F.2d 840 (2d Cir. 1959).
32. Id. at 844.
34. "Any transaction which has been or shall be exempted by the Commission from the requirements of section 16(a) shall, in so far as it is otherwise subject to the provisions of section 16(b), be likewise exempted from section 16(b)." 17 C.F.R. § 240.10a-10 (1969).
35. See Greene v. Dietz, 247 F.2d 689, 692-93 (2d Cir. 1957).
is limited to transactions "not comprehended within the purposes of this subsection." In order to determine whether Martin could be held liable, the Federal court had to decide whether the Commission acted within its power when it made rule 16a-10.

The court began its reasoning by asking whether the transaction was of the type which Congress had intended to eliminate. The court reasoned that where the security is purchased before the buyer becomes a director, only a subsequent sale could be motivated by inside information. On the other hand, where the purchase is made during the directorship and the sale is made after the resignation, both the purchase and the sale could be motivated by inside information. From this analysis, the court concluded that the latter transaction was definitely of the type which Congress meant to control and that Rule 16a-10 was invalid to the extent that it exempted such a transaction. At this point, the court's analysis had followed a line of reasoning characteristic of section 16b decisions, i.e. "every transaction which can reasonably be defined as a purchase will be so defined, if the transaction is of a kind which can possibly lend itself to the speculation encompassed by section 16(b)." Certainly, a sale of stock within six months after leaving a position as director could easily be motivated by inside information.

If the court had concluded its opinion when it reached this point, there would be little reason to question its decision. The court, however, chose to go on, explaining that Form 4—provided by the SEC for a director to file his monthly statement of changes in stock ownership—requires beneficial owners, directors and officers to file if they are in one of those categories at any time during a calendar month. Thus if an individual is a director on September 1 and resigns on September 2, he must file a Form 4 statement for the month of September. This, in effect, would require a director to file one month after his resignation. The court felt this was an arbitrarily inadequate requirement because it places a great deal of emphasis on the director's date of resignation. For instance, if the hypothetical director had resigned on August 31, he would not have had to file under Form 4 for September. For this reason, the court decided that 16b applies for six months from the date of purchase, regardless of the date of resignation.

It is difficult to understand the court's reasoning since the

Six month requirement is as arbitrary as the Form 4 requirement. Just as the director may choose to avoid liability by resigning on the last day of the month, he can wait six months plus one day and sell with impunity. Since the section was intended to be objective, arbitrary and therefore relatively simple to obey, Form 4's arbitrariness should not be considered an improper exercise of the Commission's power. What the court did in Feder was to take note of the camel's nose under the tent and reason that because of its presence the whole beast must be admitted. Such reasoning, after what appeared to be customary grounds for an extension of section 16b, gives the impression that the court lacked confidence in that original position.

The impact of Feder upon future security transactions by corporate insiders remains in doubt. It seems likely that section 16b could be extended to a director's purchase and sale, both occurring after his resignation. Although the reasoning of Feder does nothing to dispel this possibility, the courts may wisely reject it and require claimants to seek redress under Rule 10b-5 of the Exchange Act or similar remedies. Such an extension would unduly inhibit an individual from any short swing trading in the stock of a corporation if he had ever served on its board. This results from the fact that the claimant under section 16b need not prove that the insider actually used inside information when engaged in short swing trading. Since all he needs to prove is that the insider was in fact an insider, no former director would be able to engage in short swing trading of a corporation's stock after leaving its board of directors. Thus, Rule 10b-5 and other remedies which require proof of the actual use of inside information are more equitable means of controlling the short swing trading of former directors.

Another problem presented by Feder is the fact that 16b liability was imposed upon an insider who apparently relied upon an SEC ruling which was later found to be invalid. According to SEC Form 4, which governs the reporting provision of section 16a, Martin was required to file only for the month in which its deputy, Bunker, resigned from Sperry's board. SEC Rule 16a-10 provided that any transaction exempted from section 16a reporting requirements, "shall in so far as it is otherwise

40. For more discussion on this point see 1969 Duke L.J. 812, 817.
subject to the provisions of section 16(b), be likewise exempted from section 16(b)." This would result in the conclusion that Martin was exempt from section 16b liability for transactions occurring after the month in which Bunker resigned. *Feder*, however, found this aspect of Rule 16a-10 invalid, and yet did not consider the impact of section 23a of the Exchange Act. This section states that liability under the Act should not be imposed where a party has relied in good faith on a SEC rule which is later determined to be invalid. The court imposed section 16b liability without discussing section 23a even though Martin had apparently relied in good faith on SEC Rule 16a-10. The court's failure to mention this section is especially troublesome in light of the difficulty an insider has in determining his status regarding 16b. This difficulty stems from the judicial extension of 16b liability based upon an interpretation of Congressional intent with little attention to the precise language of the statute itself.

The decision in *Feder* raises more problems than it solves. There is a need for the development of definitive guidelines on how to determine when a director has been deputized to act on behalf of another corporation. The present case by case approach can only force directors and their attorneys into unnecessary confusion, uncertainty and overcaution in their securities dealings. Since one of the goals of section 16b was to provide an objective test for the imposition of liability, it seems imperative that corporations should be provided with means for determining the question of deputizing with certainty. Such means could

41. 17 C.F.R. § 240.16a-10 (1969).
42. 406 F.2d at 268. See text accompanying note 40 supra.
43. Section 23a:

No provision of this chapter imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission or the Board of Governors of the Federal Reserve System, notwithstanding that such rule or regulation may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason.

44. Martin's reliance is shown by the fact that it did not begin to sell its Sperry stock until one month had elapsed following Bunker's resignation. Imposition of section 16b liability in circumstances such as this places an attorney in a most difficult position when advising his client.

The solution to such unexpected liability can be found in a more extensive use of the section 23a "good faith reliance doctrine" which has already been used in some 16b cases. See, e.g., Greene v. Dietz, 247 F.2d 689 (2d Cir. 1957).
be provided by a more specific opinion than *Feder*, by an amend-
ment to the 1934 Act, or by SEC regulation.

Preferably, the SEC should promulgate a regulation which
would state that any officer, director or beneficial owner placed
on the board of another corporation would be prima facie pre-
sumed to be a deputy of his company. In addition, any other
agent whose primary purpose is to represent his corporation on
the board of another corporation would be conclusively pre-
sumed deputized. These criteria have the advantage of using
terms whose meanings the courts have already considered as
well as including most of the individuals a corporation would
be likely to use as representatives of its interests on the board
of another company. Further, if anyone outside one of these
groups were to serve as a director, the courts would be un-
likely to find that he had been deputized under the tests laid
down in *Feder*.45

These reforms of section 16b have been suggested in an
attempt to alleviate the almost unavoidable problems of a stat-
ute meant to be objective and simple, but which expresses Con-
gressional intent in such unequivocal terms that the courts have
felt obligated to extend its sanctions as far as possible. Section
16b was not meant to impose a general hindrance upon the in-
vestment practices of insiders. It was meant to render profitless
an investment practice within a specific time period by a limited
group of individuals which had frequently resulted in an un-
fair advantage to them. It was meant to be one part of a
comprehensive regulatory scheme, and not the sole regulatory
device for insider trading.

---

45. This amendment would not place as great a burden on the
deputizing corporation as it may first appear. If the corporation wishes
to sell its stock it need wait only six months and do so then. Of
course, it is protected from a falling market by the fact that it may sell
when the price of the stock reaches the purchase price even though six
months have not passed. Section 16b states that no profits may be
realized by a short swing transaction; it does not prohibit short swing
sales per se.