



1-1-1969

## Case Comments

John P. Freeman

Richard H. Farina

Thomas J. DeLuca

James Webster

Follow this and additional works at: <http://scholarship.law.nd.edu/ndlr>



Part of the [Law Commons](#)

### Recommended Citation

John P. Freeman, Richard H. Farina, Thomas J. DeLuca & James Webster, *Case Comments*, 44 Notre Dame L. Rev. 122 (1969).

Available at: <http://scholarship.law.nd.edu/ndlr/vol44/iss1/7>

This Commentary is brought to you for free and open access by NDLScholarship. It has been accepted for inclusion in Notre Dame Law Review by an authorized administrator of NDLScholarship. For more information, please contact [lawdr@nd.edu](mailto:lawdr@nd.edu).

## CASE COMMENTS

SECURITIES REGULATION — SECURITIES ACT OF 1933 — RELIANCE ON MANAGEMENT'S REPRESENTATIONS CONCERNING THE ACCURACY OF MATERIAL FACTS IN REGISTRATION STATEMENT WILL BAR COMPANY COUNSEL WHO ARE DIRECTORS, UNDERWRITERS, AND ACCOUNTANTS FROM ASSERTING AFFIRMATIVE DEFENSES OF SECTION 11(B)(3)(A) AND (B) IN SECTION 11 ACTIONS. — On March 30, 1961, BarChris Construction Corporation [BarChris] filed a registration statement pursuant to section 5 of the Securities Act of 1933<sup>1</sup> covering a \$3,500,000 offering of 5½% convertible subordinated debentures due May 1, 1976. The original registration statement was amended on May 11, 1961, and again on May 16, 1961, the effective date of the statement. According to the prospectus contained in the registration statement,<sup>2</sup> the purpose of the issue was to finance construction of a new plant, develop a new equipment line, cover a loan to a wholly owned subsidiary, and contribute funds to BarChris's working capital. On May 24, 1961, BarChris received the net proceeds from the sale of the debentures. Primarily because of customer delinquencies and defaults, the financial position of the corporation rapidly deteriorated, and, on October 29, 1962, it filed a petition for arrangement under chapter XI of the Bankruptcy Act.<sup>3</sup> Four days earlier, nine plaintiff bondholders had brought a class action<sup>4</sup> under section 11 of the Securities Act<sup>5</sup> naming as defendants the

1 Securities Act of 1933 § 5, 48 Stat. 74 (1933), *as amended*, 15 U.S.C. § 77a-aa (1964). Securities Act of 1933 § 5, 68 Stat. 684 (1954), 15 U.S.C. § 77e (1964) makes it illegal to use the mails or interstate commerce to sell securities unless a registration statement pertaining to the securities has been filed with the S.E.C. Excepted from this requirement are securities exempted from registration by the Securities Act of 1933 § 3, 48 Stat. 75 (1933), *as amended*, 15 U.S.C. § 77c (1964), or Securities Act of 1933 § 4, 78 Stat. 580 (1964), 15 U.S.C. § 77d (1964). The information needed in the registration statement is prescribed by the Securities Act of 1933 § 7, 48 Stat. 78 (1933), 15 U.S.C. § 77g (1964).

2 While the prospectus was once considered a supplement to the material contained in the registration statement, at the present time it is viewed as "the basic part of the statement." See 3 L. LOSS, SECURITIES REGULATION 1721-22 (2d ed.1961) [hereinafter cited as Loss].

3 The chapter XI bankruptcy proceeding was converted into a straight bankruptcy in March, 1963. The adjudication in bankruptcy was vacated in November of 1963, and the company was placed in reorganization under chapter X of the Bankruptcy Act. The last proceeding was still pending in March of 1968. *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 654 n.5 (S.D.N.Y. 1968).

4 The action was maintained under Federal Rule of Civil Procedure 23(a)(3) before this rule was changed by the 1966 amendment. *Id.* at 704-05.

5 Securities Act of 1933 § 11, 48 Stat. 82 (1933), *as amended*, 15 U.S.C. § 77k, in relevant part provides that:

(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been

signers of the registration statement, the directors of the corporation, the underwriters of the debenture issue, and BarChris's auditors.<sup>6</sup> Subsequently, fifty-nine purchasers of the debenture issue were granted leave to intervene as plaintiffs in the proceeding.<sup>7</sup> Although the defendants pleaded a variety of defenses,<sup>8</sup> the court ruled that the only defenses common to all plaintiffs were those pleaded under section 11(b)(3) of the Securities Act of 1933, and deferred judgment on the propriety of the other asserted defenses until a later date. In an opinion dealing solely with questions of law and fact which applied to every plaintiff, the court *held*: in an action brought under section 11, reliance on the affirmations of management concerning the accuracy of material facts presented in the registration statement, without a further attempt to verify those affirmations, is a sufficient ground to bar company counsel who are directors of the corporation, underwriters, and accountants from establishing the right to the defenses available to them under section 11(b)(3)(A) and (B). *Escott v. BarChris Construction Corporation*, 283 F. Supp. 643 (S.D.N.Y. 1968).

The decision rendered by the court in *Escott* moved one popular newspaper to term the case a "Legal Blockbuster."<sup>9</sup> The reason for that gush of journalistic hyperbole lies in the interpretation of the requirements of section 11(b)(3) by the court. Since the pleadings of both plaintiff and defendant relating to the issue of liability were fit snugly within the four corners of the section, a brief

named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

6 For a list of the named defendants in this action other than BarChris, see note 63 *infra*.

7 By May of 1963, eighteen plaintiffs had intervened without opposition. An additional twenty five sought to intervene in May of 1964. The motion to intervene was denied by the United States District Court for the Southern District of New York, but that decision was reversed and leave to intervene was granted to the petitioners. See *Escott v. BarChris [sic] Constr. Corp.*, 340 F.2d 731 (2d Cir.), *cert. denied sub nom. Drexel & Co. v. Hall*, 382 U.S. 816 (1965). The balance of the intervenors were granted leave to intervene in accordance with that decision. *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 704 (S.D.N.Y. 1968).

8 In addition to the defenses of estoppel, waiver, and release, the defendants pleaded the defenses contained in section 13, section 11(b)(3)(A),(B) and (C), and section 11(e). Securities Act of 1933 § 13, 48 Stat. 84 (1933), *as amended*, 15 U.S.C. 77m, is the limitation of liabilities section of the act and provides in relevant part:

No action shall be maintained to enforce any liability created under section [11] unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence . . . . In no event shall any such action be brought . . . more than three years after the security was bona fide offered to the public . . . .

Subsection (e) of section 11 was pleaded by each defendant with the exception of BarChris, to whom as the issuer it was not available. It establishes the criteria for what amounts to a defense based on lack of causation. It provides in relevant part:

That if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from [the materially misstated] part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. . . .

Paragraph (3) of subsection (b) establishes the criteria for the maintenance of the affirmative defense under section 11. For the relevant provisions of this section see text accompanying notes 61, 62 *infra*.

9 *The Wall Street Journal*, May 14, 1968, at 1, col. 6.

discussion of its legislative history may be helpful in adding perspective to the analysis of *Escott* which follows.<sup>10</sup>

The Securities Act of 1933 is primarily a disclosure statute.<sup>11</sup> The philosophy of the Act was embodied in the words of President Franklin D. Roosevelt in his message to Congress of March 29, 1933: "This proposal adds to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware.' It puts the burden of telling the whole truth on the seller."<sup>12</sup>

Despite the fact that there was virtually no argument concerning the need<sup>13</sup> for federal action in the regulation of the securities markets, or concerning the objectives of the Securities Act,<sup>14</sup> the financial community was not unduly enthusiastic in its acceptance. This reluctance was primarily a result of the apprehension felt over the civil liabilities provision in section 11.<sup>15</sup> Congress demonstrated its awareness of the situation when it attached a rider<sup>16</sup> to the Securities Exchange Act of 1934,<sup>17</sup> which tended to soften and clarify several of the provisions of the section and those of other sections which related to it.<sup>18</sup>

10 For a personalized study of the legislative history of the Act from the standpoint of one of its draftsmen, see Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959).

11 For an assessment of the role of disclosure in relation to the various aspects of securities regulation, including the Securities Act of 1933, see Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607 (1964).

12 H.R. REP. NO. 85, 73d Cong., 1st Sess. 2 (1933).

13 The total dollar loss suffered by the investing public caused by investment in stocks which proved worthless during the decade preceding passage of the Act has been estimated at 25 billion dollars. See N.Y. Times, May 28, 1933, § 1 at 2, col. 1; H.R. REP. NO. 85, *supra* note 12.

14 Edward N. Gadsby, former Chairman of the Securities and Exchange Commission stated that:

[T]he two principal objectives of the 1933 act were, first, to protect investors by requiring adequate and accurate disclosure regarding securities distributed to the public in interstate commerce or by use of the mail and, second, to outlaw fraud in the sale of all securities whether or not newly issued. Gadsby, *Historical Development of the S.E.C.—the Government View*, 28 GEO. WASH. L. REV. 6, 9 (1959).

15 See, e.g., Freeman, *A Private Practitioner's View of the Development of the Securities and Exchange Commission*, 28 GEO. WASH. L. REV. 18 (1959). The newly formed Securities and Exchange Commission had to use a degree of salesmanship to convince big business that it was comparatively safe to register securities under the Act.

As one of [the Security and Exchange Commission's] earliest tasks, the first Chairman of the Commission, Joseph P. Kennedy, and its General Counsel, John J. Burns, packed their suitcases like travelling salesmen, and went to visit the Bethlehem Steel Company to try to persuade Bethlehem to file a registration statement for a public bond issue instead of a private placement. They agreed to make special rules to expedite the financing and made many other concessions to secure the first registration statement by a major company. *Id.*;

James, *The Securities Act of 1933*, 32 MICH. L. REV. 624, 661 (1934):

Unless some of the more drastic provisions of the Act are modified fundamental changes are apt to develop in securities marketing. It is not inconceivable that much of the underwriting may be done either by the less desirable bankers, of borderline integrity, impecunious, or whose wives will be rich women . . . . It is not inconceivable that public financing may have to be done through governmental agencies such as the Reconstruction Finance Corporation. I do not consider this likely, although it has been intimated by some who have been rather closely connected with the Administration.

See also Ballantine, *Amending the Federal Securities Act*, 20 A.B.A.J. 85 (1934).

16 Securities Exchange Act of 1934, § 206, 48 Stat. 907 (1934), 15 U.S.C. § 77k (1964).

17 Securities Exchange Act of 1934, 48 Stat. 881 (1934), 15 U.S.C. § 78a-78jj (1964).

18 The amendment did not have a direct effect on the outcome of the decision in *Escott*. It was mentioned solely for its historical significance and will not be discussed here. For analyses of the effects of the amendments on the original act see 3 Loss 1725-29; Hanna, *The Securities Exchange Act of 1934*, 23 CALIF. L. REV. 1, 6-8 (1934).

The civil action developed by Congress in section 11 of the Securities Act as amended by the Securities Exchange Act of 1934 is patterned after the common law tort action of deceit.<sup>19</sup> However, the tort action was modified in three essential respects which serve to handsomely benefit the plaintiff in establishing liability. These three modifications involve the privity, reliance, and *scienter* elements of the original deceit action.

The dispensation of the traditional element of privity between the purchaser of the securities and the seller was considered "the most striking innovation" in the section.<sup>20</sup> Any person who acquired the security issued pursuant to the statement<sup>21</sup> without knowledge of the misleading representations contained in it may bring an action under section 11. To establish reliance under section 11(a) the plaintiff must prove only that he purchased the security issued pursuant to the registration statement, unless the plaintiff

acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, [at which time] the right of recovery is conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying on the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration state — by such person.<sup>22</sup>

Finally, the plaintiff in an action under the section is relieved of the burden of establishing *scienter*. Instead, the burden of disproving the existence of the element is placed on the defendant. The rationale behind the transposition of the burden is that:

Unless responsibility is to involve merely paper liability it is necessary to throw the burden of disproving responsibility for reprehensible acts of omission or commission on those who purport to issue statements for the public's reliance. The responsibility imposed is no more than nor less than that of a trust. It is a responsibility that no honest banker and no honest

19 3 LOSS 1683. For statements of the elements of the tort cause of action in deceit, see W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* 700 (3d ed. 1964); 1 F. HARPER AND F. JAMES, *THE LAW OF TORTS* 528 (1956).

20 Shulman, *Civil Liability and the Securities Act*, 43 YALE L. J. 227, 249 (1933).

21 This provision of the section has been a source of frustration to plaintiffs. See *Fischman v. Raytheon Mfg. Co.*, 9 F.R.D. 707 (S.D.N.Y. 1949), *rev'd*, 188 F.2d 783 (2d Cir. 1951) (purchasers of common stock were not entitled to join with preferred stockholders in a suit under section 11 where the registration statement pertained only to the issuance of preferred stock); *Barnes v Osofsky*, 254 F. Supp. 721 (S.D.N.Y. 1966), *aff'd*, 373 F.2d 269 (2d Cir. 1967) (two stockholders were denied permission to share in the settlement proceeds following a section 11 action because they could not trace their shares to those issued under the misleading registration statement); *Colonial Realty Corp. v. Brunswick Corp.*, 257 F. Supp. 875 (S.D.N.Y. 1966) (defendant's motion for summary judgment concerning suit brought to enforce liability under section 11 granted, on basis that plaintiff had not purchased stocks issued pursuant to registration statement, although the stocks purchased by plaintiff and those covered by the statement were of the same class).

22 Securities Act of 1933 § 11(a), 48 Stat. 82 (1933), 15 U.S.C. § 77k(a) (1964). The reason that this provision was included in the section was:

that in all likelihood the purchase and price of the security purchased after publication of such an earning statement will be predicated on that statement rather than on the information disclosed upon registration. H.R. REP. NO. 1838, 73d Cong., 2d Sess. 41 (1934).

businessman should seek to avoid or fear. To impose a lesser responsibility would nullify the purpose of this legislation.<sup>23</sup>

The requirements which must be satisfied by a defendant in a section 11 action to successfully plead lack of *scienter* as a defense are contained in subsection (b). The issuer is the only defendant to whom the provisions of the subsection are unavailable.<sup>24</sup> The other defendants may establish lack of *scienter* as a defense under the subsection by proving:

- (1) that they took the steps required under subsection (b) (1) or (2) to disavow any responsibility for the accuracy of the material presented in the registration statement;<sup>25</sup> or
- (2) that if the misstatements in the registration statement were either statements purportedly made by an official person or which purported to be a copy of or extract from a public document, that they had no reasonable grounds to believe and did not at the time the registration statement became effective believe that the statements were materially misleading;<sup>26</sup> or
- (3) in the case of a defendant considered an expert<sup>27</sup> by the court — that either (a) that the part found to be materially misleading and attributed to him was not in fact his statement or was not an accurate representation of his work<sup>28</sup> or (b) if the statements or representations were accurate, that he had made a reasonable investigation relative to them and which gave him reasonable grounds to believe that they were true, and, that at the time the registration statement became effective he still held that belief;<sup>29</sup> or
- (4) in the case of the defendants other than the expert, that (a) if the material mistakes were contained in the non-expertised portion<sup>30</sup> of the

23 H.R. REP. No. 85, *supra* note 12, at 9, 10.

24 The issuer is liable under section 11(a)(1) as a signer of the registration statement. Securities Act of 1933 § 2(4), 48 Stat. 74 (1933), *as amended*, 15 U.S.C. § 77b (1964) defines the term "issuer".

25 Securities Act of 1933 § 11(b)(1) and (2), 48 Stat. 82 (1933), *as amended*, 15 U.S.C. § 77k (1964).

26 *Id.* § 11(b)(3)(D).

27 An expert, within the meaning of subsection (b), is

every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him . . . .

For an analysis of the liability of experts under section 11, see Douglas and Bates, *The Federal Securities Act of 1933*, 43 YALE L. J. 171, 197-98 (1933).

28 Securities Act of 1933 § 11(b)(3)(B)(ii), 48 Stat. 82 (1933), *as amended*, 15 U.S.C. § 77k (1964).

29 *Id.* § 11(b)(3)(B)(i).

