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THE FEDERAL TRADE COMMISSION AND THE STATES: THE SEARCH FOR REGULATORY AUTHORITY*

By John Harding Young

The assertion of an expanding jurisdictional role by the Federal Trade Commission (FTC) in the areas of advertising, consumer welfare and professional licensing has raised fundamental questions over the interplay of state and federal efforts to regulate trade. The uncertainty which has resulted from the FTC's assertion of jurisdiction over areas traditionally regulated by the state has placed the states and the FTC in "dynamic tension". This dynamic tension involves the issue of which governmental entity—the states or FTC—should regulate specific areas. The resolution of this tension turns on considerations central to our federal form of government.

The pivotal point in this debate is the applicability of the Supreme Court's seminal decision in *Parker v. Brown*[1] to the Federal Trade Commission Act. In *Parker,* the Court upheld California's right to regulate the price and production of raisins although the activity was clearly anticompetitive. This article will outline the development of the doctrine enunciated in *Parker* and explore whether its rationale remains valid. In particular, this article will explore the cases which have applied *Parker v. Brown,* and whether they portend a solution to three areas being considered by the FTC for trade regulation rules: consumer advertising,[2] state milk pricing[3] and professional regulation.[4] This article concludes that absent an explicit congressional mandate, the FTC Act does include within its coverage state regulations. This article further concludes that in areas where the states have properly exercised their authority to regulate competition, they must be held accountable under the First Amendment and Commerce Clause of the United States Constitution and state antitrust laws.

THE NATURE OF THE INQUIRY — REACH OF THE FTC ACT?

In *Gibbons v. Ogden,*[5] Chief Justice Marshal indicated that when a state law collided with a federal statute enacted under the Commerce Clause of the United States Constitution, the state law was invalidated by that collision. In

*This article was originally given as an address at the Federal Bar Association's 1977 Administrative Law Workshop, held November 16, 1977, in Washington, D.C. Courts and commentators that have considered the question of state-mandated activities and the antitrust laws have referred to the question as one of finding a "state action immunity" or "exemption". *Parker v. Brown,* 317 U.S. 341 (1943), upon which these assertions rely, however, announced no rule of antitrust "exemption", or "immunity"; rather, the Court in *Parker* determined that the Sherman Act was not intended to apply in the first instance to the state acts.

[1]317 U.S. 341 (1943).

[2]*See e.g.* Advertising of Ophthalmic Goods and Services, 16 C.F.R. 456 (1978); see notes 98-122 *infra* and accompanying text.

[3]*See e.g.* 3 Trade Reg. Rep. (CCH) ¶ ¶ 10, 190 (1977).

[4]*See* notes *infra.*

analysis of preemption is necessary.[14] If, however, state regulations are not within the coverage of the FTC Act, the analysis is terminated since no conflict exists.[15] Although this proposition is basic to statutory construction of federal statutes, the analysis of state action has been complicated by the failure of many commentators to properly define the nature of the inquiry.[16] This failure may be understandable since the Court's opinions on the role of state action have contained a great deal of dicta which fail to focus on the need for statutory construction.[17] The analysis of state action has been further complicated by the general language of the Sherman Act and FTC Act regarding their coverage.[18]

Parker, Its Progeny and the States

A. The Distinction Between State and Private Action.

In *Parker,*[19] a unanimous Supreme Court ruled that a California pro rata raisin marketing plan—devised for the express purpose of restricting competition among raisin growers and maintaining prices—did not violate the

[14]The Supremacy Clause of the United States Constitution renders invalid any state law or regulation that "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress". Florida Lime & Avocado Growers Inc. v. Paul, 373 U.S. 132, 141 (1963) quoting Hines v. Davidowitz, 312 U.S. 52, 67 (1941). In the most direct form of preemption Congress expresses its intent to preempt inconsistent state laws. *See e.g.* The Federal Election Campaign Act Amendments of 1976, 2 U.S.C. §453 (1977) ("The provisions of this Act, and rules prescribed under this Act supercede and preempt any provision of state law with respect to election to Federal office"). State law not directly in conflict with a federal law may be nonetheless preempted if a federal design to occupy the field exists. *See e.g.,* Jones v. Roth Parking Co., 430 U.S. 519 (1977); California v. Zook, 336 U.S. 725 (1949). As is very often the case the relevant statute neither expressly authorizes preemption of state law, nor expressly forbids it. Cases of preemption have typically involved state laws or regulations that disrupt an isolated aspect of a particular federal activity or a comprehensive scheme of federal regulation. *See e.g.,* Goldstein v. California, 412 U.S. 546 (1973) (repugnancy between federal and state laws); Hines v. Davidowitz, 312 U.S. 52 (1941) (state statute stands as an obstacle to the accomplishment and execution of Congress' full purposes and objections); Campbell v. Hussey, 368 U.S. 297 (1961) (uniform nationwide regulation is intended); Burbank v. Lockheed Air Terminal, 411 U.S. 624 (1973) (federal regulatory scheme is so pervasive so as not to allow similar state regulation). For example, in Free v. Bland, 369 U.S. 663 (1964), the court held that treasury regulations governing survivorship rights to the United States Savings Bonds preempted state law which would have rendered the bonds unattractive to investors. Similarly, the Court has invalidated state statutes which disrupt long-standing federal practices regarding common carrier rates, Public Utilities Comm'n of California v. United States, 355 U.S. 534 (1958), and negotiations for the award of government contracts, Leslie Miller, Inc. v. Arkansas, 352 U.S. 187 (1956). In these cases, the nexus between the underlying congressional enactment and the preemptive impact attributed to the agency regulation was particularly close. In these cases, the particular federal concerns (savings bonds, military supplies, government contracts), together with the comprehensive federal regulations of those areas, lent force to the claim that the agencies acted within congressional authority to preclude operation of inconsistent state laws. Of course, if the court finds either a congressional design for exclusively federal regulation or a direct conflict between federal and state regulation, the Supremacy Clause requires that state law give way. Doctrinally, at least, there is no room in preemption analysis for a flexible balancing of interrelated federal and state interests. *See e.g.,* Free v. Bland, 369 U.S. 663, 666 (1962): "The relative importance to the State of its own law is not material when there is a conflict with a valid federal law, for the Framers of our Constitution provided that the federal law must prevail."

[15]Bates v. State Bar of Arizona, 433 U.S. 350 (1977).

[16]*See* note 12 *supra.*

[17]*See e.g.* City of Lafayette v. Louisiana Power & Light Co., 435 U.S. 389 (1978); 428 U.S. 579 (1976); Goldfarb v. Virginia State Bar, 421 U.S. 773 (1975).

[18]Section One of the Sherman Act 15 U.S.C. §1 (1977) provides in pertinent part: "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal." Section (a)(1)5 of the FTC Act 15 U.S.C. §45(a)(1)(1977) provides "(a) Unfair methods

The Court's distinction in *Parker* between acts merely authorized and those mandated by the state was further examined by the Court in *Schwegmann Brothers v. Calvert Distillary Corp.*[26] In *Schwegmann,* the Court applied the Sherman Act to Louisiana's "fair trade" statute which contained a "nonsigner" provision permitting retailers to enjoin other retailers who knowingly undersold the retail price maintained between "signing" retailers and their suppliers. While fair trade statutes were exempt from the antitrust laws under the Miller-Tydings Act,[27] the Act did not include within its scope nonsigners. *Schwegmann's* basic teaching, thus, reaffirms *Parker's* holding that a state may not confer upon a private party the unsupervised power to fix prices or to otherwise violate the antitrust laws.

B. *Parker:* Reexamined in *Goldfarb, Bates* and *City of Lafayette*

Minimum Fees and Liability Under the Sherman Act

Parker remained undisturbed by the Supreme Court until the Court's decision in *Goldfarb v. Virginia State Bar.*[28] In *Goldfarb,* the Court was presented with "[W]hether a minimum fee schedule for lawyers published by the Fairfax County Bar Association and enforced by the Virginia State Bar" violated Section 1 of the Sherman Act.[29] Since the State Bar was a state agency,[30] the Court addressed its claim, based on *Parker,* that the Sherman Act did not apply. An expansive reading of *Parker* appeared to support the State Bar. The Court, however, rejected the State Bar's claim, and found, as a "threshold" matter, that the State Bar's involvement was not state action since no Virginia statute required the promulgation of minimum fees.[31] Significantly, *Goldfarb* involved two bar organizations, the State Bar, an administrative agency of the Supreme Court which required each attorney practicing in Virginia to be a member, and the Fairfax County Bar Association, a private, voluntary bar association.[32] The Court found that neither was acting pursuant to a state command. The Court accordingly held that the anticompetitive conduct was not "compelled by direction of the state acting as a sovereign".[33] Significant to the Court's decision was its conclusion that the Supreme Court of Virginia explicitly directed lawyers not to be controlled by the fee schedules,[34] although violation of the fee schedule might result in disciplinary action by the State Bar.[35]

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[26]341 U.S. 384 (1951).

[27]50 Stat. 693 (1937), 15 U.S. §1 (1973) was repealed by 89 Stat. 801 (1975). The Court's decision in Schwegmann Bros. v. Calvert Distillers Corp., 341 U.S. 384 (1951) was rendered inoperative by the enactment of the McGuire Act, 66 Stat. 632 (1952), 15 U.S. §45 (1973), which exempted Fair Trade enforcement against nonsigners outside the scope of the antitrust laws. *See,* Hudson Distribs. Inc. v. Eli Lilly & Co., 377 U.S. 386 (1964), Parke, Davis & Co. v. Health Cross Stores, Inc., 364 F.2d 214 (4th Cir. 1966).

[28]421 U.S. 657 (1974).

[29]421 U.S. at 775.

[30]*Va. Code* §54-49 (1972). *See,* 421 U.S. at 775 n. 2.

[31]421 U.S. at 789-92.

[32]*Id.* at 790.

sovereign.[48] To accomplish this task, the Court has devised rules of construction similar to those set forth by Justice Stevens.[49] These rules include a presumption against exemption.[50] These rules do not, however, apply where the conflict is between two sovereigns and the question is one of federal coverage and preemption. In an analysis of preemption, the presumption is that state law will prevail unless proof of an overriding federal exercise of power is established.[51] To turn the state action on proof that the state program meets the "minimum extent necessary" test is to reverse the presumption, and thus, undercut the concern for federalism expressed in *Parker*. Subsequent cases have failed to expand on Justice Stevens' dicta.[52]

Justice Blackmun, while concurring in the result, set forth a rule of reason analysis to govern the interface of state and federal laws.[53] Justice Blackmun in *Cantor* would require a balancing of state and federal interests in an attempt to resolve jurisdictional issues. He abandoned however, his balancing test for state action in *Bates v. State Bar of Arizona*.[54] The use of a balancing test, while improper in a state action analysis must be distinguished from the proper use of a balancing test utilized in evaluating state burdens on commerce under the Commerce Clause.[55]

After *Cantor*, the precise parameters of state action were tremendously confused, although all members of the Court appeared to agree that state action existed in a civil action challenging the state, state officials or specific acts of legislature. The Court's failure to produce a well reasoned majority opinion led many to suggest that *Cantor* had vitiated *Parker*.[56]

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[48]*See e.g.* Siver v. New York Stock Exchange, 373 U.S. 341 (1963) (reconciling the Securities Exchange Act, 48 Stat. 881 (1934) Codified in scattered section of 15 U.S.C. with the Sherman Act, 15 U.S.C. §1 (1973).

[49]428 U.S. at 596-98.

[50]*See e.g.* United States v. Philadelphia Nat. Bank, 347 U.S. 321 (1963) (reconciling the Bank Merger Act, 74 Stat. 129 (1960) as amended 12 U.S.C. §1828(c) (1970) with the Sherman Act §1, 15 U.S.C. §1, and the Clayton Act §7, 15 U.S.C. §18.

[51]*See e.g.* Florida Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 146 (1963) (preemption must be based on "clear and manifest purpose of Congress"); Parker v. Brown, 317 U.S. 341, 351 (1943) (court indicated its reluctance to imply Congressional intent to nullify state regulation). *See also*, Note, *The Preemption Doctrine: Shifting Perspective on Federalism and the Burger Court*, 75 *Colum. L. Rev.* 623 (1975).

[52]*See e.g.* City of Lafayette v. Louisiana Power & Light Co., 435 U.S. 389 (1978); Bates v. State Bar of Arizona, 433 U.S. 350 (1977).

[53]Justice Blackmun declared: "I would apply at least for now, a rule of reason, taking it as a general proposition that state-sanctioned anti-competitive activity must fall like any other if its potential harms outweigh its benefits. This does not mean that state-sanctioned and private activity are to be treated alike. The former is different because the fact of state sanction figures powerfully in the calculus of harm and benefit. If, for example, the justification for the scheme lies in the protection of health or safety, the strength of that justification is forcefully attested to by the existence of a state enactment. I would assess the justifications of such enactments in the same way as is done in equal protection review, and where such justifications are at all substantial as one would expect them to be in the case of most professional licensing or fee setting schemes, for example, ef. Olsen v. Smith, 195 U.S. 332, 25 S.Ct. 52, 49 L.Ed. 224 (1904), I would be reluctant to find the restraint unreasonable. A particularly strong justification exists for a state-sanctioned scheme if the State in effect has substituted itself for the forces of competition, and regulates private activity to the same ends sought to be achieved by the Sherman Act. Thus, an anticompetitive scheme which the State institutes on the plausible ground that it will improve the performance of the market in fostering efficient resource allocation and low prices can scarcely be assailed." 428 U.S. at 610-11.

municipalities which owned and operated an electrical utility may be subjected to counterclaims alleging violations of the Sherman Act. The municipalities moved to dismiss the counterclaims on the ground that the Sherman Act did not apply because of their governmental status.[70] Although a majority agreed to remand the case for the development of a fuller factual record, the Court was divided over the appropriate analysis of the state action criteria.[71] A plurality of the Court, led by Justice Brennan, declared that although *Parker* did not set forth a rule for all governmental entities, the Sherman Act would not apply to activities taken pursuant to state regulations that contemplated the replacement of competition.[72] Although agreeing with the remand, the Chief Justice would require that the municipalities establish that their acts were compelled by the State acting in its governmental capacity, and that an antitrust exemption was essential to the regulatory scheme.[73] The dissent written by Justice Stewart, argued that under *Parker,* the Sherman Act did not apply to any activities of a governmental entity.[74]

The net effect of the opinions in *City of Lafayette* is that the Sherman Act does not cover governmental action taken pursuant to a state policy to displace competition with regulation.[75] *City of Lafayette* is otherwise difficult to analyze because it lacks a clear majority opinion and an adequate record delineating the state's policy. Despite these ambiguities, one lesson from *City of Lafayette* is clear: State action must be supported by a factual record.[76]

THE FEDERAL TRADE COMMISSION AND STATE REGULATIONS

A. Applicability of *Parker*.

While the case law on the Sherman Act and state action has been subjected to pointed, if not confusing, reevaluation, few cases have considered the FTC Act's application to state regulation. None of the cases have adequately addressed the issue.[77] The cases suggesting that the FTC Act preempts state laws are defective for three reasons: 1) none consider *Parker;* 2) none involve a direct conflict between the FTC Act and state law, and 3) none involve FTC

[70] *Id.* at 392.