30 The term "non-expertised portion" is used in the interest of brevity. It means any portion of the registration statement not purporting to be made on the authority of an expert, not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement.

registration statement, he had, after reasonable investigation, reasonable grounds to believe and did at the time the statement became effective believe that the statements were true and not materially misleading, and, (b) that if the mistakes were in the part of the registration statement which was the expert's work, or a copy or extract of the expert's work, that he had no reasonable grounds to believe, and did not believe at the effective date of the registration statement that the statements made on the expert's authority were materially misleading.<sup>31</sup>

Despite the use of these three modifications of the deceit action by Congress to enable the plaintiff to successfully plead his case under section 11, the number of judicial decisions involving actions brought under the section is surprisingly low. This situation prompted Professor Loss in his treatise published in 1961 to characterize section 11 as "the *bête noire* that was going to stifle legitimate financing — and which has produced two reported recoveries in almost twenty-eight years."<sup>32</sup> A number of reasons have been advanced in an attempt to account for the scarcity of reported actions: the high degree of care exercised by the bar and the accounting profession in the preparation of registration statements; the careful examination of the accuracy of materials contained in the statements by the Securities and Exchange Commission; the cost of litigation; and, probably to some extent, investor apathy.<sup>33</sup>

While these elements have no doubt aided in holding down the amount of reported litigation, there has been a decided trend in this decade toward greater use of section 11 by investors seeking to litigate. Professor Loss listed only 11 reported actions and two recoveries from 1933 to 1961.<sup>34</sup> He noted, however, that the utilization of the class action device could give "investors with a mind to litigate an easier row to hoe."<sup>35</sup> Since Professor Loss made that observation there have been at least six actions brought under section 11. Five of these actions, including *Escott*,<sup>36</sup> resulted in agreement and compromise settlements, while in the remaining one there was no adjudication of liability because the

31 *Id.* § 11(b)(3)(A), (C).

32 3 Loss 1721. For a listing of reported decisions involving section 11 actions from 1933 through 1960, see *id.* at 1688 n.11.

33 *Id.* at 1690-92. An additional factor which should be mentioned is the probability of out-of-court settlements by an issuer with investors who appear to have well-founded claims. The liability of an issuer under section 11 in the case of a material misrepresentation is virtually absolute if 1) the investor did not know of the misrepresentation at the time he purchased the security, 2) the limitations section of the Act has not run, and 3) the causation defense of section 11(e)(3) is inapplicable.

34 *Id.* at 1688 n.11.

35 *Id.* at 1692.

36 *Barnes v. Osofsky*, 254 F. Supp. 721 (S.D.N.Y. 1966) (agreement and compromise settlement of \$775,000 approved by court); *Derdarian v. Futterman Corp.*, 38 F.R.D. 178 (S.D.N.Y.) (agreement and compromise settlement estimated by counsel to be approximately \$2,200,000, approved by court); *Fox v. Glickman Corp.*, 253 F. Supp. 1005 (S.D.N.Y. 1966) (agreement and compromise settlement of \$1,825,000 approved by court); *Cherner v. Transitron Electronic Corp.*, 221 F. Supp. 48 (D. Mass. 1963) (agreement and compromise settlement of \$5,300,000 approved by court).

In *Escott*, a stipulation of settlement was entered into by all parties other than the trustee in bankruptcy, and this stipulation was approved by the court. Letter from E. Michael Bradley to John P. Freeman, August 9, 1968, on file with the NOTRE DAME LAWYER.

plaintiffs were barred on other grounds.<sup>37</sup> It appears that Professor Loss was extremely accurate in his appraisal, since only one<sup>38</sup> of the six cases was not a class action brought under the provisions of Rule 23(a)(3) of the Federal Rules of Civil Procedure.

While the relatively few decisions concerning section 11 had the effect, to a certain extent, of allaying the apprehension of some that our economic system might revert to a "barter economy,"<sup>39</sup> it also had the direct effect of stunting the growth of judicial interpretation of the section's key provisions. At the time of the Act's passage it was realized that judicial interpretation of the section, particularly subsection (b), would be necessary before the full impact of the statute could be fully evaluated.<sup>40</sup> No one, of course, knew how much time would be required before the judiciary fully interpreted the provisions of the section, although one estimate was advanced that it would take a decade for the courts to complete the task.<sup>41</sup>

*Escott*, as mentioned previously, is distinctly a section 11 action. In a sense the case is precisely the type of suit envisioned by Congress when it drafted the section and provided the defendants with the affirmative defenses contained in subsection (b). But *Escott*, a typical section 11 action, is singularly atypical because in no reported case in the thirty-five year history of the Act has a court been called upon to interpret the requirements of the "due diligence defenses" of subsection (b). Essentially, *Escott* involved first a judgment by the court that the misstatements contained in the prospectus were materially misleading,<sup>42</sup> and then an appraisal of the right of each defendant to the defenses of subsection (b).<sup>43</sup>

### I. The Material Misstatements

In determining whether the untrue statements of fact or misleading omissions contained in the registration statement were material, the court adopted the standard of materiality developed in *Charles A. Howard*,<sup>44</sup> which ruled that a material fact is a "fact which if it had been correctly stated or disclosed would have deterred or tended to deter the average prudent investor from purchasing the securities in question."<sup>45</sup> The court, after a detailed investigation of the errors claimed by plaintiffs to be material, concluded that the registration state-

37 *Colonial Realty Corp. v. Brunswick Corp.*, 257 F. Supp. 875 (S.D.N.Y. 1966) (defendant's motion for summary judgment granted because plaintiff had not purchased stocks issued pursuant to the registration statement).

38 *Id.*

39 See James, *supra* note 15; Ballantine, *supra* note 15.

40 See, e.g., Teass, *Duty of Directors and Others as Prescribed by Section 11 of the Securities Act of 1933*, 20 VA. L. REV. 818 (1934).

There will no doubt grow up a body of law to guide directors, officers, experts, etc., in the degree of care they must exercise to avoid liability but in the interval they should exercise extreme care and caution to secure freedom from liability, and record for purposes of refreshing their memories at least a brief digest of the investigations made and grounds of their belief. *Id.* at 845.

41 This estimate was made by Mr. Justice Douglas, then a Professor of Law at Yale University, and George C. Bates. Douglas and Bates, *supra* note 27, at 173.

42 *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 655-82 (S.D.N.Y. 1968).

43 *Id.* at 682-703.

44 1 S.E.C. 6 (1934).

45 *Id.* at 8.

ment filed by BarChris which became effective on May 16, 1961, misstated BarChris's true financial position within the meaning of section 11(a) in eight different respects:<sup>46</sup>

- (1) current assets were overstated by approximately \$600,000 in BarChris's December 31, 1960, balance sheet.<sup>47</sup> The working capital ratio,<sup>48</sup> originally stated at 1.9 to 1, which the court considered "bad enough"<sup>49</sup> was, with the overstatement of current assets eliminated, 1.6 to 1.<sup>50</sup>
- (2) Contingent liabilities as of April 30, 1961, were understated by more than \$600,000.<sup>51</sup>
- (3) Sales for the quarter ended March 31, 1961, were overstated by more than \$500,000, with a corresponding overstatement of gross profits of \$230,000.<sup>52</sup>
- (4) Orders on hand were overstated as of March 31, 1961, by \$4,490,000.<sup>53</sup>
- (5) Page 10 of the prospectus contained in the registration statement represented that all loans made by the officers of BarChris to the corporation had been repaid. In reality, at the time the registration statement became effective, loans made by three of BarChris's officers to the corporation aggregating over \$380,000 were outstanding and unpaid.<sup>54</sup>
- (6) The company failed to make adequate disclosure of the fact that several of its customers were in arrears in meeting their payments to BarChris's chief factor, Talcott, and that BarChris was contingently liable in case of customer defaults in the sum of over \$1,350,000.<sup>55</sup>
- (7) On page 2 of the prospectus the company represented that the proceeds of the debenture sale would be used to finance construction of a new plant, develop a new equipment line, cover a loan to a wholly owned subsidiary, and to expand its business generally. Actually, the officers of the corporation intended to use over \$1,000,000 of the proceeds to pay its creditors, and an additional \$120,000 to make a loan to another company.<sup>56</sup>
- (8) The section of the prospectus which described BarChris's business failed

46 The existence of a single material misstatement in a registration statement at the date it becomes effective is a sufficient basis for liability under the section. Securities Act of 1933 § 11(a), 48 Stat. 82 (1933), 15 U.S.C. § 77k (1964).

47 *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 682 (S.D.N.Y. 1968).

48 The working capital ratio, or "current ratio," is obtained by dividing the total dollar value of current assets by the total dollar value of current liabilities. This ratio indicates a corporation's ability to pay all current liabilities if current assets were converted to cash in the normal operating cycle of the business. For an analysis of the various ratios that may be used in determining the quality and value of a security, see D. BELLEMORE, *INVESTMENTS PRINCIPLES PRACTICES AND ANALYSES* 629-57 (2d ed. 1962).

49 *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 682 (S.D.N.Y. 1968). A current ratio of 2:1 generally is considered to be satisfactory, but the acceptability of a ratio should also be judged according to averages in the particular industry. J. BOGEN, *FINANCIAL HANDBOOK* 8-32 (4th ed. 1964).

50 *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 682 (S.D.N.Y. 1968).

51 *Id.* at 667.

52 *Id.* at 668.

53 *Id.* at 668-71.

54 *Id.* at 671-73.

55 *Id.* at 676-78, 680.

56 *Id.* at 673-76.

to state that BarChris, in addition to building, equipping, and repairing bowling alleys, was also in the business of operating them.<sup>57</sup>

## II. The Section 11(b)(3) Defenses

Since the plaintiffs had successfully sustained the burden of establishing a prima facie case against the defendants, the burden of pleading and proving the right to the affirmative defenses of section 11(b)(3) shifted to the defendants.<sup>58</sup> BarChris, who as the issuer, was barred from establishing the defenses of section 11(b)(3),<sup>59</sup> was the only defendant which did not plead the affirmative defenses contained therein. With the exception of Peat, Marwick, Mitchell & Co. — determined by the court to be the “expert” within the meaning of the subsection<sup>60</sup> — each of the defendants relied on the provisions of subsections (b)(3)(A) and (b)(3)(C). These provide, in relevant part, that no person other than the issuer shall be liable under the provisions of section 11 if he sustains the burden of proving

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert . . . he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) . . . he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statement therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert. . . .<sup>61</sup>

Peat, Marwick, Mitchell & Co. pleaded the due diligence defense for an expert available under section 11(b)(3)(B). That subsection, in relevant part, provides, that an expert will not be held liable under section 11 if he sustains the burden of proving that

as regards any part of the registration statement purporting to be made upon his authority as an expert . . . he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be

<sup>57</sup> *Id.* at 678.

<sup>58</sup> See text accompanying note 23 *supra*.

<sup>59</sup> See text accompanying note 24 *supra*.

<sup>60</sup> *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 683-84 (S.D.N.Y. 1968).

<sup>61</sup> Securities Act of 1933 § 11(b)(3)(A),(C), 48 Stat. 82 (1933), 15 U.S.C. § 77k (1964).

stated therein or necessary to make the statements therein not misleading . . . .<sup>62</sup>

In all, nineteen defendants pleaded the due diligence defenses of section 11(b)(3).<sup>63</sup> To attempt to present a searching analysis of the degree of care exercised by *each* defendant and the court's view with respect thereto is beyond the scope of this comment. On the other hand, to merely indulge in broad generalizations concerning the degree of due diligence exercised by the defendants as a whole would result in, at best, a too casual appraisal of the guidelines established by the court relative to the affirmative defenses in subsection (b)(3), and would defeat the intent of this discussion. Therefore, in the competing interests of clarity and brevity, this study will consider individually the extent to which the various classes of defendants sustained the burden of successfully pleading their affirmative defenses. These classes are categorized according to the similarities noted by the court concerning the degree of care exercised by them and demanded by the statute.

### A. *The Signers of the Registration Statement*

#### 1. Officers of the Corporation

Vitolo was the President, Russo, the Executive Vice-President, Pugliese, the Vice-President, Kircher, the Treasurer, and Birnbaum, the Secretary of BarChris.<sup>64</sup> Each of them, the court held, had knowledge of the misleading character of at least some of the material misstatements contained in the prospectus. Kircher and Russo were held by the court to have known all the relevant facts regarding the actual state of BarChris's financial position at the time the registration statement became effective. Birnbaum, Vitolo, and Pugliese could not, it was judged, have believed that the registration statement was wholly true because of their knowledge and appreciation of BarChris's financial problems which were not disclosed in the registration statement.<sup>65</sup> What is significant is that even if one (or, for that matter, all) of BarChris's officers had absolutely no knowledge or reason to know that there were any material misstatements in the registration statement, he still would not have been able to avoid liability. Mere lack of culpability is not a defense under section 11. This is so because one of the chief prerequisites to the successful maintenance of a subsection (b)(3)(A) defense is proof of a reasonable investigation of the non-expertised portion of

<sup>62</sup> *Id.* § 11(b)(3)(B).

<sup>63</sup> The defendants, and the basis of their liability under the section, were: Trilling, signer of the registration statement [section 11(a)(1)]; Vitolo, Russo, Pugliese, Kircher, Birnbaum, Auslander, Rose, and Grant, signers of the registration statement and directors of BarChris [section 11(a)(1),(2)]; Coleman, signer of the registration statement, director of BarChris, and underwriter [section 11(a)(1),(2),(5)]; Drexel & Co., Hemphill, Noyes & Co., Paine, Webber, Jackson & Curtis, Salomon Brothers & Hutzler, Peter Morgan & Co., Blair & Co. and G. H. Walker & Co., underwriters of the debentures [section 11(a)(5)]; and Peat, Marwick, Mitchell & Co., BarChris's auditors [section 11(a)(4)]. All failed to sustain the burden of proof required by section 11(b). Birnbaum, Auslander, Rose, Grant, Coleman, and the underwriters successfully pleaded section 11(b)(3)(C), but failed to meet the requirements of section 11(b)(3)(A).

<sup>64</sup> *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 652 (S.D.N.Y. 1968).

<sup>65</sup> *Id.* at 684-87.

the registration statement,<sup>66</sup> and no investigation was conducted by any of the defendants. The court indicated that had an investigation been made, it could not have afforded the defendants reasonable grounds to believe the prospectus contained no material misstatements because they had actual knowledge of the true state of BarChris's financial affairs.<sup>67</sup> However, the complete absence of any investigation was in itself sufficient grounds to deny the defense of due diligence to the officers.

## 2. Trilling

Trilling was BarChris's controller and was neither a director nor officer of BarChris. He was, the court noted, actually a comparatively minor figure in BarChris's corporate scheme.<sup>68</sup> The plaintiff's sole basis for alleging that Trilling was liable was the fact that he signed the statement, and as a signer he was required to exercise due diligence in relation to the facts presented therein. As was the case with the officers, Trilling failed to make an investigation of the accuracy of the statements contained in the registration statement. Consequently, he could not establish the initial prerequisite of the due diligence defense contained in subsection (b)(3)(A).

## 3. The Outside Directors<sup>69</sup>

### *i. Auslander and Rose*

Auslander and Rose became directors of the corporation on April 17, 1961, less than one month before the effective date of the registration statement. The court noted that both were informed that they stood to reap indirect benefits of a monetary nature by accepting directorships. Vitolo told Auslander, the Chairman of the Board of a bank, that BarChris would deposit \$1,000,000 of the proceeds from the debenture sale in his bank,<sup>70</sup> and Kircher intimated to Rose, a civil engineer, that BarChris might in the future have need for his professional services.<sup>71</sup> Before becoming directors, both had made independent inquiries into the financial position of the company and had read copies of BarChris's annual report for 1960.<sup>72</sup> At the board of directors meeting held on May 15, 1961, the day before the registration statement became effective, both signed the signature sheet for the registration statement. The registration statement itself in its final form was not presented for inspection at that meeting, and apparently neither had read it before it became effective on the following day.<sup>73</sup> At the meeting Rose

<sup>66</sup> See text accompanying note 61, *supra*.

<sup>67</sup> *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 684-87 (S.D.N.Y. 1968).

<sup>68</sup> *Id.* at 686.

<sup>69</sup> An outside director for the purpose of this discussion means one who was not an officer of the corporation.

<sup>70</sup> *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 687 (S.D.N.Y. 1968). In reality the amount actually deposited was \$300,000, \$138,000 of which was soon withdrawn. *Id.* at n.18.

<sup>71</sup> *Id.* at 689.

<sup>72</sup> *Id.* at 687, 689.