[71] Justice Brennan wrote the plurality opinion and was joined by Justices Marshall, Powell and Stevens. Chief Justice Burger wrote an opinion concurring in part and concurring in the judgment. Justices Stewart, White, Rehnquist and Blackmun (in a separate opinion) dissented.

[72] Justice Brennan stated: "We therefore conclude that the *Parker* doctrine exempts only anticompetitive conduct engaged in as an act of government by the State as sovereign, or, by its subdivision, pursuant to a state policy to displace competition with regulation or monopoly public service." 435 U.S. 413.

[73] 435 U.S. at 424-25.

[74] *Id.* at 426-441.

[75] *See* note 72 *supra.*

[76] The Court affirmed the Court of Appeals for Fifth Circuit opinion which provided in part that: "Whether a governmental body's actions are comprehended within the powers granted to it by the legislature is, of course, a determination which can be made only the specific facts in each case. A district judge's inquiry on this point should be broad enough to include all evidence which might show the scope of legislative intent." 532 F.2d 431, 435 quoted in 435 U.S. at 394.

[77] Peerless Prods., Inc. v. Federal Trade Comm'n, 284 F.2d 825 (7th Cir. 1960) *cert. denied,* 365 U.S. 844 (1961) *aff'g In Re* Peerless Prods., Inc. 56 F.T.C. 1070 (1960) (no conflict between FTC enforcement action to prevent shipment to the state of lottery (punch) boards and local ordinance which approved their use); Royal Oil Corp. v. Federal Trade Comm'n, 262 F.2d 741 (4th Cir. 1959) (no conflict between FTC finding that used motor oil labeling required by North Carolina was

gants, which necessitates a *Parker* rule to insulate the state. Under the FTC Act, on the other hand, the FTC would promulgate trade regulation rules only after considering the public's interest under its rules[87] and the Administrative Procedures Act.[88] While these arguments may have a surface attractiveness, they fail to confront the fundamental issue of whether the FTC Act was intended in the first instance to apply to the states.

B: The Impact of *National League of Cities.*

The view that the FTC Act does not apply to state action is reenforced, in part, by the Supreme Court's recent decision in *National League of Cities v. Usery.*[89] *National League of Cities* involved a challenge to the 1974 Amendments of the Fair Labor Standards Act[90] which applied the minimum wage and maximum hour requirements to state and local employees. The Amendments, unlike the FTC Act, expressly included the states within their scope.[91] The Supreme Court, nevertheless, ruled that to the extent the Amendments sought control over state employees, they were an unconstitutional infringement upon the sovereignty of the state.[92] The Court held that the Act could not be expanded to interfere with traditional state governmental functions exercised pursuant to the reserve powers of the state under the Tenth Amendment.[93] *National League of Cities* is significant since past decisions of the Court has construed the Commerce Clause to include many traditional state government functions.[94]

Although the distinctions between traditional attributes of sovereignty protected by the Tenth Amendment and the Commerce Clause are unclear, concerns of federalism expressed in *Parker* are noticeable in *National League of Cities.* In *National League of Cities,* the Court recognized that the Commerce Clause does not extend to essential elements of state sovereignty. Although the Court's concept of federalism has been determined on a case-by-case basis, activities of the states that are essential to their exercise of sovereignty may find new protection in the Tenth Amendment.

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[87]Procedures and Rules of Practice for The Federal Trade Commission 16 C.F.R. parts 1-4 (1978).

[88]5 U.S.C. §§551-575, 701-706 (1977).

[89]426 U.S. 833 (1976).

[90]88 Stat. 55, 29 U.S.C. §203(d), (5)(x) (1976 ed. Supp. IV).

[91]29 U.S.C. §203(x) (1970 ed. Supp. IV). A "public agency" under the Amendments included: "[T]he Government of the United States; the government of a state or political subdivision thereof; any agency of the United States. . .a State, or a political subdivision of a state; or any interstate governmental agency."

[92]Justice Rehnquist in the opinion of the Court declared: "Our examination of the effects of the 1974 Amendments, as sought to be extended to the States and their political subdivisions, satisfies us that both the minimum wage and the maximum hour provisions will impermissively interfere with the integral governmental functions of these bodies." 426 U.S. at 851.

[93]The Court quoting Fry v. United States. 421 U.S. 542, 547, n. 7 declared: "While the Tenth Amendment has been characterized as a 'truism' stating merely that 'all is retained which has not been surrendered', United States v. Darby, 312 U.S. 100, 124 (1941) it is not without significance. The Amendment expressly declares the constitutional policy that Congress may not exercise power in a fashion that impairs the States' integrity or their ability to function effectively in a federal system." 426 U.S. at 842-43.

[94]*National League of Cities* expressly overruled Maryland v. Wirtz 392 U.S. 183 (1968) (which upheld similar exten-

dies under Section 5.[103] Two issues regarding the jurisdiction of the FTC under Section 5 are present. First, whether state regulations may be characterized as "unfair" under Section 5; and second, whether the FTC in fashioning a remedy to anticompetitive conduct can preempt state regulations. Like the Sherman Act, Section 5 of the FTC Act makes no reference to state regulatory programs.[104] The FTC, however, has argued that the definition of "unfair methods of competition" or "unfair or deceptive practices" is broad enough to include areas to be defined by it on a case-by-case basis.[105] The case law prior to the enactment of the Magnuson-Moss/FTC Improvement Act recognizes, however, that Section 5 is not limitless authority for the FTC's enforcement action.[106] Under Section 5, therefore, the FTC is confronted with problems of statutory construction similar to those found in the Sherman Act, and resolved in *Parker v. Brown* and its progeny.

The FTC staff has attempted alternatively to rely on Section 6(g) of the FTC Act to preempt state regulations.[107] Section 6(g) extends to the Commission the power to promulgate substitutive trade rules.[108] Section 6(g), however, does not provide a solid base for the issuance of trade regulation rules overriding state regulations. Rules promulgated under Section 6(g) are enforced in adjudicative proceedings under Section 5.[109] While the FTC staff has argued that §6(g) could provide a basis for the issuance of rules having preemptive effect under the Supremacy Clause,[110] it is unsound to hold that the FTC's rulemaking authority under §6(g) is broader than the enforcement authority under Section 5. As with all other legislation in this area, Congressional intent to preempt state regulations is absent.[111]

The legislative history of the Magnuson-Moss/FTC Improvement Amendments is also unsatisfactory as support for extending the coverage of

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[103]Federal Trade Comm'n v. National Lead Co., 352 U.S. 419, 427 (1957); Pep Boys—Manny, Moe & Jack, Inc. v. Federal Trade Comm'n, 122 F.2d 158, 161 (3d Cir. 1941).

[104]*Compare* Sherman Act, §1, 15 U.S.C. §1 (1973) ("Every contract, combination in the form of trust or otherwise on conspiracy, in restraint of trade or commerce among the several States, or with foreign nations is declared illegal") with FTC Act §5(a)(1), 15 U.S.C. 45(a)(1) (1973) ("unfair methods of competition in commerce, and unfair or deceptive acts or practices in commerce, are declared unlawful").

[105]*See e.g.* Advertising of Ophthalmic Goods and Services, 16 C.F.R. 456.5 (1978); Summary of Basis of Rule, 43 *Fed. Reg.* 24003 (June 2, 1978). ("The Commission does not believe that the *Parker* exception to the Sherman Act is determinative of the question of Commission preemption authority under the Federal Trade Commission Act").

[106]*See e.g.*, Federal Trade Comm'n v. Bunte Bros., Inc., 312 U.S. 349 (1971). Cf., United States v. American Bldg. Maintenance Indus., 422 U.S. 271 (1975).

[107]Federal Trade Commission, Report of the State Regulation Task Force (March 14, 1978) 50-52. [hereinafter "State Regulation Task Force"].

[108]*See,* National Petroleum Refiner's Ass'n v. Federal Trade Comm'n, 482 F.2d 672 (D.C. Cir. 1973) *cert. denied* 415 U.S. 951 (1974). The grant of rulemaking authority under the Magnuson-Moss/Federal Trade Commission Improvement Act, 15 U.S.C. §57a(a)(1)(B) (1976) was enacted to remove any doubt of the ruling in *National Petroleum* Refiners.

The report of the Senate Commerce Committee contained similar language which is uninstructive in ascertaining the preemptive effect of the FTC rules.[118]

The lack of language extending the coverage of the FTC Act to state action, together with the presumption against interference with state laws,[119] leads to the conclusion that the state action doctrine developed in *Parker* and the subsequent case law is applicable to the regulation of advertising by the state. A troublesome aspect of an analysis which concludes that the FTC Act does not cover state advertising regulation is that state rules may be detrimental to consumers' right to receive commercial information. This concern has been dealt with, however, by the Supreme Court in *Virginia State Board of Pharmacy v. Virginia Citizen Consumer Council*[120] and *Bates v. State Bar of Arizona.*[121] Both *Virginia Pharmacy* and *Bates* support the consumers right to receive commercial information under the First Amendment. While important issues remain unresolved,[122] both cases may lead to increased consumer welfare through the dissemination of commercial advertising. The FTC has realized in part, the influence of the Supreme Court's decision in *Virginia Pharmacy* by foregoing the promulgation of a trade regulation rule on the advertising of prescription drugs.[123] To the extent that FTC rules and regulations also involve important First Amendment issues, attempts to extend the FTC Act's coverage to state law are unnecessary. As the FTC considers trade regulation rules for the protection of the consumers, limited agency resources ought not be expended in areas protected by the First Amendment. Moreover, the potential for abuse in permitting an administrative agency to administer and prescribe rules covered by the First Amendment further supports a limitation of the FTC authority.

B. State Milk Pricing.

One of the markets traditionally regulated by the state is agriculture. Both the states and the federal government have programs regulating the production and sale of agricultural products.[124] Recently, the FTC announced that it is considering a trade regulation rule affecting state agriculture policy on the setting of retail and wholesale prices for milk.[125]

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[118]S. Rep. No. 93-151, 93d Cong., 2d Sess. 27 (1974).

[119]Parker v. Brown, 317 U.S. 341 (1943).

[120]425 U.S. 748 (1976).

[121]433 U.S. 350 (1977).

[122]Although both *Virginia Pharmacy* and *Bates* established that commercial speech is protected by the First Amendments, the limits of that protection have not been defined. *See e.g.* Bates v. State Bar of Arizona, 433 U.S. at 366-67 ("The issue presently before us is a narrow one. First, we need not address the peculiar problems associated with advertising claims relating to the quality of legal services. Such claims probably are not susceptible of precise measurements or vertification and, under some circumstances, might well be deceptive or misleading to the public, or even false").

[123]*See,* 43 Fed. Reg. 54951 (Nov. 24, 1978) (proceeding withdrawn and closed); *See also,* 41 Fed. Reg. 27391 (July 2, 1976) (indefinite postponement of staff submission of final reports).

[124]*Compare* Va. Code § (3110347) (1973 Rept. Vol.) (granting the Virginia Milk Commission the authority to set minimum and maximum retail and wholesale prices for milk) with 7 U.S.C. 608(c) (1978) (providing for a federal milk

from out-of-state competition.[137] Similarly, in *Hunt v. Washington Apple,*[138] a North Carolina statute was struck down under the Commerce Clause when the state attempted to regulate the flow of apples to North Carolina by requiring out-of-state apples be graded according to North Carolina's standards.[139] Under the Commerce Clause test, the Court in *Parker* could very well have overturned California's pro rata program.[140] An analysis of *Parker,* however, reveals that the Commerce Clause attack was rejected, in large part, on the congruence of federal and state agricultural policies intended to overcome the effects of the Depression.[141]

In view of the serious questions of the FTC Act's coverage, it appears, as with state controls of advertising, best to defer questions involving traditional regulations of the state to examination under the United States Constitution.

C. Regulation of the Professions.

One of the most controversial areas of putative federal regulation is the professions. Currently, the FTC is examining proposed trade regulation rules affecting lawyers,[142] doctors,[143] dentists,[144] real estate salesmen,[145] funeral directors and other professions.[146] To the extent that state regulations violate the First Amendment or the Commerce Clause, these constitutional provisions provide adequate means to control abuses arising from state regulations.[147] The hard case is professional regulations which are clearly anticompetitive,

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[137] *Id.* at 375 (The Court responded to the State's arguments, stating "Mississippi's contention that the reciprocity clause serves its vital interests in maintaining the States' health standards borders on the frivolous. . .[T]his is a case where the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits"). (citations omitted).

[138] 432 U.S. 333 (1977).

[139] 432 U.S. 351-52 ("[B]y prohibiting Washington growers and dealers from marketing apples under their State's grades, the statute has a leveling effect which insidiously operates to the advantage of local apple producers").

[140] *See* note 127 *supra.*

[141] 317 U.S. at 365-67.

[142] 3 *Trade Reg. Rep.* (CCH) ¶ 10,198 (1978) ("The FTC authorized its Boston Regional Office to conduct an industrywide investigation of the effects of state or bar association regulation or policies that may interfere with the formation or operation of cost-efficient systems for delivery of legal services").

[143] 3 *Trade Reg. Rep.* (CCH) ¶ 10,176 (1976) ("The FTC commenced an investigation to determine whether the American Medical Association may have illegally restrained the supply of physicians and health care services. . . .").

[144] 3 *Trade Reg. Rep.* (CCH) ¶ 10,202 (1977) ("Practices that may illegally restrict entry and otherwise restrain competition in the dental care industry are the target of an FTC investigation that the agency announced concurrently with its announcement of the Complaing against the American Dental Association." *Id.* ¶ 21,225).

[145] 3 *Trade Reg. Rep.* (CCH) ¶ 10,169 (1978) ("The FTC announced that it is conducting an industrywide investigation to determine whether certain real estate brokers, real estate salesmen, realtors, Board of Realtors, trade associations, multiple listing services and others may be in violation of the FTC Act.").

[146] *See e.g.* 3 *Trade Reg. Rep.* ¶ 10,167 (1975) (licensing requirements for veternarians), ¶ 10,168 (home appliance repairmen), ¶ 10,175 (travel agents), ¶ 10,178 (automobile repairmen), & ¶ 10,206 (bail bondsmen).

[147] *See* notes 120-23, 127-140, *supra* and accompanying text. *But* see, Canby & Gellhorn, *Physician Advertising: The First Amendment and The Sherman Act,* [1978] *Duke L.J.* 543, 583. ("The first amendment is a specialized tool, however, and a somewhat inflexible one. There are many restrictive practices of the professions that may adversely affect the consumer and that the first amendment cannot reach because they do not involve the supression of information . .On the other hand, just the opposite may be said of the Sherman Act. Its application is appropriate to test the entire range of self-regulation by the professions".) The author does not disagree with Mr. Canby and Dean Gellhorn in the need for control of professional self-regulation through the active enforcement of the antitrust laws. The difference is that Mr. Canby and Dean Gellhorn would expand the scope of the Sherman Act, (and possibly the FTC Act) to regulations covered by the rule

CONCLUSION

The extent to which the FTC Act applies to state action is a question of statutory construction involving the FTC Act's coverage.[157] Until it is determined that state action is within the coverage of the FTC Act, questions of preemption are not reached.[158] Although the Court in *Goldfarb*[159] may have confused this approach by referring to the question as a "threshold inquiry", the Court in *Bates*[160] readily accepted that once the questioned activity is state action, it is outside the scope of the Sherman Act, and no further analysis is appropriate. An analysis of the FTC Act similarly indicates that its coverage does not extend to state programs which replace competition with state supervised regulation.[161] To view the question of the FTC Act's coverage as requiring a finding of exemption is to impose on the state action analysis a requirement wholly improper for the reconciliation of two sovereign regulations.[162]

Although state action is outside the FTC Act's coverage, the state's right to regulate is subject to limitation imposed by the United States Constitution. To the extent that state regulations infringe on the Constitution, particularly the First Amendment and the Commerce Clause, the Courts should fully examine those regulations and invalidate state regulation when a conflict is found.[163] In areas where state regulations are constitutional although anticompetitive, the states should clearly weigh the need for competition with the need for regulation. The growth of state antitrust laws parelleling the

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[157] *See* notes 12-18 *supra* and accompanying text.