<sup>73</sup> *Id.* The court noted that Rose had read the initial version of the statement for roughly ten minutes, and that Auslander had glanced briefly at the statement filed on May 11, 1961. *Id.* at 688, 689.

inquired if the information contained in the registration statement was correct and Vitolo and Russo stated before the group that it was.<sup>74</sup>

The question presented to the court concerning the due diligence defenses pleaded by Auslander and Rose was whether, because of their comparatively short tenure on the board of directors during which they had relatively little opportunity to familiarize themselves with the company's affairs,<sup>75</sup> the inquiries made by them before they became directors and their reliance on the representations of the two officers of the company constituted a reasonable investigation within the meaning of the statute. The court first noted that the standards of investigation demanded by section 11(b)(3)(A) had never been judicially interpreted. The court did not hold that no investigation had been made by Auslander and Rose as it did in the case of the officers. However, it concluded that the investigation was insufficient and made it quite clear that a director, no matter how new he may be, who relies solely on management's representations when management is a "comparative stranger," has not made the reasonable investigation required by section 11(b)(3)(A).<sup>76</sup>

## ii. Grant

Grant became a director of the corporation in October, 1960. He was an attorney and his firm was counsel to BarChris in matters which pertained to securities registration statements. He had taken initial responsibility in the preparation of the debenture registration statement. The fact that Grant was the director most intimately connected with the preparation of the registration statement was crucial to the court's analysis of the reasonableness of his investigation. The court observed that

in considering Grant's due diligence defenses, the unique position which he occupied cannot be disregarded. As the director most directly concerned with writing the registration statement and assuring its accuracy, *more was required of him in the way of a reasonable investigation than could fairly be expected of a director who had no connection with this work.*<sup>77</sup> (Emphasis added.)

The standard for determining reasonableness of investigation and reasonable grounds for belief within the meaning of section 11(b)(3) is defined in section 11(c) as "that required of a prudent man in the management of his own property."<sup>78</sup> The standard used in that subsection is substantially the standard for a fiduciary defined in the *Restatement (Second) of Trusts*, with the exception that the *Restatement* provides that "if the trustee has or procures his appointment as trustee by representing that he has greater skill than that man of ordinary prudence, he is under a duty to exercise such skill."<sup>79</sup> The court in essence

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> *Id.* at 688.

<sup>77</sup> *Id.* at 690.

<sup>78</sup> Securities Act of 1933 § 11(c), 48 Stat. 82 (1933), 15 U.S.C. § 77k (1964).

<sup>79</sup> RESTATEMENT (SECOND) OF TRUSTS § 174 (1959).

adopted this view in considering Grant's defense, and thereby judicially modified the requirements of section 11(c).

Regarding the standard of care demanded by the statute, Grant contended that if the court held he did not make a reasonable investigation, it would, practically speaking, be equivalent to holding that a lawyer must conduct an independent audit of the material contained in the registration statement. To the court, this was not a "realistic statement of the issue."<sup>80</sup> The question, in the court's opinion, was whether he made a reasonable effort to detect errors which could have been discovered without an audit.<sup>81</sup> The court then recounted a series of omissions in Grant's investigation which resulted in his failure to uncover any of the material discrepancies.<sup>82</sup> Grant failed to establish his due diligence defense because,

[a]fter making all due allowances for the fact that Bar Chris's [*sic*] officers misled him, there [were] too many instances in which [he] failed to make an inquiry which he could have easily made which, if pursued, would have put him on his guard.<sup>83</sup>

One such inquiry which Grant failed to make illustrates particularly well the court's interpretation of the type of investigation he could have used to check matters "easily verifiable" which "would have put him on his guard." On page 10 of the prospectus it was stated that Grant's law firm had received, as of the effective date of the statement (May 16, 1961), fees which totaled \$13,000. Grant had taken the word of Kircher, BarChris's Treasurer, that this bill had been paid. In reality, the law firm had received less than \$5,000, and the check for the balance of that figure was not received until shortly before June 1, 1961. BarChris had been holding delivery of checks already drawn and signed because of the lack of sufficient funds to pay them until the proceeds from the debenture issue were received. The court observed that

[i]n approving this erroneous statement in the prospectus, [Grant] did not consult his own bookkeeper to ascertain whether it was correct. . . . If he had inquired and found this representation was untrue, this discovery might well have led him to a realization of the true state of BarChris's finances in May, 1961.<sup>84</sup>

The court, with one exception, evaluated Grant's investigation in terms of what Grant did or failed to do in relation to the material misstatements contained in the registration statement. The lone exception involved the misstatement of the fees paid to Grant's firm, which is discussed above.<sup>85</sup> The sole reason the court was required to pass upon the adequacy of Grant's investigation was that the plaintiffs successfully proved that the registration statement was ma-

---

80 *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 690 (S.D.N.Y. 1968).

81 *Id.*

82 *Id.* at 690-92.

83 *Id.* at 692.

84 *Id.*

85 BarChris was not required to disclose the fees paid in the prospectus, but Grant chose to do so "in the spirit of complete disclosure." Memorandum on Behalf of Defendant Philip R. Grant at 87, *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

terially misleading. The fact that the misleading statements existed is irrefutable evidence that none of the defendants who investigated the validity of the registration statement succeeded in discovering them. The court's proposition — that the reasonableness of Grant's investigation depended on whether he took all the steps that he could have taken to lead him to a discovery of the errors — seems to break down if Grant had indeed taken the steps suggested by the court. In such a case he would not only have made a reasonable investigation; he would have uncovered all the mistakes in the unexpertised portion of the registration statement. In short, to determine the reasonableness of the investigation required of a defendant by analyzing solely whether steps which would have led to the discovery of the errors were taken is, in view of the fact that the errors were not discovered, to hold that the defendant cannot establish a defense. The more logical and reasonable method of evaluation — which, hopefully, courts faced with the same determination in succeeding cases will follow — would be to examine the *overall* scope of the investigation. The court in *Escott* chose to apply the quintessence of hindsight to its examination of Grant's investigation, and held him liable for his omissions.

### iii. *Coleman*

Coleman, like Auslander and Rose, became a director of BarChris on April 17, 1961. He was a partner in the underwriting firm of Drexel & Co., and was therefore subject to liability under section 11(a) as a signer of the registration statement, a director, and also as an underwriter. Technically it was possible for Coleman to avoid liability under the subsection as a signer and director, but still to be held liable as an underwriter. The court noted the three bases for Coleman's liability, but did not explicitly disclose the capacity or capacities in which it held him liable.

The court treated the degree of care exercised by Coleman concurrently with its discussion of the underwriters. Regarding the sufficiency of Coleman's investigation, the court stated:

The same conclusions [which the court had reached in determining that the underwriters failed to exercise due diligence] must apply to Coleman . . . . He made no investigation after he became a director. When it came to verification, he relied upon his counsel to do it for him. Since counsel failed to do it, Coleman is bound by that failure. Consequently, in his case also, he has not established his due diligence defense . . . .<sup>86</sup>

The "counsel" referred to by the court were the counsel which made the investigation for Drexel & Co. In a sense, then, the court equated the insufficiency of Coleman's investigation with that of the investigation made on behalf of the underwriters. The question thus arises whether the court was holding that the standards of reasonableness required of underwriters and directors are identical, or rather that Coleman *as an underwriter* failed to establish his affirmative defense because that defense did not measure up to the standard required of an underwriter.

<sup>86</sup> *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968).

Because of the character of the legal argument presented by the underwriters, the exact basis for Coleman's liability becomes crucial. The underwriters, as had the director Grant, relied to a great extent on the representation of management that the material contained in the registration statement was correct. The issue regarding the adequacy of the underwriter's investigation was, in the court's words: "[I]s it sufficient to ask questions, to obtain answers which, if true, would be thought satisfactory, and let it go at that, without seeking to ascertain from the records whether the answers in fact are true and complete?"<sup>87</sup> The court noted that such reliance on affirmations made by management was insufficient to establish a defense in Grant's case, and addressed itself to a determination of whether underwriters should be entitled to a different standard of care.

The legal argument advanced by the underwriters was this: under New York law a director is entitled to rely on information furnished him by the management of the corporation without making an investigation of its accuracy; since section 11 requires the same standards of due diligence of underwriters as it does of directors, underwriters should also be entitled to rely on management's word regarding the accuracy of the information furnished.

The court noted that the authority relied on by the underwriters—the New York Supreme Court case of *Litwin v. Allen*<sup>88</sup>—was not binding on federal courts in their interpretation of the Securities Act. However, the underwriters' argument was not rejected for that reason. Instead, the court attacked the analogy used to equate the position of director with that of underwriter:

In my opinion the two situations are not analogous. An underwriter has not put the company's officers "into a position of trust for the express purpose of attending to details of management."<sup>89</sup> The underwriters did not select them. In a sense, the positions of the underwriter and the company's officers are adverse. It is not unlikely that statements made by company officers to an underwriter may be self-serving. They may be unduly enthusiastic. As in this case, they may, on occasion, be deliberately false.<sup>90</sup>

The court then proceeded to hold that since the underwriter's counsel had failed to make an adequate investigation (*i.e.*, had failed to adequately verify the data presented by management), the underwriters were bound by that failure.

In its analysis of the analogy offered by the underwriters, the court impliedly recognized a difference between the standard of investigation required of a director and that required of an underwriter. The court left the impression that a director is entitled to rely to some extent on management's affirmations. Grant was not entitled to rely on management's representations, but the court

<sup>87</sup> *Id.* at 696.

<sup>88</sup> 25 N.Y.S.2d 667 (Sup. Ct. 1940). In this case, a group of directors were held not to have been negligent in connection with certain loans made by Guarantee Trust Company which ultimately resulted in a loss of \$9,000,000. The court stated that "[d]irectors have a right in forming their conclusions to rely upon information furnished and conclusions expressed by the management." *Id.* at 719.

<sup>89</sup> The court here was quoting dicta from *Dovey v. Corey*, [1901], App. Cas. 477, 486, which was cited in *Litwin v. Allen*, 25 N.Y.S.2d 667, 719 (Sup. Ct. 1940).

<sup>90</sup> *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 696-97 (S.D.N.Y. 1968).

also pointed out that "more was required of him"<sup>91</sup> since he prepared the statement. Auslander and Rose, who acted "in sole reliance upon representations of persons who [were] comparative strangers and upon general information which [did] not purport to cover the particular case,"<sup>92</sup> were unable to establish their due diligence defenses. The key word in their case, however, was "sole". Since the court seemed to infer that a director may rely on management to some degree, it therefore appears that if they had conducted at least some independent research pertinent to the registration statement they may have been successful in establishing the defense.

In Coleman's case, the court was presented with the perfect occasion to delineate precisely the exact scope of a director's duty as contrasted with the duty of an underwriter. This opportunity was bypassed, for it appears that the adequacy of the investigation made by Coleman's counsel was judged by the standards established by the court for underwriters, and that the basis for Coleman's liability was thus failure of his duty as an underwriter. Nevertheless, because of the inexactness of the court's language, the possibility that Coleman was held liable in his capacity as director cannot be completely ruled out. If such were the case, then the court did not just destroy the analogy presented by the underwriters, but it also rejected the proposition that a director need not independently verify information presented by management. It is surprising that a court which was aware that it was setting standards to be applied or at least considered in future cases<sup>93</sup> would fail to make such a distinction.

### B. The Underwriters

Drexel & Co. was the lead underwriter and conducted the investigation of BarChris both for itself and for the other underwriters named as defendants.<sup>94</sup> The court's analysis of the investigation made by Drexel was discussed in relation to Coleman, and will not be reviewed here. The court's determination that the investigation conducted by Drexel's counsel was not sufficient bound Drexel and the other underwriters who relied on Drexel to make the investigation for them.<sup>95</sup> Although not pointed out by the court, it is significant to note that Drexel's investigation was made with substantially the same degree of care as that exercised by the underwriting profession in general. Professor Loss remarked that:

In view of the paucity of § 11 actions, there is little case law on the several defenses. In practice, the principal underwriters usually arrange sometime during the waiting period a "due diligence meeting" attended by

<sup>91</sup> *Id.* at 690.

<sup>92</sup> *Id.* at 688.

<sup>93</sup> With respect to Grant, the court stated: "In my opinion, this finding on the evidence of this case does not establish an unreasonably high standard for company counsel who are also directors." *Id.* at 692.

<sup>94</sup> Hemphill, Noyes & Co.; Paine, Webber, Jackson & Curtis; Salomon Brothers & Hutzler; Peter Morgan & Company; Blair & Co.; G. H. Walker & Co.; and Ira Haupt & Co. The action was severed as against Ira Haupt & Co., which went bankrupt prior to the date of the opinion.

<sup>95</sup> *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 693 (S.D.N.Y. 1968).

representatives of the issuer, its counsel, the underwriters and their counsel, the accountant, and any other experts. Everybody is thus afforded the opportunity to exercise "due diligence" by asking questions. Nobody knows how valuable a safeguard this is. But it seems advisable, in the present state of the law and in view of the potentially grave liabilities under § 11, to do something of this sort in a serious manner rather than perfunctory.<sup>96</sup>

The opinion of the court mentioned three meetings held in March of 1961 that were attended by representatives of the underwriters and BarChris. Peat, Marwick, Mitchell & Co. was represented at one of these meetings.<sup>97</sup> The court also noted that several other meetings of this nature were held.<sup>98</sup> Yet because of the ruling in *Escott* that an underwriter must go behind and beyond the representations of the company's officers in an attempt to verify the accuracy of management's statements, this and other methods of investigation used by the underwriting profession as a whole are, no doubt, undergoing serious re-evaluation and revision.<sup>99</sup>

### *C. Peat, Marwick, Mitchell & Co.*

The affirmative defense available to and pleaded by Peat, Marwick as the expert within the meaning of subsection (b) was section 11(b)(3)(B).<sup>100</sup> The question which the court had to decide was

[W]hether [at the date the registration became effective] Peat, Marwick, after reasonable investigation, had reasonable ground to believe and did believe that the 1960 figures [certified by Peat, Marwick] were true and that no material fact had been omitted from the registration statement which should have been included in order to make the 1960 figures not misleading.<sup>101</sup>

In its analysis of Peat, Marwick's audit of BarChris for the year ended December 31, 1960, and subsequent S-1 review, the court stated that it was concerned only with the investigation as it related to the errors which the court considered material.<sup>102</sup> The standard by which the accounting firm was measured supposedly reflected generally recognized principles of the profession. On this basis, the investigation was held insufficient. The court observed that the Peat, Marwick accountant who conducted the S-1 review did not fully complete the steps required in the firm's own written program for the review, and, most importantly, that "he was too easily satisfied with glib answers"<sup>103</sup> to the inquiries he made of management.

96 3 Loss 1730-31.

97 *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 693 (S.D.N.Y. 1968).

98 *Id.* at 694.

99 For a list of the steps taken in the performance of a "due diligence" investigation by one underwriting firm when it acts as managing underwriter of an issue for a company making its initial offering of common stock, see *Report of the Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Cong., 1st Sess. pt. 1, 513 (1963).

100 See text accompanying note 62 *supra*.

101 *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 698 (S.D.N.Y. 1968).

102 *Id.* at 699.

103 *Id.* at 703.

### III. Conclusion

In judging the availability of the due diligence defenses to the defendants, the *Escott* court was required to make two basic determinations. The first related to the standard of care required of the defendants, and the second to an evaluation of the degree to which the defendants succeeded in fulfilling that standard of care. The guidelines promulgated by the *Escott* court regarding the degree of diligence demanded of the different defendants varied, as the House Committee which discussed the Securities Act felt it should, "with the importance of their place in the scheme of distributions and with the degree of protection the public has a right to expect."<sup>104</sup> The accounting firm, Peat, Marwick, Mitchell & Co., was held to the standard of care practiced in the accounting profession. Grant, a director, was held to a greater standard of care than would have been the case had he not been involved in the preparation of the registration statement. The court also implied that the degree of care required of underwriters was greater than that of directors, other than those in a position similar to that of Grant. The court made it clear that, in the case of experts, underwriters and company counsel associated with the preparation of the registration statement, more is required to establish the reasonable investigation demanded by the statute than acceptance of management's affirmations regarding the accuracy of the materials presented in the statement. Although the court held that Auslander and Rose were also not entitled to rely on the representations made by the officers, the position can be taken that the court did not read the statute to bar at least partial reliance by directors on information prepared and supplied by management. This interpretation is based on the court's implied acceptance of *Litwin v. Allen*,<sup>105</sup> and on the fact that the court considered that, in relying on Vitolo and Russo, Auslander and Rose placed their faith in the statements of "comparative strangers."<sup>106</sup> Because of the uniqueness of Auslander and Rose's position as newly elected directors, a generalization concerning the standard of care required of a director, based on the court's treatment of them, would be founded on what must be regarded as an uncertainty. Until additional judicial interpretation is forthcoming, the investigative standard required of a director under section 11(b)(3)(A) must be considered an open question.

The criterion used by the court in its determination of whether the investigative standards of reasonableness demanded by subsection (b)(3) were met by the underwriters, accountants, and lawyers was based primarily on a study of the steps which the defendants might have taken to discover the errors contained in the registration statement. For example, in relation to the misstatement in the prospectus that all loans by officers to BarChris had been repaid, the court observed that "Grant should have investigated further,"<sup>107</sup> that the underwriter's counsel "made no inquiry after March,"<sup>108</sup> and that Peat, Marwick's

104 H.R. REP. No. 85, *supra* note 12, at 9.

105 25 N.Y.S.2d 667 (Sup. Ct. 1940).

106 *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 688 (S.D.N.Y. 1968).

107 *Id.* at 691.

108 *Id.* at 695.

senior accountant in charge of the S-1 review "did not know"<sup>109</sup> of the situation. In reality it was not until the spring of 1966, more than three years after the suit was brought, that plaintiff's counsel "despite all their [independent] auditing procedures and investigative expertise"<sup>110</sup> discovered the error.

By holding that the defendants failed to make the reasonable investigation which a prudent man in the management of his own property would have made, the *Escott* court expressed the opinion that, had the defendants conducted a reasonable investigation, they would have discovered at least some of the material misstatements. The court recognized that each case is unique, and that the criteria used by one court in evaluating investigative techniques would not be binding on courts faced with the same determination in later cases. Hopefully such subsequent courts will make a determination of reasonableness based on the overall scope of investigation made by the defendant and not solely on what he might have done, based on hindsight, to discover the errors. As the Supreme Court stated in *United States v. American Bell Telephone Company*:<sup>111</sup> "But a wisdom born after the event is the cheapest wisdom of all. Anybody could have discovered America after 1492."<sup>112</sup>

At the time of its enactment it was recognized that while the civil liabilities provisions of the Securities Act were primarily remedial in nature, they also operated *in terrorem*<sup>113</sup> and exercised coercive pressure on those engaged in the issuance of securities to comply with the disclosure requirements of the Act. Over a third of a century has since passed, and if, as plaintiff has suggested, the passage of years has caused the *in terrorem* provisions of the Act to blur,<sup>114</sup> *Escott* has served well to remind the financial community of its fundamental obligations to the investing public.<sup>115</sup>

John P. Freeman

---

CIVIL RIGHTS — PUBLIC ACCOMMODATIONS — AMUSEMENT PARK IS A PLACE OF PUBLIC ACCOMMODATION AS DEFINED IN SECTIONS 201(B)(3) AND 201(C)(3) OF THE CIVIL RIGHTS ACT OF 1964. — Amusement Enterprises, Inc. is a Louisiana corporation which operates a small amusement park in Baton Rouge, Louisiana, under the trade name "Fun Fair Park." On its two and three-quarters acres of land, Fun Fair has eleven permanently fixed mechanical "kiddie rides" and an ice skating rink which is operated only during the winter. In conjunction with the amusement facilities, Fun Fair operates a concession stand which offers soft drinks and prepared foods for customers' refreshment. On about

109 *Id.* at 702.

110 Memorandum on Behalf of Defendant Philip R. Grant at 5, *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

111 167 U.S. 224 (1897).

112 *Id.* at 261.

113 See Douglas and Bates, *supra* note 27, at 173; Shulman, *supra* note 20, at 227. See also Rodell, *Regulation of Securities by the Federal Trade Commission*, 43 YALE L. J. 272, 273 (1933).

114 Memorandum of Plaintiffs to Trial Court at 14, *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

115 For a view of the significance which members of the financial community attach to the court's decision in the instant case, see *The Wall Street Journal*, May 14, 1968, at 1, col. 6.

March 1, 1965, Mrs. Patricia Miller, a Negro, took her two minor children to the park to ice skate. They were told by the manager that Fun Fair did not "serve colored," in accordance with Fun Fair's policy of refusing Negroes access to all the park's facilities, including the concession stand and skating rink. Mrs. Miller and her children subsequently brought suit for an injunction in the United States District Court for the Eastern District of Louisiana, basing their action on sections 201(b)(3) and 201(c)(3) of the Civil Rights Act of 1964.<sup>1</sup> The district court denied plaintiff's motion for summary judgment and dismissed the action on the merits, holding that Fun Fair was not a "place of entertainment" within the meaning of section 201(b)(3) and that its operations did not "affect commerce" according to the criterion of section 201(c)(3).<sup>2</sup> Appeal was taken to the United States Court of Appeals for the Fifth Circuit which affirmed by a two to one decision on September 6, 1967.<sup>3</sup> A petition for rehearing en banc was granted. On April 8, 1968, the Fifth Circuit reversed itself, and, over the dissent of three judges, *held*: an amusement park is a place of public accommodation within the meaning of sections 201(b)(3) and 201(c)(3) of the Civil Rights Act of 1964. *Miller v. Amusement Enterprises, Inc.*, 394 F.2d 342 (5th Cir. 1968).

The issue in *Miller* had been squarely put in the district court: did the coverage of sections 201(b)(3) and 201(c)(3) extend to Fun Fair? This was

<sup>1</sup> Civil Rights Act of 1964 § 201, 78 Stat. 243-44, 42 U.S.C. § 2000a (1964) provides in part:

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

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

(1) any inn, hotel, motel, or other establishment which provides lodging to transient guests . . . ;

(2) any restaurant, cafeteria, lunchroom, lunch counter, soda fountain, or other facility principally engaged in selling food for consumption on the premises . . . ;

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

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

(c) The operations of an establishment affect commerce within the meaning of this subchapter if (1) it is one of the establishments described in paragraph (1) of subsection (b) of this section; (2) in the case of an establishment described in paragraph (2) of subsection (b) of this section, it serves or offers to serve interstate travelers or a substantial portion of the food which it serves, or gasoline or other products which it sells, has moved in commerce; (3) in the case of an establishment described in paragraph (3) of subsection (b) of this section, it customarily presents films, performances, athletic teams, exhibitions, or other sources of entertainment which move in commerce; and (4) in the case of an establishment described in paragraph (4) of subsection (b) of this section, it is physically located within the premises of, or there is physically located within its premises, an establishment the operations of which affect commerce within the meaning of this subsection. . . .

<sup>2</sup> *Miller v. Amusement Enterprises, Inc.*, 259 F. Supp. 523 (E.D. La. 1966), *aff'd*, 391 F.2d 86 (5th Cir. 1967), *rev'd on rehearing*, 394 F.2d 342 (1968).

<sup>3</sup> *Miller v. Amusement Enterprises, Inc.*, 391 F.2d 86 (5th Cir. 1967).

accomplished by a stipulation of counsel which effectively excluded relief based on the segregated operations of the concession stand.<sup>4</sup>

The district court, in deciding whether Fun Fair was included in the language "other place of . . . entertainment," applied the rule of statutory construction known as *ejusdem generis*.<sup>5</sup> Reasoning that since all the specific establishments enumerated in section 201(b)(3) "are the kind that furnish entertainment to spectators as distinguished from participants," the court held that any establishment to be included in the phrase "other place of . . . entertainment" must be of a class which offers "spectator" rather than "participative" amusement.<sup>6</sup> On appeal this rationale was accepted and supported by the authority of *Robertson v. Johnston*<sup>7</sup> and *Kyles v. Paul*.<sup>8</sup> In the latter case, the United States District Court for the Eastern District of Arkansas had said:

The statutory phrase "other place of exhibition or entertainment" must refer to establishments similar to those expressly mentioned. When one considers the exhibitions and entertainment offered by motion picture houses, theatres, concert halls, sports arenas, and stadiums, it is clear at once that basically patrons of such establishments are edified, entertained, thrilled, or amused in their capacity of spectators or listeners; their physical participation in what is being offered to them is either nonexistent or minimal; their role is fundamentally passive.<sup>9</sup>

To decide whether the operations of Fun Fair "affect commerce" within the definition of section 201(c)(3), the district court in *Miller* relied upon two arguments. First it reasoned that the rule *ejusdem generis*, applied to section 201(c)(3), would dictate that "sources of entertainment" be limited to those used "for [the entertainment of] spectators and not participants."<sup>10</sup> Then it

4 It is \* \* \* stipulated by and between counsel that the plaintiff herein is making no claim that the defendant, in the operation of the concession stands wherein refreshments are allegedly served on a discriminatory basis, is operating his facilities in violation of either Sec. 201(b)(2), Sec. 201(c)(2), Sec. 201(b)(4), or Sec. 201(c)(4) of the Civil Rights Act of 1964, the plaintiff's sole contention in this suit being that the defendant is operating his place of entertainment in violation of Sec. 201(b)(3) and Sec. 201(c)(3) of the Act. It was further stipulated that the reference in the stipulated facts to the operation of the concession stands is merely to show the total operation of the defendant's facility and not to allege or show a violation of Sec. 201(b)(2), 201(c)(2), 201(b)(4), or 201(c)(4) of the Civil Rights Act of 1964. *Miller v. Amusement Enterprises, Inc.*, 394 F.2d 342, 346 (5th Cir. 1968).

5 "Of the same kind, class, or nature." BLACK'S LAW DICTIONARY 608 (4th ed. 1951).

6 *Miller v. Amusement Enterprises, Inc.*, 259 F. Supp. 523, 525-26 (E.D. La. 1966).

7 249 F. Supp. 618 (E.D. La. 1966). In *Robertson* a nightclub was found to be a "place of . . . entertainment" within section 201(b)(3) by reason of its presentation of a band. In its decision the court stated:

Any determination of the scope of the general phrase "other place of exhibition or entertainment" must be guided by the interpretive principle *ejusdem generis*: when specific terms in a statute are followed by general terms, the general terms are limited to matters similar to, or of the same general kind or class as, those specified. But the rule does not require that the general provisions be limited in scope to the identical things specifically named; rather, the purpose of this aid to construction is to prevent the general words from extending the operation of the statute into a field not really intended. Thus "place of entertainment" is not to be construed to mean "place of enjoyment", but rather must be limited at least to "place where performances are presented." *Id.* at 622. (Footnotes omitted.)

8 263 F. Supp. 412 (E.D. Ark. 1967).

9 *Id.* at 419.

10 *Miller v. Amusement Enterprises, Inc.*, 259 F. Supp. 523, 527 (E.D. La. 1966).

observed a distinction between that which "moves" in commerce and that which "has moved" in commerce. Since the mechanical rides which Fun Fair maintained were not "sources of entertainment" until they had become permanently fixed to the land and no longer moved anywhere, the court held that these devices were not "source[s] of entertainment which move in commerce."<sup>11</sup>

The approach of the majority on rehearing was trilogistic. The previous decision was reversed on the grounds that: 1) granting the applicability of *ejusdem generis* to both sections of the statute, Fun Fair was nonetheless included within the literal terms of sections 201(b)(3) and 201(c)(3);<sup>12</sup> 2) *ejusdem generis* should not be applied to limit the coverage of the words "other place of . . . entertainment" because to do so would be contrary to the obvious purpose of the legislature;<sup>13</sup> and 3) the operations of Fun Fair "affect commerce" within the meaning of section 201(c)(3).<sup>14</sup>

The first of these arguments purports to circumvent the "spectator—participant" dichotomy by asserting that Fun Fair does indeed present an exhibition for spectators. As the court said:

The amusement park *presents a performance* of small children riding on various mechanical "kiddie" rides plus a performance of ice skating. It is obvious to us that many of the people who assemble at the park come there to be entertained by watching others, particularly their own children, participate in the activities available.<sup>15</sup> (Emphasis added.)

Apparently the germ of this rationale was planted by a somewhat obscure footnote in appellant's brief on rehearing, since the argument had not been previously advanced in the *Miller* case or in any case cited by the court or counsel. The footnote contained the following clause: "[S]urely [amusement parks] are a type of spectacle, and the customers' enjoyment does not depend solely on their actual participation in the available activities."<sup>16</sup>

Having found the requisite "spectator" type performance, the court then had to show that the presentation of this performance "affects commerce" according to the criterion of section 201(c)(3). This would be accomplished if it were shown that the performers (the children) "move in [interstate] commerce."<sup>17</sup> As the court put it: "[W]e can not ignore the logical conclusion that a number of the patron-performers of the Fun Fair amusement park, an essential part of Fun Fair's exhibition, move in commerce."<sup>18</sup>

11 *Id.* at 528.

12 *Miller v. Amusement Enterprises, Inc.*, 394 F.2d 342, 348-49 (5th Cir. 1968).

13 *Id.* at 349-51.

14 *Id.* at 351-52.

15 *Id.* at 348.

16 Supplemental Brief for Appellants on Rehearing at 8 n.8, *Miller v. Amusement Enterprises, Inc.*, 394 F.2d 342 (5th Cir. 1968). The district court had apparently been under the impression that the basis for this argument had been stipulated away: "[I]t [was] agreed by all parties to this suit that no exhibitions are presented or conducted on the defendant's premises . . ." *Miller v. Amusement Enterprises, Inc.*, 259 F. Supp. 523, 525 (E.D. La. 1966). Appellee's brief similarly indicates that the defendant was under the same impression: "It has been conceded by Appellant . . . that the park is not a place of exhibition . . ." Appellee's Brief on Rehearing at 5, *Miller v. Amusement Enterprises, Inc.*, 394 F.2d 342 (5th Cir. 1968).

17 110 CONG. REC. 6557 (1964) (remarks of Senator Kuchel).

18 *Miller v. Amusement Enterprises, Inc.*, 394 F.2d 342, 349 (5th Cir. 1968).

The foregoing rationale immediately invites inquiry whether a group of children ice skating or riding a "roto-whip" can be properly said to be a performing group<sup>19</sup> or an exhibition which Fun Fair presents for the amusement of its (adult) customers. Such would at least be a novel performance in that the entertainers rather than the entertained have paid the price of admission.<sup>20</sup> In a Virginia case involving an ice skating rink, and even though the spectators as well as the participants had paid an admission fee, the Virginia Supreme Court of Appeals had noted:

Moreover, if it can be justly said that on ordinary occasions there was any public performance, because of the fact that some of those who visited the rink were mere spectators of the exercises, it certainly cannot be said that such performance was exhibited by the [defendant]. For those whose movements were witnessed by the spectators were not agents or employes of the [defendant], or in any way subject to his control; but were persons who resorted thither for their own pleasure or amusement, and not for the purpose of exhibiting themselves or their skills to others.<sup>21</sup>

No doubt some of the patrons of Fun Fair were amused by the antics of others, but if this alone were sufficient to extend coverage of sections 201(b)(3) and 201(c)(3) to the establishment, it would follow that bowling alleys, pool halls, and dance studios would also be covered. In these places, too, some people may be entertained by watching as well as by doing, but the history of the 1964 Civil Rights Act is clear that such establishments are not to be covered. Representative Kastenmeier made this point quite explicit when he observed, "[T]he bill would allow discrimination to continue in . . . bowling alleys, and other places of recreation and participation sports, unless such places serve food."<sup>22</sup> Senator Magnuson, floor manager of S. 1732, the Senate version of the bill which eventually became the Civil Rights Act of 1964, re-emphasized this fact: "The following establishments would, therefore, be generally exempt: . . . Dance studios. Bowling alleys and billiard parlors."<sup>23</sup> It might be suspected that the Fifth Circuit recognized the tenuous nature of its literal-coverage argument when it characterized its remarks as "not necessary to our decision."<sup>24</sup>

The court's second task concerned the inapplicability of *ejusdem generis* to the language "other place of exhibition or entertainment." In *Cuevas v. Sdrales*,<sup>25</sup> the Tenth Circuit had offered the following statement of the rule: "Ordinarily, when specific terms in a statute are followed by general terms, the general terms are limited to matters similar to those specified, unless to do so would defeat the obvious purposes of the statute."<sup>26</sup> The argument in *Miller* that application of *ejusdem generis* would defeat the obvious purpose of the

19 This term is used in S. REP. NO. 872, 88th Cong., 2d Sess. 3 (1964).

20 Absence of an admission fee was one factor considered in determining whether piano playing was an "exhibition" in *People v. Campbell*, 51 App. Div. 565, 65 N.Y.S. 114 (1900).

21 *Harris v. Commonwealth*, 81 Va. 240, 244, 59 Am. R. 666, 668-69 (1885).

22 H.R. REP. NO. 914, 88th Cong., 1st Sess. 40-41 (1963). See *Adams v. Fazzio Real Estate Co.*, 268 F. Supp. 630, 633 (E.D. La. 1967).

23 110 CONG. REC. 7407 (1964).

24 *Miller v. Amusement Enterprises, Inc.*, 394 F.2d 342, 348 (5th Cir. 1968).

25 344 F.2d 1019 (10th Cir. 1965), *cert. denied*, 382 U.S. 1014 (1966).