[158] *See* notes 14-15 *supra* and accompanying text.

[159] 421 U.S. at 790. ("The threshold inquiry in determining if an anticompetitive activity is state action of the type the Sherman Act was not meant to proscribe is whether the activity is required by the State acting as sovereign.")

[160] 433 U.S. at 359-363. ("Once state action was found, no further inquiry under the Sherman Act was conducted; although the disciplinary rule was invalidated under the First Amendment.")

[161] *See* notes 77-94 *supra* and accompanying text.

[162] *See* notes 45-52 *supra* and accompanying text.

[163] ALA. CODE tit. 57, §§106-108; ARIZ. REV. STAT. §44-1411; ARK. STAT. §70-101-143; CAL. BUS. PROF. CODE §§16700-16758; §§1700-17101; COLO. REV. STAT. §§55-4-1 through 55-4-9; CONN. GEN. STAT. REV. ch. 624; FLA. STAT. §§540; 541.001-541.09; 542.12; GA. CODE §20-504; HAWAII REV. LAWS tit. 26, ch. 480; IDAHO CODE §§48-101 through 48-117; 48-201 through 48-206; ILL. REV. STAT. ch. 38, §60-1 *et seq.*; IND. STAT. §23-101; IOWA CODE ch. 553 (Iowa Competition Law); KAN. STAT. §50-101 *et seq.* KY. STAT. ch. 667; LA. REV. STAT. §§51:121-51:152; ME. REV. STAT. ch. 201, §§1101-1107; MD. CODE art. 83, §36 *et seq.* MASS. GEN. LAWS ch. 93, §1-4; MICH. COMP. LAWS §445.701 *et seq.*; 445.761 *et seq.*; MINN. STAT. §325.8011 *et seq.*; MISS. CODE §75-21-1 *et seq.*, MO. REV. STAT. §416.001, *et seq.* MONT. REV. CODES §§51-109 through 51-118; NEB. REV. STAT. LB 1028, (1974 legis.); NEV. REV. STAT. ch. 598A; N.H. REV. STAT. ch. 356; N.J. REV. STAT. §56:9-1 *et seq.* N.M. STAT. ch. 49, art. 1; N.Y. GEN. BUS. LAW art. 22; N.C. GEN. STAT. §§75-1.1 through 75-16; N.D. CENT. CODE §§51-08; 51-09; OHIO REV. CODE ch. 1331; OKLA. STAT. tit. 79; ORE. REV. STAT. §§646.705-646.805; P.R. LAWS tit. 10, §§951-956; S.C. CODE §§66-51 through 66-54; S.D. COMPILED LAWS §37-1-1; TENN. CODE §§69-

EXCLUSIVE SERVICE TERRITORIES, POWER POOLING AND ELECTRIC UTILITY REGULATIONS

By David C. Hjelmfelt

Despite substantial technological and economic changes in the electric utility industry in the past fifteen years, states continue to enact legislation establishing exclusive retail service areas.[1] It is the purpose of this article to consider the effects of such legislation in promoting commonly accepted regulatory goals in view of the present state of the electric utility industry.

The rationale for regulation of the electric utility industry, it has been argued, rests on four points.[2] First, an adequate, reliable and economical power supply is essential to society. Second, to provide an adequate, reliable and economical power supply requires a very large investment in capital facilities. The ratio of such investment to annual revenue in the electric utility is about $4 of capital for each $1 of annual revenue; the ratio for the steel industry is about $1.70 to $1 and for retail stores about 30 cents of capital for each $1 of revenue.[3] Third, the power supply industry is complex, and substantial additional complexities are created when more than one firm operates in a given area. Fourth, the required facilities require the use of significant land areas and have important effects on the environment.

A more traditional statement of the rationale of regulation is that electric utilities are natural monopolies. Therefore, to insure the most efficient allocation of resources, utilities are granted exclusive franchises and placed under regulation to prevent exploitation by the producer while reaping the economies of scale.[4]

If the electric utility industry is a declining cost industry, it follows that electricity will be produced most efficiently and at lowest cost by a single producer. For that reason, it would appear reasonable to grant to a single firm a monopoly in the form of an exclusive franchise which permits the single firm to exploit economies of scale which would not be realized if service were provided by a number of smaller firms. At the same time, it must also be recognized that a monopolist will attempt to maximize profits by producing only at the level where marginal revenue equals marginal cost.[5] At this level of production, the firm will reap economic profits, but some consumer demand at the level of long run average costs will not be satisfied. This results in a misallocation of resources to other industries and a loss of consumer surplus to society.[6] To eliminate the loss of consumer surplus, the electric utility is re-

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[1]Ohio House Bill No. 577 which became effective July 12, 1978. Minnesota enacted territorial legislation in 1975. Approximately 40 states now have some form of territorial legislation with varying degrees of rigidity.

[2]Herbert R. Cohn, "The Rationale and Benefits of Regulation", 45 Antitrust Law Journal 215 (1976).

[3]"... circular, for regulation itself leads to over capitalization.

Group (CAPCO) have joined together to construct large generating units to exploit economies of scale.[16] Separately, none of these companies could exploit economies of scale.[17] CAPCO comes very close to achieving the economies of scale which could be attained by a larger single firm.[18]

The ability of several firms to jointly exploit the economies of scale at the generation level has lead many to conclude that no natural monopoly exists at this level.[19] At the generation level, the electric utility industry is technologically capable of effective competition.[20] At the same time, the economies of scale in generation has been an important factor in the decline in the number of municipal systems which generate their own power.[21]

The transmission level performs three functions: (1) delivery of bulk power to load centers for distribution, (2) connecting generating stations, and (3) interconnecting electric utilities. Transmission, like generation, offers substantial economies of scale.[22] The opportunity for further exploitation of the economies of scale of transmission appear to be large, presenting major new opportunities for transporting bulk power over long distances.[23] High-voltage long-distance transmission requires a substantial capital investment and is economical only if large blocks of power are involved. Capital and operating costs increase in direct proportion to the voltage increase, but the transfer capacity increases virtually as the square of the voltage increases. High-voltage transmission permits utilities to buy and sell large blocks of power to each other.[24]

The same opportunities for sharing the costs and ownership of large transmission lines exist as are found in generation. Additionally, contractural arrangements can be made whereby one utility agrees to transfer power for another utility.[25] Thus, natural monopoly does not exist at the transmission level.

Even assuming the uncertain fact that the distribution function does exhibit natural monopoly characteristics, at the generation and transmission level, i.e. bulk power supply, the industry is now capable of effective competition. Moreover, such competition can economically be extended to large industrial retail customers.[26]

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[16]Initial Decision of the Atomic Safety and Licensing Board in The Toledo Edison Company and The Cleveland Electric Illuminating Company (Davis-Besse Nuclear Power Station, Units 1, 2, and 3) 5 NRC 133, 152.

[17]5NRC p. 155.