26 *Id.* at 1020. (Citations omitted.)

statute rested on two grounds: 1) that the rule would give "words and phrases embodied in the statute a definition or interpretation different from their common and ordinary meaning,"<sup>27</sup> and would render superfluous the word "entertainment";<sup>28</sup> and 2) that "the spirit embodied in [the] law" would be violated if the rule were applied.<sup>29</sup>

The first of these contentions is supported in the opinion by citations to Webster's Third New International Dictionary, Rodale's Synonym Finder, and Roget's International Thesaurus, each of which indicates that the word "entertainment" includes or is synonymous with the word "amusement."<sup>30</sup> The logic is that since Fun Fair is surely a place of amusement, and since the word "entertainment" contains the meaning "amusement," then Fun Fair must be a "place of . . . entertainment" and hence covered by the language of section 201(b)(3). Judicial authority cited for this proposition consists of two cases, *Cheney v. Tolliver*<sup>31</sup> and *Young v. Board of Trustees*.<sup>32</sup> The former asserts (paraphrasing Webster) that "entertainment" is synonymous with "amusement"; the latter defines "entertainment" as including "amusement," and cites Webster. In the *Cheney* case, the statute under scrutiny referred to "places of amusement, . . . athletic, entertainment, recreational events, . . . access to or the use of amusement, entertainment, athletic or recreational facilities . . ." <sup>33</sup> This language clearly included both "spectator" events ("athletic . . . events") and participative activities ("use of amusement, entertainment, athletic or recreational facilities"). In *Young*, the phrase "public entertainments" was construed to include dancing. The statute involved<sup>34</sup> contained no specific enumerations or other indications which would limit the generic term, and it appeared that the legislature had used the word in its broadest sense.

Analysis of other judicial constructions of these terms makes it clear that the word "amusement" — like the word "entertainment" — is generic, and includes both "spectator" and "participative" activities depending upon its context.<sup>35</sup> On the other hand, the word "exhibition" is very restricted, and refers only to "spectator" events.<sup>36</sup> In each decision construing one of the generic words, the extent of coverage is determined either by definitions in the statute<sup>37</sup> or by consideration of the language surrounding the generic word.<sup>38</sup> In many

27 *Miller v. Amusement Enterprises, Inc.*, 394 F.2d 342, 350 (5th Cir. 1968).

28 *Id.* at 350-51.

29 *Id.* at 353.

30 *Id.* at 351.

31 234 Ark. 973, 356 S.W.2d 636 (1962).

32 90 Mont. 576, 4 P.2d 725 (1931).

33 ARK. STAT. ANN. § 84—1903 (1947).

34 Law of March 12, 1913, ch. 76, § 2104, Mont. Laws 298, 300 as amended Law of March 1, 1929, ch. 48, § 1, Mont. Laws 78, 80.

35 Thus, in the absence of language that would restrict the general meaning or "distinguish between amusements that are participative and those that are exhibitive", the word "amusement" would include both types of activity. *Stiska v. City of Chicago*, 405 Ill. 374, 381-83, 90 N.E.2d 742, 746-47 (1950).

36 See *Longwell v. Kansas City*, 199 Mo. App. 480, 484, 203 S.W. 657, 659 (1918).

37 *Stiska v. City of Chicago*, 405 Ill. 374, 90 N.E.2d 742 (passim) (1950) (discussing the city ordinance); *Webber v. City of Chicago*, 148 Ill. 313, 36 N.E. 70 (1894).

38 A public dance was included by the language "other public amusement" in *Pearson v. City of Seattle*, 14 Wash. 438, 44 P. 884 (1896). This case involved an ordinance which expressly covered, *inter alia*, skating rinks, theaters, and shows. The court noted that the inclusion of the skating rink (a participative amusement) made it possible to consider dancing

cases considering the problem, the language of the statute involved has made it clear that the word in context includes both "spectator" and "participative" types of amusement, either by definition, as in *In re City of Enid*,<sup>39</sup> or by specific enumerations which contain examples of both types of activity, as in *Pearson v. City of Seattle*.<sup>40</sup> In such instances there can be no room for *ejusdem generis*, and arguments based on the rule have been properly rejected.

In *Miller* the statute under scrutiny contained no such bar to the application of *ejusdem generis*. Indeed, every one of the specific establishments enumerated is of the "spectator" rather than the "participative" genus. Even the word "exhibition," while not as specific as the words which precede it, has been judicially interpreted to include only "spectator" or "audience" events and to exclude "participative" activities.<sup>41</sup> There is no language in the statute that would indicate an intent to cover recreational facilities of a non-exhibitive nature.

Turning to the legislative history of the Act, it should be noted that all of the twenty-two competing civil rights bills as introduced into the House and Senate used the language "public place of amusement or entertainment" in their public accommodations provisions.<sup>42</sup> However, H.R. 7152 as reported by the House Judiciary Committee — the bill which became law — had substituted the restricted word "exhibition" for the generic "amusement."<sup>43</sup> Representative Kastenmeier was of the opinion that the bill as reported did indeed make a distinction between places of spectator entertainment and places of participative activity. He stated:

---

(another participative amusement) as within the class of regulated activities. *Id.* at 885. Dancing was also within coverage of an Iowa civil rights statute in *Amos v. Prom, Inc.*, 117 F. Supp. 615 (N.D. Iowa 1954), *appeal dismissed per stipulation*, 214 F.2d 350 (8th Cir. 1954). This case, and its discussion of the authorities, makes it clear that the phrase "place of amusement" in a state civil rights statute will be given general meaning when the statute which contains it does not appear to impose any restriction on its meaning. A swimming pool was included by the language "any [place] of public accommodation, resort or amusement" in *State v. Rosecliff Realty Co.*, 1 N.J. Super. 94, 62 A.2d 488 (1948). In this case, language in the statute which might have restricted the meaning of the general terms was clearly not intended by the legislature to be an exhaustive list of covered establishments. Furthermore, the specific facilities mentioned included examples of both spectator and participative amusements. *Id.* at 100-01, 62 A.2d at 490. Bowling was within the term "amusement" in *Hanover Borough v. Criswell*, 205 Pa. Super 65, 208 A.2d 39 (1965), *affg mem.* 35 Pa. D. & C.2d 203. The statute in that case evidenced an intent to cover participative activities by its use of the words "engaging in." Also, the list of amusements specifically covered by the statute was not intended to be exhaustive as is clear from the language "All manner and form of entertainment, including but not limited to . . ." *Id.*

39 195 Okla. 365, 158 P.2d 348 (1945). In this case the statute contained the language: ". . . places of amusements, . . . athletic, entertainment, recreational events, . . . privilege of or having access to or the use of amusements, entertainment, athletic or recreational facilities . . ." There was thus drawn a distinction between "spectator" and "participative" activities. By definition, both types were included within the purview of the statute.

40 14 Wash. 438, 44 P. 884 (1896).

41 *Longwell v. Kansas City*, 199 Mo. App. 480, 484, 203 S.W. 657, 659 (1918).

42 *Hearings on Miscellaneous Proposals Regarding the Civil Rights of Persons Within the Jurisdiction of the United States Before Subcomm. No. 5 of the House Comm. on the Judiciary*, 88th Cong., 1st Sess., ser. 4, pt. 1, at 652, 663, 678, 689, 700, 712, 723, 734, 745, 756, 767, 778, 789, 799, 819, 821, 832, 843, 854, 865, 888 (1963) [hereinafter cited as *House Hearings*]; *Hearings on S. 1732 Before the Senate Comm. on Commerce*, 88th Cong., 1st Sess., ser. 26, pt. 1, at 3 (1963) [hereinafter cited as *Senate Hearings*].

43 H.R. REP. No. 914, 88th Cong., 1st Sess. (1963) reprinted in BUREAU OF NATIONAL AFFAIRS, THE CIVIL RIGHTS ACT OF 1964 135, 137 (1964).

In title II, the bill reported by the full committee is deficient in that it guarantees equal access to only some public accommodations, as if racial equality were somehow divisible. Discrimination is prohibited in the reported version of H.R. 7152 in all . . . places of entertainment and *spectator sports*. At the same time, the bill would allow discrimination to continue in . . . bowling alleys, and other places of *recreation* and *participation* sports, unless such places serve food.<sup>44</sup> (Emphasis added.)

Moreover, the original bills contained language clearly directed toward participative amusement facilities, and which would have extended coverage to swimming pools, tennis courts, amusement parks, and other recreational areas. That provision covered: “. . . any . . . establishment where goods, services, *facilities*, privileges, advantages, or accommodations *are held out* to the public for sale, use, rent, or hire . . . .”<sup>45</sup> (Emphasis added.) This provision was conspicuously absent from the reported bill.<sup>46</sup> The omission of this provision, taken together with the simultaneous substitution of the word “exhibition” for “amusement,” is strong evidence of a legislative intention to exclude recreational areas from the coverage of section 201(b)(3).

The only direct congressional reference to amusement parks is contained in a statement made by Senator Humphrey.<sup>47</sup> He referred to a demonstration that had taken place at Gwynn Oak Amusement Park, Maryland, saying:

If doubts existed prior to this weekend about the desirability of President Kennedy's pending proposal to secure equal access to public facilities, these events surrounding the mass arrests at Gwynn Oak Amusement Park should have banished them.

. . . .

. . . If ever there was proof of need of the President's program, it took place within 40 miles of the Nation's Capital [*sic*] . . . .<sup>48</sup>

Two points should be noted in considering this statement. First, coverage might have extended to Gwynn Oak under sections 201(b)(4) and 201(c)(4) of the statute, a real possibility which had been stipulated away in *Miller*.<sup>49</sup> Second,

44 H.R. REP. NO. 914, 88th Cong., 1st Sess. 40-41 (1963).

45 *House Hearings*, *supra* note 42, at 653, 663, 678, 689, 700, 713, 723, 734, 745, 756, 767, 778, 789, 799, 810, 821, 832, 843, 854, 866, 888; *Senate Hearings*, *supra* note 42, at 3.

46 H.R. REP. NO. 914, *supra* note 44, at 2-3. Thus, while the proposed bills surely would have covered amusement parks with this provision, the reported version makes no such attempt. See 43 NOTRE DAME LAWYER 440, 444 (1968).

47 The point is advanced in Supplemental Brief for Appellants on Rehearing at 7 n.6, *Miller v. Amusement Enterprises, Inc.*, 394 F.2d 342 (5th Cir. 1968).

48 109 CONG. REC. 12275-76 (1963).

49 See note 4 and accompanying text, *supra*. In another case involving Gwynn Oak, *Drews v. Maryland*, 381 U.S. 421 (1965), certiorari was denied by the United States Supreme Court. In his opinion dissenting to the denial of certiorari, Mr. Chief Justice Warren noted that the 1964 Civil Rights Act covered the amusement park. He implied (without elaboration) that section 201(b)(3) might be applicable, but in fact based his contention on the “captive facilities” provision of the Act. He chose to frame his argument in the following terms:

There is a restaurant at Gwynn Oak Park; indeed petitioners were standing next to it when they were arrested. If a substantial portion of the food served in that restaurant has moved in interstate commerce, the entire amusement park is a place of public accommodation under the Act. §§ 201(b)(2), 201(b)(4), 201(c). See also § 201(b)(3). If the Court were unwilling to assume that the restaurant

Senator Humphrey made the statement on July 9, 1963, while the administration's proposed bill was still in committee, *i.e.*, before H.R. 7152 had been amended by omission of the "use of facilities" provision and deletion of the word "amusement."

Precisely the same objections are applicable to the statement of President Kennedy which the *Miller* majority quoted on rehearing:

No action is more contrary to the spirit of our democracy and Constitution — or more rightfully resented by a Negro citizen who seeks only equal treatment — than the barring of that citizen from restaurants, hotels, theaters, *recreational areas* and other public accommodations and facilities.<sup>50</sup> (Emphasis added.)

The administration's bill in its proposed form very likely would have covered most "recreational areas" under its "use of facilities" provision or the provision which is presently section 201(b)(4). But the Humphrey and Kennedy statements are not entirely apposite to the *Miller* case.

Even if, *arguendo*, it is conceded that the legislative history of the Act is "inconclusive," "obscure," or capable of "[supporting] differing interpretations" as contended by the majority on rehearing,<sup>51</sup> this would be yet another reason to apply *ejusdem generis*. As is pointed out in the case of *Hanover Borough v. Criswell*,<sup>52</sup> cited by the majority: "[E]jusdem generis is but a rule of construction to aid in giving effect to the legislative intent, *where there is uncertainty . . .*"<sup>53</sup> (Emphasis added.) The rule should not be applied, said the *Miller* majority," when the result of its use would be contrary to the *obvious* purpose of the statute in question."<sup>54</sup> (Emphasis added.) If, then, the legislative history is thought "inconclusive," and if no "obvious" purpose to include recreational establishments or facilities appears from the language of the statute (as it did in *Hanover Borough*), then the rule *ejusdem generis* should be applied to help properly discover the limits of the statute's general terms.

The third question discussed by the majority is whether the activities of Fun Fair "affect commerce" within the meaning of section 201(c)(3). There can be no doubt that Fun Fair is well within the reach of a statute based on commerce clause power.<sup>55</sup> The Fifth Circuit places great emphasis on the facts which connect Fun Fair with interstate commerce, and these facts are more than adequate to show that Fun Fair could easily be reached by a federal non-discrimination statute. It should be noted, however, that the commerce clause of

serves a substantial portion of such food, the proper course would be to remand the case for a hearing on the issue. *Id.* at 428 n.10 (dissenting opinion).

An interesting possibility whereby section 201(b)(3) might be applied to amusement parks such as Gwynn Oak is suggested in 43 NOTRE DAME LAWYER 445 n.40 (1968).

50 Letter from John F. Kennedy to the Congress of the United States, Feb. 28, 1963, quoted in *Miller v. Amusement Enterprises, Inc.*, 394 F.2d 342, 353 (5th Cir. 1968).

51 *Miller v. Amusement Enterprises, Inc.*, 394 F.2d 342, 349 (5th Cir. 1968).

52 35 Pa. D. & C.2d 203 (1964), *aff'd mem.*, 205 Pa. Super. 65, 208 A.2d 39 (1965).

53 *Id.* at 206.

54 *Miller v. Amusement Enterprises, Inc.*, 394 F.2d 342, 350 (5th Cir. 1968) (citations omitted).

55 *See, e.g.*, *Heart of Atlanta Motel, Inc. v. United States*, 379 U.S. 241 (1964); *Katzenbach v. McClung*, 379 U.S. 294 (1964); 110 CONG. REC. 7401-04 (1964) (remarks of Senator Magnuson).

the Constitution is not "self-executing."<sup>56</sup> It is not sufficient to show that a particular activity is within the province of congressional control; it must also be shown that some legislation has been addressed to the particular activity and thus exercised the power granted by the Constitution. The proper criteria for determining whether Fun Fair is within the coverage of the Civil Rights Act is the language of section 201(c)(3) and not the limits of commerce clause authority.<sup>57</sup> Senator Magnuson, chairman of the Senate Commerce Committee, framed the question:

[T]he commerce power is broad and plenary; and of course the committee did not have any problem as to the authority of Congress to implement its power under the commerce clause. The committee's real problem was to determine how far it wished to go within this authority, as a matter of national policy.

.....

... [I]t appears that the question involved is not one of power but one of policy.<sup>58</sup>

It appears from the history of the Act that the statute was not designed to reach as far as the commerce clause power of the Constitution would allow. In a statement before the House Judiciary Committee the Attorney General said:

[T]he principle upon which title II stands is a moral one and all forms of racial discrimination are equally objectionable.

One can argue legitimately from this moral principle to the inclusion of all forms of business enterprise within the reach of the Constitution. The administration proposal did not attempt to extend Federal law so far.

.....

... We were reluctant to extend Federal power beyond those areas where it was clearly needed to meet existing problems.<sup>59</sup>

Turning, therefore, to the language of section 201(c)(3) as the proper guide, the same problem of construction is encountered that was dealt with in interpreting section 201(b)(3). The question becomes whether Fun Fair's mechanical rides are included by the language "films, performances, athletic teams, exhibitions, or other sources of entertainment." All the authority tending to show that section 201(b)(3) was intended to cover "spectator" rather than "participative" establishments would similarly support the application of *ejusdem generis* here. The language of section 201(c)(3) contains no bar to the application of the rule, since each of the specific terms ("films," "performances," "athletic teams") refers to a source of spectator entertainment. There is no

56 Cf. *Williams v. Howard Johnson's Restaurant*, 268 F.2d 845 (4th Cir. 1959), followed in *Slack v. Atlantic White Tower System, Inc.*, 284 F.2d 746 (9th Cir.), *aff'g per curiam* 181 F. Supp. 124 (D. Md. 1960).

57 With respect to inns, hotels, motels, and other places of lodging for transients, there is clear congressional intention to exercise commerce clause powers to their limits, as is evidenced by section 201(c)(1) of the Act. If the limits of constitutional authority were all that congress intended to delineate the scope of section 201, all of section 201(c) could have been omitted. As it is, "Section 201(c) provides the criteria for determining whether the operations of an establishment affect commerce." H.R. REP. No. 914, 88th Cong., 2nd Sess. (1963) reprinted in 2 U.S. CODE CONG. & AD. NEWS 2391, 2396 (1964).

58 110 CONG. REC. 7402-03 (1964) (remarks of Senator Magnuson).

59 *House Hearings*, *supra* note 42, at 2655-56.

specific language that would suggest coverage of recreational areas. The less specific word "exhibition" is used here, as it was in section 201(b)(3), but it too is a word whose meaning is confined to a source of spectator entertainment.<sup>60</sup>

Some marginal light was shed upon the meaning of the phrase "sources of entertainment" during the Attorney General's testimony before the House Judiciary Committee:

[S]ome significant percentage of an establishment's *performances* must move in interstate commerce . . . .

. . . [T]here is no requirement in the bill that the *production being presented* at any given time need have moved . . . .<sup>61</sup> (Emphasis added.)

Similar language was used by Senator Magnuson in a statement made "to assure that the will of Congress and the policies it seeks to express . . . are effectuated by the judicial branch."<sup>62</sup> He, too, used the words "performances" and "production presented."<sup>63</sup> The choice of such terms would seem to contemplate spectator or audience events rather than recreational areas.

It is not suggested that these references alone are conclusive, but when sections 201(b)(3) and 201(c)(3) are read together in light of the total history of title II, it is extremely difficult to support the majority's claim in *Miller* that recreational areas are within the language or the legislative intent of these portions of the Act.<sup>64</sup>

The Fifth Circuit in *Miller* is clearly loathe to perpetuate "the inconvenience, unfairness and humiliation of racial discrimination."<sup>65</sup> The court's rhetoric reflects its indignation when it says:

This case demonstrates the evils of such discriminatory practices especially when imposed upon a child of tender years during the formative period of her life, which practices, no doubt, generate permanent attitudes which become evident and active later. The venom of hate and prejudice should not be generated and cultivated at any time, especially during the early years of childhood. . . . We refuse to register our acceptance of the conduct here involved. To do so would shock our conscience and disturb our mind.<sup>66</sup>

What has perhaps escaped adequate attention, however, is that *Miller* was conceived and prosecuted as a test case to determine the coverage of specific statutory language. There is really no question of Mrs. Miller's ability to obtain

60 See *Longwell v. Kansas City*, 199 Mo. App. 480, 484, 203 S.W. 657, 659 (1918).

61 *House Hearings*, *supra* note 42, at 1403.

62 110 CONG. REC. 7397 (1964).

63 *Id.* at 7406.

64 The distinction between that which "moves" and that which "has moved" in commerce was heavily relied upon by the district court. *Miller v. Amusement Enterprises, Inc.*, 259 F. Supp. 523, 527-28 (E.D. La. 1966). But this argument was properly exposed and rejected by the majority on rehearing. *Miller v. Amusement Enterprises, Inc.*, 394 F.2d 342, 351-52 (5th Cir. 1968). In addition to the authority cited by the majority, note that references in the legislative history exhibit a conspicuous lack of a conscious distinction. See, e.g., *House Hearings*, *supra* note 42, at 1403 (testimony of the Attorney General) where "move," "moved," and "have moved" are all used in the same sense. See also amendments No. 794 and 795 proposed by Senator Ervin, 110 CONG. REC. 13915 (1964), which were rejected by the Senate 110 CONG. REC. 13921 (1964).

65 *Miller v. Amusement Enterprises, Inc.*, 394 F.2d 342, 353 (5th Cir. 1968).

66 *Id.*

relief under the 1964 Civil Rights Act, since it is all but conceded by the parties that sections 201(b)(4) and 201(c)(4) would cover Fun Fair and most other amusement parks of any consequence. In light of the voluntary stipulation between the parties and considering the fact that Fun Fair and similar establishments are covered by parts of the statute not in issue, the court's moral-indignation argument becomes less persuasive. In no sense would a holding that Fun Fair is excluded by the language of sections 201(b)(3) and 201(c)(3) be "to register . . . acceptance of the conduct . . . involved." Such a holding might, on the other hand, go far in providing the clarity called for by Attorney General Robert Kennedy when he said, "[T]he areas of coverage should be clear to both the proprietors and the public . . . ."<sup>67</sup>

*Richard H. Farina*

CLASS ACTIONS — FEDERAL RULE OF CIVIL PROCEDURE 23 — RELIANCE ON NUMBERS TO DETERMINE ADEQUACY OF REPRESENTATION IS UNWARRANTED — NOTICE IS REQUIRED IN ALL CLASS ACTIONS. —

Between the years 1960 and 1966, Morton Eisen, a New York wholesale shoe salesman, engaged in 47 odd-lot<sup>1</sup> transactions on the New York Stock Exchange, paying a total of \$259 in odd-lot differentials.<sup>2</sup> In 1966 he brought a class action, on behalf of himself and an estimated 3,750,000 other individuals and corporate buyers and sellers of odd-lots during this six year period, against Carlisle & Jacquelin, De Coppet & Doremus and the New York Stock Exchange. He alleged that the two brokerage firms, which handle 99% of the volume of odd-lots on the New York Exchange,<sup>3</sup> had combined and conspired to monopolize odd-lot trading by fixing the odd-lot differential at an excessive rate in violation of the Sherman Act.<sup>4</sup> The New York Exchange was joined as a defendant on the premise that it had failed to discharge its duties to insure fair dealing and to protect investors according to the rules and regulations established by the Securities Exchange Act of 1934.<sup>5</sup> The United States District Court for the Southern District of New York ordered that the suit be dismissed as a class action because Eisen failed to demonstrate that he could adequately protect the interests of the class.<sup>6</sup> In reversing the dis-

67 *House Hearings supra* note 42, at 2655.

1 The regular unit of trading on the Exchange is the "round lot" of 100 shares. An "odd-lot" is the term used to designate transactions involving less than 100 shares. Odd-lot orders do not form part of the "regular auction market" but are exclusively handled by special odd-lot dealers who buy and sell for their own account as principals. *Eisen v. Carlisle & Jacquelin*, 391 F.2d 555, 559 (2d Cir. 1968).

2 The cost to the customer of an odd-lot transaction includes both a standard commission payable to a brokerage firm and an odd-lot differential which is received by the odd-lot dealer. The differential is a figure amounting to a fraction of a point for each share traded which is added to the customer's price. During the years 1960 to 1966, the odd-lot differential was 1/6 of a point (12½ cents) per share on stock selling below \$40, and ¼ of a point (25 cents) per share on stock selling at \$40 or more. *Id.*

3 SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKET, H.R. DOC. NO. 95, pt. 2, 88th Cong., 1st Sess. 172 (1963).

4 15 U.S.C. §§ 1, 2 (1964).

5 15 U.S.C. §§ 78f(b), 78f(d), 78s(a) (1964).

6 *Eisen v. Carlisle & Jacquelin*, 41 F.R.D. 147 (S.D.N.Y. 1966), *rev'd*, 391 F.2d 555 (1968). A motion to dismiss Eisen's appeal on the ground that the district court's order of dismissal was not a "final order" was denied by Judge Kaufman of the court of appeals. *Eisen v. Carlisle & Jacquelin*, 370 F.2d 119 (2d Cir. 1966), *cert. denied*, 386 U.S. 1035 (1967).

strict court's order and remanding for evidentiary proceedings, the United States Court of Appeals for the Second Circuit *held*: reliance on quantitative elements to determine adequacy of representation is unwarranted, and thus additional information concerning class members and the complexity of the administration of the suit was needed before a proper determination under Federal Rule of Civil Procedure 23(c)(1) could be made. *Eisen v. Carlisle & Jacquelin*, 391 F. 2d 555 (1968).

The origin of the class suit was described by Justice Stone in *Hansberry v. Lee*<sup>7</sup> as

[a]n invention of equity to enable it to proceed to a decree in suits where the number of those interested in the subject of litigation is so great that their joinder as parties in conformity to the usual rules of procedure is impracticable.<sup>8</sup>

Thus, the class action is essentially a creature of necessity which, in allowing one or more members of a class to bring an action on behalf of the entire class, serves the important function of providing claimants with a method of obtaining redress for claims which would otherwise be too small to warrant individual litigation.<sup>9</sup> Federal Rule of Civil Procedure 23, as originally enacted in 1937<sup>10</sup> (hereinafter Old Rule 23), offered three categories of class actions which reflected the "jural relationships of the members of the class."<sup>11</sup> These categories were defined

in terms of the abstract nature of the rights involved: the so-called "true" category was defined as involving "joint, common, or secondary rights"; the "hybrid" category, as involving "several" rights related to "specific property"; the "spurious" category, as involving "several" rights affected by a common question and related to common relief.<sup>12</sup>

There were significant differences in the res judicata effect of the various class actions. For example, while the judgments in the "true" and "hybrid" class actions would extend to the entire class, the judgment in a "spurious" type would only extend to the parties and intervenors.<sup>13</sup> This limitation of the "spurious" category detracted from its usefulness as a class action and made it merely a permissive joinder device.<sup>14</sup> In some instances, class members were permitted to intervene after a favorable judgment even though they were not bound by an unfavorable one.<sup>15</sup> This "one-way intervention" created an "everything to gain, nothing to lose" proposition which frustrated the class action's function of settling all questions in one suit.<sup>16</sup>

7 311 U.S. 32 (1940).

8 *Id.* at 41.

9 Kalven & Rosenfield, *The Contemporary Function of the Class Suit*, 8 U. CHI. L. REV. 684, 714 (1941).

10 Class Action R. 23, 39 F.R.D. 94 (1966).

11 3A J. MOORE, FEDERAL PRACTICE ¶ 23.08, at 3434 (2d ed. 1968).

12 Advisory Committee's Note, Proposed Rules of Civil Procedure, 39 F.R.D. 98 (1965).

13 *Id.*

14 3A J. MOORE, *supra* note 11, ¶ 23.10, at 3442; *see, e.g., California Apparel Creators v. Wieder of California*, 162 F.2d 893, 897 (2d Cir.), *cert. denied*, 332 U.S. 816 (1947).

15 *Hohmann v. Packard Instrument*, 43 F.R.D. 192, 195 n.1 (N.D. Ill. 1967).

16 Kalven & Rosenfield, *supra* note 9, at 699-70.

In an attempt to cure the restricted res judicata effect of the spurious class action and other deficiencies of Old Rule 23, the rule was completely revised in July, 1966<sup>17</sup> (hereinafter New Rule 23). Under (c)(1) of New Rule 23, the court determines by order "as soon as practicable after the commencement of an action" whether it can be maintained as a class action. The court's determination is based on the satisfaction of the four prerequisites listed in 23(a), and fulfillment of one of the four additions noted in subdivision (b).<sup>18</sup> Although no mention is made of Old Rule 23 categories, (b)(1) and (b)(2) embrace the "true" and "hybrid" categories, while "(b)(3) bears many resemblances to the old spurious category."<sup>19</sup> However, in spite of these resemblances, the spurious class action had undergone vital changes.

*Eisen v. Carlisle & Jacquelin* is the first court of appeals case interpreting a portion of New Rule 23 which was not contained in the Old Rule.<sup>20</sup> For this

17 Advisory Committee's Note, *supra* note 12, at 98-99.

18 Federal Rule of Civil Procedure 23(a) and (b) provides:

- (a) Prerequisites to a Class Action. One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.
- (b) Class Actions Maintainable. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:
  - (1) The prosecution of separate actions by or against individual members of the class would create a risk of
    - (A) inconsistent or varying adjudication with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or
    - (B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or
  - (2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or
  - (3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

19 Address on Some Preliminary Observations concerning Civil Rule 23 by Marvin E. Frankel, Eighth Circuit's Judicial Conference, St. Louis, Missouri, Sept. 18, 1967, in 43 F.R.D. 39, 43 (1968).

20 Three cases had reached the federal court of appeals level previously. Two of these cases, *Alvarez v. Pan American Life Ins. Co.*, 375 F.2d 992 (5th Cir.), *cert. denied*, 389 U.S. 827 (1968), and *Gas Service Co. v. Coburn*, 389 F.2d 831 (10th Cir. 1968), did not interpret the text of New Rule 23, and the other, *Anderson v. Moorer*, 372 F.2d 747 (5th Cir. 1967), involved an aspect handled in the same manner under both Old and New Rule 23. *Alvarez* and *Coburn* presented opposing views on aggregation of claims of the entire class in order to satisfy the jurisdictional requirements set out in 28 U.S.C. § 1331. While *Alvarez* upheld the principle established under the Old Rule that claims could not be aggregated to meet the \$10,000 amount in controversy requirement in cases that would have been classified as "spurious", *Coburn* held that since aggregation of claims was allowed in some class actions under the Old Rule (notably the "true" category), the New Rule's elimination of the "true, hybrid, and

alone it will achieve notoriety. But *Eisen* additionally offers an astonishing result to those who are befuddled by pure numbers. It upholds the possibility that one person can represent a class of well over three million.

Both Old and New Rule 23 require the representative of the class to adequately protect the interest of the class.<sup>21</sup> However, adequate representation is more strictly interpreted under New Rule 23, since, unlike the analogous spurious class action of the Old Rule, this section now provides that all members of the class are bound by the judgment unless they specifically ask to be excluded.<sup>22</sup> The two primary ingredients that enable one to be termed an adequate representative were listed by Judge Medina in *Eisen* as 1) representation by a qualified attorney, and 2) complete absence of any interests antagonistic to those of the absent members of the class.<sup>23</sup> Special attention is focused on denouncing any determination of adequacy according to sheer numbers.<sup>24</sup> While the history of Old Rule 23(a) apparently made it clear to some courts and commentators that number is not in itself determinative of adequacy or inadequacy of representation,<sup>25</sup> certain decisions had watered down this early thought. Indicative of this weakening process are the often quoted statement in *Pelelas v. Caterpillar Tractor Company*<sup>26</sup> that "[t]here must be a sufficient number of persons to insure a fair representation of the class"<sup>27</sup> and the Second Circuit's statement in *Oppenheimer v. F. J. Young & Company*:<sup>28</sup>

If it shall later appear that the plaintiffs are not able within a reasonable time to obtain others to intervene in the class action it may properly be dismissed as a class action because of lack of adequate representation of members of the class.<sup>29</sup>

Especially noticeable in the *Eisen* court's denunciation of this "numbers block" is the underlying emphasis given to the function of the class action as a device for vindicating small claims which otherwise would not be litigated. To uphold the necessity of some proportional numerical representation of the class for maintenance of a class action would defeat, in most cases, this very function.<sup>30</sup>

Subdivision (b) (3) serves as the appellate court's springboard into viewing the new portions of New Rule 23. To qualify as a class action under (b) (3), the court must be convinced that common questions predominate over individual questions and that the class action is the superior method for the fair and efficient adjudication of the controversy.<sup>31</sup> Plaintiff's alleged conspiracy between

---

spurious" categories places the claims of the entire class in controversy in all class actions. *Anderson* was a Fifth Circuit decision denying the use of a class action because the representative and the class members had conflicting interests in the subject matter of the suit.

21 Class Action R. 23(a), 39 F.R.D. 94-95 (1966); FED. R. CIV. P. 23(a)(4).

22 FED. R. CIV. P. 23(c)(2)(B); *Hohmann v. Packard Instrument*, 43 F.R.D. 192, 197 (N.D. Ill. 1967).

23 *Eisen v. Carlisle & Jacquelin*, 391 F.2d 555, 562 (2d Cir. 1968).

24 *Id.* at 563.

25 3A J. MOORE, *supra* note 11, ¶ 23.07 at 3430.

26 113 F.2d 629 (7th Cir. 1940).

27 *Id.* at 632.

28 144 F.2d 387 (2d Cir. 1944).

29 *Id.* at 390.

30 *Eisen v. Carlisle & Jacquelin*, 391 F.2d 555, 563 (2d Cir. 1968).