[18]Dr. William Hughes, Testimony before the Nuclear Regulatory Commission in The Toledo Edison Company and The Cleveland Electric Illuminating Company, *supra;* Members of the New York Power Pool obtain all of the economies of a single company, Vark Beil, "Power to the People", *The Monopoly Makers,* Mark Green, Editor, 1973.

[19]Weiss, *op. cit.;* Wilcox and Shepherd, *op. cit.* p. 397.

[20]Wilcox and Shepherd, *op. cit.* p. 415. Meeks, *op. cit.* 76.

[21]Roland Kampmeier, Testimony before the Nuclear Regulatory Commission, The Toledo Edison Company and The Cleveland Electric Illuminating Company (Davis-Besse Nuclear Power Station, Units 1, 2 and 3) Docket Nos. 50-346A, 50-500A and 50-501A.

[22]Federal Power Commission; National Power Survey, vol. 1.

[23]Wilcox and Shepherd, *op. cit.* p. 397.

Without addressing arguments for deregulation, it is apparent that the existing scheme of dual regulation will produce better results if it is supplemented by competition at the generation and transmission level and at the retail distribution level at least with regard to large industrial customers and large blocks of small customers through franchise competition.[37]

TERRITORIAL RESTRAINTS AND ECONOMIES OF SCALE

With economies of scale for nuclear generation reaching a frontier at 1200 megawatts, only very large utilities can install them economically. A utility experiencing an annual growth in peak demand of 200 megawatts would find it uneconomical to add a 1200 megawatt unit and carry a large amount of very expensive excess capacity for 4 to 5 years until its load growth finally caught up with unit sizes.[38]

In an industry in which most generation is owned by large, privately-owned, vertically integrated utilities, which size their generating units to match their own system load growth, very few firms could afford to exploit the available economies of scale. This has led some such as Donald Cook, the Chairman of American Electric Power, to argue that a competitive system will not take advantage of economies of scale. Accordingly, he has proposed that the industry be reorganized into 12 to 15 regional giants, each monopolistically supreme in its region.[39]

Territorial restraints not only limit retail competition but also limit the growth potential for vertically integrated firms. The effect is to insure that for the foreseeable future most firms, independently, will not be large enough to fully utilize economies of scale. The result will be more firms than advocated by Mr. Cook, each operating at a higher position on the long run average cost curve. In terms of regulatory objectives territorial legislation may improve resource allocation at the distribution level but has the opposite effect at the generation and transmission levels. Beneficial effects at the distribution level may prove to be illusory if in fact natural monopoly tendencies do not exist.[40] Dr. Shepherd has observed that most utilities could compete vigorously among themselves for at least their major customers. Each utility would gain by raiding its neighbor's main customers, and nearly all major urban centers would have at least two or three alternative suppliers.[41]

Some territorial statutes do provide for competition for franchisers to serve large blocks of customers without regard to certificated service areas.[42]

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[37]The doctrine of regulated competition as opposed to regulated monopoly is the norm in state regulation. "Public Utilities—Certificates of Public Convenience and Necessity—Regulated Monopoly Doctrine", note, 38 U. of Colorado Law Review 626 (1966).

[38]For example in the year 1889-1900, Toledo Edison's load growth is estimated at 153 MW, and for The Cleveland Electric Illuminating Company 450 MW. Amendment No. 12 to Application For A License For Davis-Besse Nuclear Power Plant Unit 1, Docket No. 50-346, Nuclear Regulatory Commission.

[39]Cook, "Coordination and The Small Electric Power System", Public Utilities Fortnightly, November 23, 1967.

[40]Note 12, *supra*.

[41]Wilcox and Shepherd, *op. cit.* p. 415.

[42]For example the newly enacted Ohio statute provides "In the event that a municipal corporation refuses to grant a

mote competition. Meanwhile on a state level, restrictive legislation is drawing more rigidly defined boundaries between service areas of supposed competitors. The ultimate result may be one of multiple local monopolies rather than meaningful competition.[48]

Finally, one might question whether territorial legislation has any substantial effect on the real world where utilities have transmission and distribution lines in place and have established strong competitive positions tending to exclude market entry by outsiders.[49]

It may be concluded that territorial legislation offers only limited benefits in insuring optimum resource allocation. These benefits, if they exist, are overshadowed by the stimulus to better service and resource allocation from competition. In limiting the growth of electric utilities, such legislation tends to preclude exploitation of economies of scale. As will be seen below, this latter tendency can be overcome by proper industry organization at the generation and transmission level.

POWER POOLS

One means by which utilities which are unable to aggregate sufficient load on their own systems to install the most economically sized generation and transmission facilities can exploit the economies of scale is through the formation of power pools. In power pooling, firms aggregate their loads to plan, build and operate large scale generation and transmission facilities.[50] The Federal Power Commission advocated the formation of power pools in the first National Power Survey. The number of power pools has increased from 9 in 1960, accounting for 23% of the nations generating capacity, to 22 in 1970, accounting for 65% of generating capacity.[51] The potential economies from pooled operations are substantial.

The term "power pooling" connotes a variety of contractual arrangements permitting the contracting parties to realize certain economies inherent in the nature of the industry.[52] The availability of these economies is a function of the method by which firms seek to meet the demands of their customers. The ultimate consumer of electrical energy desires to purchase firm power; that is, power which the consumer is assured will be available on demand. Any power generating equipment is subject to both planned outages for routine maintenance and forced outages resulting from breakdown. To provide firm power, therefore, it is necessary to install production capacity over and above that directly required to meet peak demand. How much excess capacity or reserve capacity should be carried is a matter for managerial discretion. One common rule of thumb measure of reserves is that reserves should

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[48]William K. Jones, "The Public Service Enterprise and The Deregulation Debate—The Historical Perspective", 45 Antitrust Law Journal 197, 203.

[49]5 NRC 122, pp. 194-5.

[50]Meeks, *op. cit.* pp. 100-101.

[51]Beil, *op. cit.*

Many other types of coordinated operations transactions regularly occur among interconnected utilities designed to reduce power supply costs and improve reliability.

Power pooling provides an alternative to the 10 to 15 large monopoly firms recommended by Mr. Cook, yet it carries with it opportunities for group boycott and other anticompetitive behavior. Direct regulatory control over power pools is unclear. The Federal Power Commission held that it could not compel a pool to engage in additional pooling activities even if those activities would produce additional economies.[57] On the other hand, the Commission can regulate the rates and terms and conditions of power exchanges as part of a pooling arrangement and insure that they are non-discriminatory.[58] The Commission cannot compel joint ownership agreements.[59]

A serious defect in the initial growth of power pooling has been the exclusion of small systems from pools. Of the twenty-two formal pools in existence in 1970, only four included public power systems (which are typically small). Of the remaining eighteen pools only eight of the participating private systems were small.[60] The systematic exclusion of small systems from power pools has two results (1) those which continue to generate power must utilize smaller less efficient generating plants, and (2) an increasing number of firms cease generation reducing competition in power production. Reduced competition and resource misallocation then are the readily identifiable problems arising from the existing system of power pools.

One approach to the problem is to increase the power of regulatory commissions to control power pools. However, since power pooling negates any argument that natural monopoly exists at the generation and transmission level much of the rationale for increased regulation does not exist. The history of regulation by the Federal Power Commission reveals that that Commission has not been a friend of competition.[61]

What is called for is a rigorous application of antitrust law to open the channels of commerce to all firms desiring to participate in pooling arrangements. Not only will this offset and perhaps rationalize the imposition of territorial restraints on retail competition, but it will permit more vigorous competition at the generation level. Although antitrust actions are expensive and time consuming, it is by no means certain that proceedings before the Federal Energy Regulatory Commission are any faster. Regulatory lag is a disgrace. Simple rate cases often languish for as much as four years without decision.