31 FED. R. CIV. P. 23(b)(3).

the two brokerage firms gives rise to a "common nucleus of operative facts."<sup>32</sup> Under the New Rule, common questions arising out of anti-trust violations have already been accepted as sufficient to deserve class action treatment.<sup>33</sup>

The question of whether the class action is the superior method for adjudication of the controversy can be answered only by a survey of the possible alternatives. Among the various alternative procedural devices are joinder, intervention, consolidation and the test case.<sup>34</sup> However, as Judge Frankel has pointed out, these devices presuppose economically powerful parties who are able and willing to take care of their own interests individually by means of individual suits or individual decisions about joinder or intervention.<sup>35</sup> Thus the majority of the Second Circuit felt bound by Judge Kaufman's holding on a prior appeal<sup>36</sup> that, effectively, the class action is the only possible way of litigating the issue due to the small individual claims.<sup>37</sup>

Nevertheless, since (b) (3) type class actions are geared to achieving economies of time, effort and expense,<sup>38</sup> the class action's ability to resolve the controversy in a fair and efficient manner was still at issue. A class which has a membership of over three million, scattered across the world, hints at being administratively unmanageable by its very nature. In following Judge Kaufman's ruling, the *Eisen* court does not turn its head on this presumably obvious fact of complex manageability. In fact, one of the four factors helpful in assessing satisfaction of New Rule 23 (b) (3) confronts this very problem — "the difficulties likely to be encountered in the management of a class action."<sup>39</sup> Yet, without specific data showing that inordinate paper work costs and attorney fees will absorb the entire judgment, the Second Circuit professed to be uninfluenced by the multitudinous population of the class and unwilling to deviate from Judge Kaufman's ruling. As an indicator for future class actions, this warns counsel who may have clients sued by numerous-membered classes to be prepared to detail analogous situations in which filing claims, fees and all other expenses surpass any eventual recovery.

Another serious obstacle to plaintiff's maintenance of a class action is the notice requirement of New Rule 23 (c) (2). While the class action has the exceptional status of settling absent members' rights without their day in court, it is of course not relieved from the fourteenth amendment's requirements of due process. In the words of *Mullane v. Central Hanover Bank & Trust Company*,<sup>40</sup> upon which the notice provision of New Rule 23 is patterned, this includes "notice

32 See *Siegel v. Chicken Delight, Inc.*, 271 F. Supp. 722, 726 (N.D. Cal. 1967).

33 *Id.*

34 *Dolgow v. Anderson*, 43 F.R.D. 472, 482 (E.D.N.Y. 1968). Although some resort to remedying the alleged conspiracy among the defendants may be available through an administrative agency such as the Securities and Exchange Commission, such an agency does not provide a feasible alternative when private claims are at stake. *Id.*

35 *Eisen v. Carlisle & Jacquelin*, 391 F.2d 555, 567 n.19 (2d Cir. 1968), citing Frankel, *Amended Rule 23 From a Judge's Point of View, Symposium on Amended Rule 23*, 32 ABA ANTITRUST L.J. 251, 295-98 (1966).

36 *Eisen v. Carlisle & Jacquelin*, 370 F.2d 119, 120 (2d Cir. 1966), *cert. denied*, 386 U.S. 1035 (1967).

37 Judge Kaufman had implied that \$70 was a reasonable estimate of Eisen's damages. *Id.*

38 Advisory Committee's Note, *supra* note 12, at 102.

39 FED. R. CIV. P. 23 (b) (3) (D).

40 339 U.S. 306 (1950).

reasonably calculated, under all circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections."<sup>41</sup> Although New Rule 23 contains both mandatory [(c)(2)] and discretionary [(d)(2)] notice provisions which are designed to fulfill the notice requirements of due process, it is unclear according to the face of the New Rule whether notice is a universal requirement for all class actions. Only with an attentive reading of the Advisory Committee's Note can this be ascertained.<sup>42</sup>

For any class action brought under (b)(3), provision (c)(2) demands a special type of notice. The mandatory notice of (c)(2) essentially advises the members of the class that, unless they exclude themselves from the class, they will be included under the court's judgment, whether favorable or not.<sup>43</sup> In addition, it provides that the "notice is to be the best practicable *under the circumstances*, and shall include individual notice to the members who can be identified through reasonable effort."<sup>44</sup> (Emphasis added.) Since the burden of furnishing notice to the class members rests upon the representative party when he is the plaintiff,<sup>45</sup> it would cost Eisen approximately \$400,000 to individually notify each of the 3,750,000 members of the class.<sup>46</sup> In order not to forfeit continuance of the class action because of this prohibitive cost, Eisen interpreted (c)(2) as permitting a less expensive means of notice — namely, publication.<sup>47</sup> Notice by publication is by no means new to class action decisions. It was accepted in *Booth v. General Dynamics Corporation*<sup>48</sup> as satisfying the due process requirement to inform several hundred thousands of taxpayers of a suit on their behalf. Of course, in *Booth* the necessity for preserving the taxpayer action device was attributed to be the controlling point in allowing notice by publication even though the court had determined it would take more than a reasonable effort to identify all members of the class.<sup>49</sup>

Understandably, the Second Circuit agrees with Judge Tyler of the district court that publication to all members will not satisfy due process requirements. To hold otherwise would be a sacrifice of absent members' rights solely for economic considerations.<sup>50</sup> But an alternative is submitted. Individual notice is not uncompromisingly the only method by which the due process notice requirement can be satisfied. The *Mullane* case holds that, when the identity of the members of the class are known or very easily ascertainable, notice by publication will not

41 *Id.* at 314.

42 Advisory Committee's Note, *supra* note 12, at 106-07.

43 FED. R. CIV. P. 23 (c)(2)(A), (B).

44 Advisory Committee's Note, *supra* note 12, at 105.

45 *School District v. Harper & Row Publishers, Inc.*, 267 F. Supp. 1001, 1004-05 (E.D. Pa. 1967), suggests that it is the court's task to prepare and forward notice and to maintain the clerical facilities for fulfilling the resultant paper work. However, this suggestion seems unwarranted, as pointed out by Professor Kaplan in *Continuing Work of the Civil Committee: 1966 Amendments of the Federal Rules of Civil Procedure (I)*, 81 HARV. L. REV. 356, 398 (1967). Only control must be maintained by the court, to insure accuracy and impartiality. The plaintiff must bear the expense for the mechanics of publication and distribution. See *Cherner v. Transatron Electronic Corp.*, 201 F. Supp. 934, 936 (D. Mass. 1962).

46 *Eisen v. Carlisle & Jacquelin*, 391 F.2d 555, 568 (2d Cir. 1968).

47 *Id.*

48 264 F. Supp. 465 (N.D. Ill. 1967).

49 *Id.* at 471.

50 *Eisen v. Carlisle & Jacquelin*, 391 F.2d 555, 569 (2d Cir. 1968).

suffice.<sup>51</sup> However, as clearly pointed out by the Supreme Court in *City of New York v. New York, New Haven & Hartford Railroad*,<sup>52</sup> "when the names, interests and addresses of persons are unknown, plain necessity may cause a resort to publication."<sup>53</sup> It is in this light that the *Eisen* court seems to offer the half-way proposition that through evidentiary hearings it can be established who are the most frequent transactors of odd-lots. To these buyers and sellers who will be more easily ascertainable, individual notice will be required to satisfy the due process requirements; while to the remainder of the class, notice by publication may suffice.<sup>54</sup> This latter determination is left up to the discretion of the district court after its findings on class membership. If the plaintiff is unable to afford the expenditures required in giving notice to those whom the district court finds deserving, then the class action will be dismissed for failure to comply with (c)(2) of New Rule 23.<sup>55</sup>

The inconsistency in the lower courts' interpretations of (c)(2) which is alleged by the court in *Eisen*<sup>56</sup> stems from the variants allowed by due process. The three cases cited by Judge Medina differ in their modes of notice because of the attendant fact situations. Decisions such as *Harris v. Jones*<sup>57</sup> show that where names and addresses of class members are "readily" available, individual notice must be obtained. The case of *Richland v. Cheatham*,<sup>58</sup> involving a class of 50,000 purchases of stock, is not a true barometer of the lower court's holding on New Rule 23 (c)(2), since there the class action's dismissal was rooted in a dispute among plaintiffs about the necessity of notice — not a particular medium of giving notice. The *Booth* case presents the pragmatic variant of satisfying due process by publication in those special cases where no other type of notice is feasible because of the anonymity of the absent members of the class. *Eisen* is a half-breed species between *Harris* and *Booth*, calling for a combination of individual notice and notice by publication. This too, is not an original concept; it was presented as a method of satisfying the notice provision of New Rule 23 (c)(2) in *Dolgow v. Anderson*.<sup>59</sup> Thus, as initial decisions indicate, the (c)(2) notice provision of New Rule 23 seems to have been so drafted as to be flexible enough to accurately encompass due process requirements.

Whether Morton Eisen will ultimately be allowed to maintain his class action against the brokerage firms of Carlisle & Jacquelin and DeCoppet & Doremus and against the New York Stock Exchange will be determined by the facts collected at the evidentiary hearings on remand. As is witnessed by the calling of these evidentiary hearings, the immediacy of the determination of an order under New Rule 23 (c)(1), which is to be made "as soon as practicable," is tempered by the knowledge that without this class action, no individual action will prevail. Inherent in the Second Circuit's decision in *Eisen* is a liberal in-

51 *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306, 318 (1950); see also *Schroeder v. City of New York*, 371 U.S. 208, 212-13 (1962).

52 344 U.S. 293 (1953).

53 *Id.* at 296 (dictum).

54 *Eisen v. Carlisle & Jacquelin*, 391 F.2d 555, 569-70 (2d Cir. 1968).

55 *Id.* at 570.

56 *Id.* at 569.

57 41 F.R.D. 70 (D. Utah 1966).

58 272 F. Supp. 148 (S.D.N.Y. 1967).

59 43 F.R.D. 472, 498 (E.D.N.Y. 1968).

terpretation of New Rule 23 which indicates that a class action will not be dismissed when the plaintiff has complied with the face of the rule. This interpretation seeks to reconfirm the concept that it is the function of the class action that is paramount. Thus in *Eisen* the Second Circuit has strongly affirmed the proposition that, in class actions, once the prerequisites of Rule 23 have been met, there is no magic in numbers.

*Thomas J. DeLuca*

CRIMINAL LAW — JUVENILE COURTS — *IN RE GAULT HELD TO HAVE RETROACTIVE EFFECT SO THAT JUVENILES CONVICTED WITHOUT REPRESENTATION BY COUNSEL ARE ENTITLED TO NEW TRIAL.* — By orders dated March 9, 1967, two juveniles, Johnnie J. Billie and Leroy Jewelryman, were committed to the Arizona State Industrial School. Their commitments were ordered without their having had the benefit of counsel, and, as was later stipulated,<sup>1</sup> without their having been advised either personally or through their parents that they had a right to counsel. After the United States Supreme Court's subsequent decision in *In re Gault*,<sup>2</sup> both minors petitioned for writs of habeas corpus, urging that *Gault* provided a basis for the reversal of their convictions. The Arizona Court of Appeals granted the writs and ordered the immediate release of the juveniles.<sup>3</sup> The State appealed to the Arizona Supreme Court, which vacated the writs and *held*: juveniles convicted without the benefit of counsel before the *Gault* decision are entitled to a reversal of their convictions, but their cases must be remanded to the juvenile court for further proceedings. *Application of Billie*, 436 P.2d 130 (Ariz. 1968).

Among the many recent Supreme Court decisions of significance in criminal or criminally related areas, one of the most momentous is *In re Gault*, where, for only the second time in its history, the Court addressed itself to the question of the applicability of constitutional safeguards in juvenile proceedings.<sup>4</sup> Justice Fortas, speaking for the Court in that since widely acclaimed<sup>5</sup> decision, pronounced it to be law that juveniles accused of crime are to be accorded the same constitutional privileges and safeguards now commonly available to adults. Specifically, the Court held that in order for a determination of delinquency and commitment to a state institution to be constitutionally valid, the child and his parent or guardian must receive such notice of a hearing as would be deemed constitutionally adequate in a civil or criminal proceeding.<sup>6</sup> It noted that under the due process clause of the fourteenth amendment, the child and his parent must be notified of the child's right to be represented by counsel retained by them, and if they are unable to afford counsel, that counsel will be appointed

1 *Application of Billie*, 436 P.2d 130, 131 (1968).

2 387 U.S. 1 (1967).

3 *Application of Billie*, 429 P.2d 699 (Ariz. Ct. App. 1967), *vacated*, 436 P.2d 130 (1968).

4 The Court first considered constitutional criminal safeguards in their relation to the special status of juveniles in *Kent v. United States*, 383 U.S. 541 (1966).

5 *See, e.g., Ketcham, Guidelines from Gault: Revolutionary Requirements and Reappraisal*, 53 VA. L. REV. 1700 (1967).

6 *In re Gault*, 387 U.S. 1, 33 (1967).

to represent the child;<sup>7</sup> it also extended the rights of confrontation and cross-examination to child and parent as a matter of due process.<sup>8</sup> Finally, the Court held that the privilege against self-incrimination guaranteed by the fifth amendment applies to juveniles as well as to adults.<sup>9</sup>

The *Gault* decision was, however, incomplete. It did not indicate whether the absence of counsel was a factor demanding reversal in all situations, or only in those where the case appeared by way of appeal. The Court also failed to establish procedures that state law enforcement agencies could follow in the event that juveniles' convictions were reversed by writs of habeas corpus.

It clearly appeared from *Gault* that the Court fully intended to make age a constitutionally irrelevant factor in the adjudication process,<sup>10</sup> and thus to extend to the minor all the constitutional rights presently secured to adults who are accused of committing a crime. However, the very nature of the proceedings before it prevented the Court from being explicit on a related aspect that for some time at least will have as much relevance as the fundamental determinations made in *Gault*. As Justice Fortas indicated in his opening remarks, the case appeared *by way of appeal* from a judgment of the Supreme Court of Arizona.<sup>11</sup> Therefore, the Court did not deal with the procedural problem — not instantly before it but which has subsequently arisen several times — of whether the Court's new rules for the administration of the judicial process in juvenile cases are to be applied only to those cases which arise for decision after the date of *Gault*, or whether the *Gault* requirements must also be extended to cases that had already become final before *Gault* was handed down. Specifically, this problem involves the juvenile who has been convicted, imprisoned, and has subsequently exhausted all his appellate remedies — a condition usually referred to as one of "pure retroactivity."<sup>12</sup> Having exhausted all of his ordinary remedies, the applicant's only recourse is a collateral attack on his conviction by means of a writ of habeas corpus based on the argument that his conviction, seen in the light of some precedent-shattering decision of the Supreme Court, was unlawfully obtained.

Whether a juvenile, presently detained and having already exhausted all his ordinary appellate remedies, may successfully attack his conviction through a writ of habeas corpus alleging that he has been deprived of one of the safeguards set out in *Gault* presents a complex legal issue, and signals practical

7 *Id.* at 41.

8 *Id.* at 56-57.

9 *Id.* at 55.

10 The National Probation and Parole Association in its Standard Juvenile Court Act has attempted to distinguish three phases in the treatment of juvenile cases: first, the petition phase; next, the adjudication phase; and finally, the disposition phase. Since recognition has recently been given to the fact that the greatest defect in the *parens patriae* system lies in its informal handling of the actual judging process, present endeavors have tended to formalize the adjudication phase, while maintaining informality in the petition and disposition phases. See NATIONAL PROBATION AND PAROLE ASS'N, STANDARD JUVENILE COURT ACT (6th ed. 1959).

11 Appeal was taken under 28 U.S.C. § 1257(a). *In re Gault*, 387 U.S. 1, 3 (1967).

12 For an extensive treatment of the entire area of retroactivity, see Note, 41 NOTRE DAME LAWYER 206 (1965). Another method of arriving at a situation of pure retroactivity occurs simply when the applicable juvenile statute makes no provision for appeal from a court decision. Arizona law, similar to that of many other states, made no such provision. See ARIZ. REV. STAT. ANN. § 12-2101 (1956).

problems that are likely to cause law enforcement officials some amount of anxiety. While not all aspects of the *Gault* requirements have yet been utilized as vehicles for attacking the conviction of such a juvenile, one of them has come to be emphasized much more than the others. This is the requirement that the minor be represented by counsel.

Several jurisdictions have had to decide whether the counsel requirement is to be applied to convictions obtained before the *Gault* decision as well as to those obtained after it — that is, whether the decision is to be applied retroactively or merely prospectively.<sup>13</sup> The court which has most recently faced this issue is the Supreme Court of Arizona, from which the *Gault* decision was originally appealed.