The necessary antitrust tools are available. The bulk of supply of electricity is technologically capable of effective competition, as least as open and complete, as in many industrial oligopolies now exists.[62] The Supreme Court's

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[57]Mid-Continent Area Power Pool Agreement, FPC Opinion No. 806, issued June 15, 1977.

[58]Gainesville Utilities v. Florida Power Corp., 405 U.S. 515; Mid-Continent Area Power Pool Agreement, FPC Opinion No. 806.

[59]The Commission's authority to deal with power pools has been enhanced by Section 210 of the Public Utilities Regulatory Policies Act of 1978.

[60]Dr. David S. Schwartz, testimony at Hearings on competitive Aspects of the Energy Industry before the Senate Anti-

trol over bottleneck resources. The pool members jointly are accused of group boycott and conspiracy.[67] Power pools have not always been required to open full membership to small utilities. Rather, it is generally provided that small utilities will be given access to similar opportunities to participate in large plants and contract for coordinating services on non-discriminatory terms.[68] Depending upon the nature of the particular pooling arrangement, it may not be in the long run interest of the large utilities to permit small utilities to take advantage of pool opportunities without pool membership.

THE FUTURE OF POWER POOLING

Power pools presently exist in a rather broad spectrum of cohesiveness. Some, like the Central Area Power Coordinating Group, are very tight pools providing for planning of generation and transmission as a single system. Members are required to look first to the power pool for all coordinating services and to participate in jointly constructed generating units. Other pools may provide only for notifying the pool of the member's power plant expansion plan coupled with limited coordination of operations. All pools have as goals reduced costs and increased reliability.[69]

In a tight pool, where systems are planned as a single system and each member participates proportionally in addition to generation and transmission costs, production costs for pool members will tend toward equality. In a situation in which small utilities are able to participate in pools by picking and choosing the pool resources in which they wish to participate, perhaps choosing from more than one pool, the small utility will have an opportunity to obtain a lower production cost than is obtained by members of the pool. Thus, the long run competitive interest of tight pool members would lie in requiring local small utilities who wish to participate in any pool facilities to become full members of the pool. Looser pools would not face the same competitive problems because pool members themselves retain flexibility to pick and choose.

Yet another form of power pooling has been developed by municipal systems and REA distribution cooperatives desiring a power supply alternative to purchases from large investor-owned utilities. REC cooperatives have formed generation and transmission cooperatives to supply bulk power to the member distribution cooperatives. The financing of G & T cooperatives is secured by long term all requirements power supply contracts with the member distribution cooperatives.[70] In similar fashion, municipal electric systems are banding together to form power supply agencies.[71] Frequently, G & T cooperatives or

[67]Consumers Power Company (Midland Plant, Units 1 and 2) ALAB-452, issued December 30, 1977.

[68]Dr. Hughes has suggested that only the largest firms be full members of pools and that smaller systems assume a position as dependent satellites, "Scale Frontiers in Electric Power", *Technological Change in Regulated Industries*, W. Caprun, Editor (Brookings Institution) 1977.

[69]Blank, Lester and Maugans, "Power Pool Rates" presented to the Rate Research Committee Edison Electric Institute, Jan. 24, 1972.

[70]For example, Alabama Electric Cooperative and Hoosier Energy Division of Indiana Statewide Rural Electric

titive alternatives. Moreover, longterm contracts for the sale of the output of a billion dollar generating plant make such projects easier to finance. Longterm contracts undoubtedly play a role in the assignment of utility bond ratings.[73] Some loss of rigidity in the market may be accomplished without detriment. Typically wholesale sales amount to less than 20% of a firm's sales with the remainder of the power sold to the producers own captive retail customers. Frequently, the percentage of wholesale sales is much less.[74] Individual wholesale customers represent a much smaller proportion of sales. Injecting an element of competition for wholesale sales should not unduly alarm investors. Moreover, with increased pooling opportunities, many small utilities may again produce at least a portion of their own power further reducing the percentage of wholesale sales.

Further, a middle ground is available in which long term all requirements contracts are replaced with long term or intermediate term contracts for blocks of power. A small system with a load of 200 MW may choose to purchase blocks of power from several different suppliers or to generate part and purchase part.

The trend of power pooling which negates natural monopoly characteristics and offers opportunities for greatly increased competition will, over time, under the second senario, make rate regulation of pool transaction and wholesale sales of power a detriment to the industry and to society.

CONCLUSION

Under the existing dual system of regulation two diverging trends exist. At the state level, the trend is toward less competition in the retail market through the enactment of territorial legislation. The benefits to society from such legislation is negligible and quite possibly the overall effect is detrimental. On the federal level, the trend is toward increased competition in the wholesale and power pool markets and the elimination of monopoly. As this trend continues, current regulatory policies will become increasingly anachronistic. Rate regulation is inappropriate where competition exists. The emphasis of federal regulation must change from rate levels to rate discrimination. The most important objectives of federal regulators should be to insure reasonable levels of service reliability and to insure that the channels of commerce do not become clogged by anticompetitive practices and agreements.

Several other Soviet bloc countries encourage biological research, but the reward bestowed on successful researchers is an inventor's certificate, not a patent.[5] The Romanian Law No. 62 on Inventions and Innovations (1974) is the broadest-gauged; rewarding, as it does, the development of "[Item 62]: new species of plants, bacteria and mushroom cultures, new species of animals or silkworms, irrespective of the way these inventions have been created."[6]

Bulgaria's provision is of similar scope, as it awards "authorship certificates" for "new species or varieties of farming crops or new animal breeds."[7] But *quaere* where microorganisms are embraced by this provision.

The Soviet Statute on Discoveries, Inventions, and Innovations (1973), on the other hand, says merely that "new strains of microorganisms shall be considered inventions,"[8] and the Czechoslovak Law on Discoveries, Inventions, Rationalization Proposals and Industrial Designs (1972) limits protection to "microorganisms used in industrial manufacture."[9]

In the West, the Israeli Patent Law (1967) accords limited protection to new forms of life — only genetically altered microorganisms are patentable: ". . . no patent shall be granted for . . . (2) new varieties of plants and animals, except microbiological organisms not derived from nature."[10]

More influential, however, is Article 53(b) of the Munich Patent Convention (1973),[11] which provides that "European patents shall not be granted in respect of . . . plant or animal varieties or essentially biological processes for the production of plants and animals; this provision does not apply to microbiological processes or the products thereof."

Von Pechmann argues that genetic mutation is a "microbiological process" within the meaning of MPC Art. 53(b) and that the "result" of this process—a mutated microorganism—would be patentable.[12] Of course, as Wegner points out, the drafters of the MPC may have been referring to chemical processes *mediated* by microbiological action.

Microorganisms are apparently protectible in Germany, England and Australia by virtue of either administrative interpretation or judicial decision.[13]

Latin American countries, on the other hand, are basically ill-disposed to patent protection of new forms of life. Article 5(b) of the Cartagena agree-

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[5]J. M. Lightman, *Inventor's Certificates and Industrial Property Rights.* 11 IDEA 133 (Summer 1967).

[6]2F SINNOTT Rumania-5.

[7]2B SINNOTT Bulgaria-3.

[8]2G SINNOTT Soviet Union-12.

[9]2C SINNOTT Czechoslovakia-7.

[10]2D SINNOTT Israel-4.

[11]F. E. Muller and H. C. Wegner, *The 1976 German Patent Law,* 59 JPOS 89, 96-9 (1977). Austria, Norway, Sweden, Switzerland, Greece, Belgium, Denmark, France, the Federal Republic of Germany, Ireland, Italy, Luxembourg, Netherlands, United Kingdom, Monaco and Liechtenstein are parties to the MPC, Id., 96 n. 27. Moreover, the national patent laws of Finland, Columbia and Nigeria contain patentability provisions similar to MPC Art. 53(b). 2C SINNOTT Finland-3, Colombia-3; 2E SINNOTT Nigeria-3. The precise interpretation of Art. 53(b) is therefore a matter of some concern.