In the *Application of Billie*, the Arizona court first turned to the treatment accorded the problem by two other jurisdictions which had dealt with the question. These jurisdictions had seemingly split in their results, with the District of Columbia Court of Appeals holding against retroactivity, and the Supreme Judicial Court of Massachusetts holding for it. The former announced its decision in *In re Wylie*,<sup>14</sup> and the latter in *Marsden v. Commonwealth*,<sup>15</sup> both of which were decided in June, 1967.

*Wylie* involved a juvenile who was accused of having committed an act which could have been the basis for any or all of three possible felony charges. In the petition, however, he was formally charged only with being "involved." He was found by a jury to have so been "involved" and was committed to the National Training School. The court of appeals reversed the conviction, holding that the jury's verdict of "involved" was too vague and indefinite to satisfy the requirements of due process.<sup>16</sup> However, the court indicated, significantly, that it did not consider the requirements of *Gault* to be retrospective, for it stated:

Our ruling with respect to the necessity for notice of the specific issues, specific instructions on such issues, and disapproval of the use of the verdict of involved shall apply only in this case and trials occurring after this date.<sup>17</sup>

*Marsden v. Commonwealth* concerned a minor, 13 or 14 years old at the time of the proceedings, who was committed as a delinquent to the Massachusetts Youth Service Board on September 2, 1965. The case arose as a stubborn-child proceeding in which the minor's mother was the petitioner. Marsden was originally brought before the municipal court, and, as the supreme judicial court commented on appeal, "the record shows that Marsden was not effectively afforded the right to counsel to which he was entitled under the *Gault* decision."<sup>18</sup> The reviewing court therefore concluded that the petitioner was entitled to have the determinations of delinquency set aside and receive a new

13 *Steinhauer v. State*, 206 So. 2d 25 (Fla. 1968); *Cradle v. Peyton*, 208 Va. 243, 156 S.E.2d 874 (1967); *Marsden v. Commonwealth*, 227 N.E.2d 1 (Mass. 1967).

14 231 A.2d 81 (D.C. Ct. App. 1967).

15 227 N.E.2d 1 (Mass. 1967).

16 *In re Wylie*, 231 A.2d 81, 83 (D.C. Ct. App. 1967).

17 *Id.*

18 *Marsden v. Commonwealth*, 227 N.E.2d 1, 3 (Mass. 1967).

hearing, even though the judge of the municipal court in 1965 could not have foreseen the *Gault* decision.<sup>19</sup>

Finding itself confronted by what appeared to be a split in the authorities, the Arizona court turned to previous decisions of the Supreme Court of the United States for guidance. The Supreme Court had established certain guidelines to be used in determining whether a decision is to be given retroactive effect. It must be pointed out, however, that these are at best only guidelines, and not definitive statements of proper application in each instance. The Arizona court, in passing on the instant applications, examined in detail the three most recent Supreme Court decisions which incorporated these guidelines. The first, *Linkletter v. Walker*,<sup>20</sup> involved a state prisoner whose judgment of conviction had become final prior to the landmark case of *Mapp v. Ohio*.<sup>21</sup> Being in the pure retroactivity situation, he attacked his conviction by habeas corpus proceedings on the ground that evidence used against him at his trial was obtained by an unlawful search and seizure. The Court introduced its opinion with an historical survey of the conflicting attitudes toward the proper method of determining retroactivity. It then declared that the *Mapp* decision had for its prime purpose the extension of the exclusionary rule so that it would serve as an effective deterrent to illegal police action. The Court concluded: "We cannot say that this purpose would be advanced by making the rule retrospective."<sup>22</sup> Three reasons were given for its decision against retroactive application: 1) the delicate balance of state-federal harmony would be further jeopardized;<sup>23</sup> 2) "the ruptured privacy of the victim's home and effects cannot be restored. Reparation comes too late";<sup>24</sup> and 3) on consideration of the interests in the administration of justice and the integrity of the judicial process, making *Mapp* retrospective would tax the administration of justice to the utmost.<sup>25</sup> The pragmatic nature of the process of determining whether a particular case should be applied retrospectively was aptly summarized in the following statement: "[W]e must then weigh the merits and demerits in each case by looking to the prior history of the rule in question, its purpose and effect, and whether retrospective operation will further or retard its operation."<sup>26</sup>

The *Billie* court set out these guidelines without comment and then turned to another recent Supreme Court decision, *Tehan v. United States ex rel. Shott*.<sup>27</sup> *Tehan* concerned the retroactive effect of the holding in *Griffin v. California*,<sup>28</sup> which had made it constitutionally impermissible for a prosecutor to comment on the accused's failure to testify. After deliberation, the Court concluded that *Griffin* was not to be applied retroactively. Asserted among the reasons for this determination was the fact that the fifth amendment's privilege against self-

19 *Id.*

20 381 U.S. 618 (1965).

21 367 U.S. 643 (1961). *Mapp* had held that evidence seized in violation of the defendant's fourth amendment rights could not be used against the defendant.

22 *Linkletter v. Walker*, 381 U.S. 618, 637 (1965).

23 *Id.*

24 *Id.*

25 *Id.*

26 *Id.* at 629.

27 382 U.S. 406 (1966).

28 380 U.S. 609 (1965).

incrimination is not an adjunct to the ascertainment of truth, but stands as a protection of the associated value of preventing a person from being forced to testify against himself.<sup>29</sup> Further, the *Tehan* Court noted that the states had long placed reliance on the previously established rule allowing comment by the prosecutor.<sup>30</sup> In the same vein, it pointed out that potential retrial of every person convicted in a trial in which comment was made regarding failure to testify "would have an impact upon the administration of [the states'] criminal law so devastating as to need no elaboration."<sup>31</sup>

The final member of the "trinity of retroactivity," *Johnson v. New Jersey*,<sup>32</sup> was also closely examined in the *Billie* opinion. The *Johnson* rationale was impressive to the Arizona court, which pointed out that in *Johnson*, the Supreme Court was "concerned with a question of probabilities and must take account, among other factors, of the extent to which other safeguards are available to protect the integrity of the truth-determining process at trial."<sup>33</sup>

Having set out relevant portions of the *Johnson* opinion, the Arizona court had exhausted its authority on the point, and therefore proceeded to the practical mechanics of disposing of the case. It assumed in passing that

because of the shortness of the interval in which juveniles committed to the Industrial School at Fort Grant are actually held there, we cannot say that in Arizona a retroactive application of the *Gault* rulings will "seriously disrupt the administration" of the juvenile court laws.<sup>34</sup>

The Arizona Supreme Court apparently agreed with the Arizona Court of Appeals that the clear thrust of the Supreme Court's "trinity of retroactivity" led to the inescapable conclusion that lack of counsel for accused minors was such a fundamental constitutional deprivation as to require reversal of their convictions, despite the practical considerations involved. However, the court failed to detail its reasons for this conclusion. Although its disposition of the applications differs from the court of appeal's in the significant particular that the juveniles were not unconditionally released, but were remanded to the juvenile court for further proceedings,<sup>35</sup> the Arizona Supreme Court failed to indicate its reasons for vacating the lower court's writs of habeas corpus.

While this disposition achieves substantially the correct legal result, the opinion is devoid of legal persuasion. For example, while the *Wylie* case is referred to as "some" authority against retroactivity, the Arizona court does not indicate sufficiently that the petitioner in *Wylie* was not in the pure retroactivity situation. As noted by the District of Columbia Court of Appeals, *Wylie's*

<sup>29</sup> *Tehan v. United States ex rel. Shott*, 382 U.S. 406, 419 (1966).

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> 384 U.S. 719 (1966). In *Johnson*, the Court refused to give *Escobedo v. Illinois*, 378 U.S. 478 (1964), and *Miranda v. Arizona*, 384 U.S. 436 (1966), retroactive effect. *Escobedo* and *Miranda* had established a rigid standard of conduct for police to observe while conducting in-custody investigations. The purpose in establishing such a standard was to protect the fifth and sixth amendment rights of the accused.

<sup>33</sup> Application of *Billie*, 436 P.2d 130, 135 (Ariz. 1968), quoting from *Johnson v. New Jersey*, 384 U.S. 719, 729 (1966).

<sup>34</sup> Application of *Billie*, 436 P.2d 130, 136 (Ariz. 1968).

<sup>35</sup> *Id.*

case appeared as an appeal, and a decision was delayed until after the *Gault* ruling was handed down.<sup>36</sup> Further, the *Wylie* decision concerned one of the other admonitions of *Gault*, the notice-of-charges requirement. It did not directly concern the absence of counsel for the accused juvenile. Therefore, the Arizona Supreme Court need not have determined that the jurisdictions were split in their results, for *Wylie* is at best only analogously relevant, and is far from being directly on point.<sup>37</sup>

The Arizona court also failed to extract from the three Supreme Court cases — *Linkletter*, *Tehan* and *Johnson* — the fundamental thesis that decisions regarding retroactivity vary on the basis of degree, and not kind. Running throughout these decisions is the undercurrent theme that basic violations of justice which render the truth-determining process a nullity must be corrected without regard to the exigencies of the situation. If the Arizona court was convinced that lack of counsel was such a violation, it did not indicate the reasons for its conclusion.

On the practical level, one of the fundamental problems which faces any court that has to make a determination regarding retroactivity is the "flood-gate" argument.<sup>38</sup> The possibility of releasing thousands of prisoners into the mainstream of society because some technical point of procedure has not been complied with undoubtedly has forceful repercussions in an otherwise abstract consideration of the legal issue. What the Arizona court had ultimately to decide was whether it should hold the *Gault* decision retroactive and risk the possibility that many "incorrigible" juveniles would be released into society, or hold against it and possibly upset the progress made by the Supreme Court in *Gault*. In offering as one of its major points of consideration the fact that judicial notice could be taken of the widespread knowledge that juveniles detained in Arizona were released at or near their eighteenth birthday, however, the court was militating against the very thrust of *Gault*, for it was applying special treatment to juveniles on the basis of their age and that alone. It appears that the Arizona Supreme Court, in attempting to answer the question of whether in fact another Gideon's Trumpet had been sounded,<sup>39</sup> was unwilling to approach the problem squarely from a legal standpoint, as the United States Supreme Court in *Gault* had demanded.

A sister jurisdiction (in an opinion not alluded to by the *Billie* court) had been confronted by the admission of the State Attorney General that *Gault*, on the basis of *Gideon*, had to be applied retroactively in the case of juveniles who had been convicted without the benefit of counsel. Thus, in *State ex rel. La-*

36 *In re Wylie*, 231 A.2d 81, 82 (D.C. Ct. App. 1967).

37 The *Wylie* decision does evidence, however, the great amount of attention all the requirements outlined in *Gault* have been receiving.

38 See Note, *supra* note 12, at 213-14.

39 The clear "adult" analog in recent Supreme Court decisions is of course *Gideon v. Wainwright*, 372 U.S. 335 (1965).

The federal courts have consistently interpreted *Gideon* as having retroactive effect. While the Supreme Court has not explicitly addressed itself to the retroactivity of the *Gideon* rule, it has indicated such by remanding *per curiam* over 40 pre-*Gideon* convictions in light of *Gideon v. Wainwright*. Note, *supra* note 12, at 209 n.21 (citations omitted).

For an account of the effects of *Gideon*, see A. LEWIS, *GIDEON'S TRUMPET* (1964).

*Follette v. Circuit Court of Brown County*,<sup>40</sup> the principal point of contention shifted quickly to an examination of the procedures to be followed in dealing with affected juveniles once writs of habeas corpus had been granted. The State contended that the proper course for the granting authority necessarily had to include a remand to the initiating juvenile court for further action consistent with the juvenile's now recognized constitutional protections.

An examination of *LaFollette* indicates that as a matter of fact the principal dispute in the *Application of Billie* did not center on the issue of retroactivity, but rather on the ultimate disposition of the juveniles. The Arizona Court of Appeals had determined previously that a retroactive application was to be made.<sup>41</sup> Indeed, its final order directed the preparation of an "appropriate writ of habeas corpus directing the *immediate release* of the petitioners." (Emphasis added.)<sup>42</sup> It was the considered opinion of the court of appeals that the exigencies that might be raised by any exodus of detained juveniles would be of far less consequence than any similar mass release of adult felons, and that in any event their detention had been determined by the United States Supreme Court to be illegal.<sup>43</sup>

While the Arizona Supreme Court is silent as to its reasons for doing so, it stated:

Nevertheless, upon issuance of the writ of habeas corpus in a proceeding attacking the legality of detention in a juvenile institution by virtue of failure of due process under *Gault*, the juveniles *should be returned to the jurisdiction of the Juvenile Court, for such further proceedings as are appropriate.* (Emphasis added.)<sup>44</sup>

There appears from the opinion no reasoning to buttress this disposition of the applications; however, an examination of the similar case of *LaFollette* indicates that this is the substantially correct legal course. In *LaFollette*, Chief Justice Currie of the Wisconsin Supreme Court phrased the issue in this manner: "Does a habeas court have the authority and the duty to remand to the jurisdiction of the juvenile court of originating commitment petitioners who have successfully challenged their juvenile commitments?"<sup>45</sup> He answered the question affirmatively, reasoning from an interpretation of the applicable Wisconsin statute on habeas corpus.<sup>46</sup> The essential criterion to be used in deciding whether a remand must be granted with the writ is a determination of whether jurisdiction had initially been properly obtained. In other words, if the legal error did not occur until after the petitioner was properly before the original juvenile authority, the correct action for the habeas court is a granting of the writ plus a remand to the originating court for further proceedings. The Wisconsin Stat-

40 155 N.W.2d 141 (Wis. 1967).

41 *Application of Billie*, 429 P.2d 699, 702 (Ariz. Ct. App. 1967).

42 *Id.*

43 *Id.*

44 *Application of Billie*, 436 P.2d 130, 136 (Ariz. 1968).

45 *State ex rel. LaFollette v. Cir. Ct. Brown County*, 155 N.W.2d 141, 144 (Wis. 1967).

46 For a discussion of the Wisconsin statutes and their similarity to the Arizona habeas corpus statutes, see text accompanying notes 47-51 *infra*.

ute<sup>47</sup> indicates that complete, total discharge can be had only in cases where the fundamental processes of obtaining jurisdiction have in some way not been legally correct.<sup>48</sup> Chief Justice Currie concluded that "if a juvenile's trial court record reveals a petition and an appearance in court, which are not under attack by the juvenile, the requisite jurisdiction for remand appears."<sup>49</sup>

It seems fairly certain that the Arizona Supreme Court would have bolstered its position considerably had it included in its opinion in *Billie* a treatment of its own habeas corpus statutes, which are substantially similar to those of Wisconsin. For example, the pertinent Arizona statute provides:

If the time during which the party may be legally detained in custody has not expired, and he is detained in custody by virtue of process issued by any court, judge or agency of the United States, in an action where such court, judge or agency has exclusive jurisdiction, or by virtue of the final judgment or decree of any court of competent jurisdiction, or of any process issued upon such judgment or decree, *the person shall not be discharged.* (Emphasis added.)<sup>50</sup>

It is also stipulated by statute that complete and total discharge may be had only where jurisdiction has been illegally obtained.<sup>51</sup> These statutes would seem therefore to justify the disposition of the applications made by the Arizona Supreme Court.

Any juvenile who has been tried without benefit of counsel, convicted, and ordered detained in a juvenile institution as of a date prior to *Gault* should heretofore have adequate redress through a writ of habeas corpus or similar collateral proceeding. The juvenile can urge that *Gault*, on the authority of *Gideon v. Wainwright*, should be applied retroactively. Whether juveniles in such a position should be immediately released or remanded to the jurisdiction of the originating juvenile court ordinarily will pivot around the applicable state habeas corpus statutes. A statute that orders a remand unless the legal error occurred in obtaining jurisdiction over the juvenile will provide state authorities with a sufficient degree of flexibility to determine those cases in which there is a practical feasibility in retrial of the juvenile, and those in which the state should not attempt retrial. In the light of past experiences,<sup>52</sup> it may be expected that the latter group will dominate, resulting in the outright release of any juveniles who had been convicted without the benefit of counsel.

*James Webster*

47 WIS. STAT. ANN. § 292.22 (1958).

48 *Id.*

49 *State ex rel. LaFollette v. Cir. Ct. Brown County*, 155 N.W.2d 141, 149 (Wis. 1967).

50 ARIZ. REV. STAT. ANN. § 13-2011(B) (1956).

51 ARIZ. REV. STAT. ANN. § 13-2012 (1956).

52 Anthony Lewis, in *Gideon's Trumpet*, commented on the consequences of *Gideon* in Florida alone: "The results were spectacular. By January 1, 1964, nine hundred seventy-six prisoners had been released outright from Florida penitentiaries, the authorities feeling they could not be successfully retried." A. LEWIS, *supra* note 39, at 205.