[12]H. C. Wegner, *Patenting Nature's Secrets—Microorganisms,* 7 IIC 235, 245-6 (1976).

[13]For German law, *see* In re Koninklijke Gist-en Spiritusfabriek N.V., 5 IIC 207 (Bundesgerichtschof, March 11, [illegible] "BAKER'S YEAST") and cf. Ex parte Schreiner, 1 IIC 136 (Bundesgerichtshof, March 27, 1969)

that there may be a public interest warranting the "special handling" of applications directed to critical fields of technology.[22] In January, 1977, in response to a suggestion by a member of the Interagency Committee on Recombinant DNA, the PTO decided to permit the accelerated processing of patent applications for inventions relating to recombinant DNA:

> Upon appropriate request, the Office will make special patent applications for inventions relating to recombinant DNA, including those that contribute to safety of research in the field. . . . Requests . . . must include a statement that the NIH guidelines . . . are being followed in any experimentation in this field, except that the statement may include an explanation of any deviations considered essential to avoid disclosure of proprietary information or loss of patent rights. The requests will be handled in the same manner as requests to make applications special that relate to energy or environmental quality.[23]

But several influential members of Congress thought that this decision was premature, and on February 24, 1977, the Secretaries of HEW and Commerce jointly announced the "temporary" suspension of accelerated processing for recombinant DNA research inventions. The announcement noted that the PTO would continue "accelerated processing of patent applications for laboratory equipment that contribute to safety in this field."[24]

The pros and cons of accelerated processing of recombinant DNA research invention patent applications are discussed in the February press release and in the minutes of the Interagency Committee's March 29, 1977, meeting. Suffice it to say that the Interagency Committee recommended the reinstatement of the Order.[25] No action has been taken by the PTO in response to this recommendation.

Appraisal

While it is certainly important that the patent status of genetically engineered microorganisms be clarified, there is some fear that the executive and legislative branches, in their hurry to regulate recombinant DNA research, have lost sight of the need for a *comprehensive* enunciation of bio-

[22]Manual of Patent Examining Procedure, § 708.02.

[23]42 Fed. Reg. 2712-3 (January 13, 1977).

[24]No. C-77-91 (released February 24, 1977), "Commerce Suspends Accelerated Processing

But Judge Rich opened the majority opinion to criticism by making this statement:

> What we have before us is an industrial product used in an industrial process—a useful or technological art if there ever was one. See *In re Waldbaum*, 59 CCPA 940, 457 F.2d 997, 173 USPQ 430 (1972). The nature and commercial uses of biologically pure cultures of microorganisms like the one defined in claim 5 are much more akin to inanimate chemical compositions such as reactants, reagents, and catalysts than they are to horses and honeybees or rasberries and roses.[31]

This statement was seized upon by the dissenters in *Bergy:*

> Such a distinction is purely gratuitous and clearly erroneous. The nature of organisms, whether microorganisms, plants, or other living things, is fundamentally different from that of inanimate chemical compositions. For example, both the microorganisms claimed herein and honeybees are alive, reproduce, and act upon other materials to form technologically useful products (lincomycin and honey, respectively). This cannot be said of chemical compositions. The weakness of the majority's position is further apparent from its failure to advance any rationale for distinguishing between different types of living things. . . .[32]

The majority failed to advance a convincing rationale for distinguishing between microorganisms and multicellular organisms.[33] It is hard to rationalize *Bergy's* benevolent attitude toward bacteria, which are microorganisms, with its apparent indifference toward higher forms of life such as seaweeds and mushrooms.[34] One wonders what reaction the CCPA would have to a new and useful strain of slime mold: slime mold live part of their life as unicellular organisms and part of their life as multicellular organisms.[35] In any event, there is nothing in Section 101 which would warrant a distinction between higher and lower forms of life.

Von Pechmann would distinguish between those organisms which, as the dissenters put it, "act upon other materials to form technologically useful products," and those which do not:

> Although new cultivations of plants, animals and microorganisms all belong to the realm of biology, they cannot be reduced to a common denominator in a legal sense. A new plant variety (e.g., a new rose or a new apple tree) is created as a rule for the sake of the plant itself or one of its parts (i.e., because of the blossoms or the fruit). On the other hand, a new microorganism (e.g., a mold, fungus or bacterium) will not directly satisfy a human or technical need, but instead is only a *technical means* for producing valuable new, as well as known, chemical substances, which are most often eliminated as *metabolic products* of this organism into the culture solution. Therefore, one only makes use of the biological function of the living cells of the organism in order to produce a technical result (e.g., specific hydrogenation of a structurally complex steriod compound). Microorganisms are therefore a means to an end. As with those biological culturing processes wherein, for example, protein is synthesized from mineral oil products by means of specific microorganisms, the organism obtained does not directly provide the solution to the technical problem at hand. . . . Only in the case of yeasts is a direct use of the new microorganism suitable (e.g., as a baking yeast).[36]

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[31]Id., 350

[32]Id., 352.

[33]While there is a fundamental scientific difference between simple prokaryotic organisms such as bacteria and complex eukaryotic organisms such as human beings, it is not clear how drawing a procaryotic/eukaryotic distinction would further the Congressional intent embodied in 35 U.S.C. § 101.

[34]The giant kelp are merely multicellular algae, little more complex than unicellular algae-like plankton. Bacteria and mushrooms are both fungi (in a broad sense) though bacteria are unicellular and mushrooms multicellular.

Walker gave testimony at the 1906 Hearing on H.R. 18851, a "horticultural patent" bill. An interesting colloquy was initiated by Congressman Chaney of Indiana:[49]

> Mr. Chaney: If you propose to do this in horticulture, might you not authorize a man breeding horses to get out a patent on an improved breed of horses?
>
> Mr. Walker: The difference is very marked. In horticulture you produce new varieties, while in animals you do not. If somebody could produce an animal that had the speed of the horse, the patience of the ox, the intelligence of the dog, and the wisdom of the elephant all combined, then perhaps he ought to have a patent on that animal.
>
> Mr. Southall: Then you would give a man a patent on a mule?
>
> Mr. Walker: Yes, although the patent on the mule would have expired by now.
>
> The Chairman: But in the first instance you would give a patent on a mule?
>
> Mr. Walker: Yes; we would on that principle give the man who bred together the horse and the ass a patent on the animal produced; that was undoubtedly a benefit to mankind.
>
> Mr. Chaney: The late Mr. Ingalls would object, because he said that the mule has neither pride or ancestry nor hope of posterity.

H.R. 18851 did not become law. But interest in biological patents did not die with it. In 1928 [John Dienner] conferred with Secretary Arthur A. Hyde, then Secretary of Agriculture, with a view to providing legislation granting broad protection like that of a patent to all originators of plants and *animals* and products thereof, such as fruits, roots, eggs, leaves, seeds, etc. Secretary Hyde was enthusiastic, but the movement was kidnapped and disguised as the 1930 Plant Patent Act.[50]

The Plant Patent Act appeased the Luther Burbanks of this country, but not the Robert Bakewells.[51] In 1966, the Patent, Trademark, and Copyright section of the American Bar Association approved a resolution calling for "the application of all principles of the Patent System to all the agricultural arts (including all plants, sexual seed breeding, micro-organisms, and animal husbandry)."[52]

Patent protection of new animal breeds would "promote the progress of the useful arts," among which animal husbandry certainly must be numbered. Dienner has rightly decried the "pattern of thinking" of those who believe that only traditional manufactures can be patented.[53] This pattern of thinking has throttled agricultural innovation: "While agriculture was making slow progress in the development of new plants and animals and products thereof, the industrial system under patent protection forged ahead with astonishing speed."[54]

When new plants and animals *have* been developed, they have changed the course of history. The Mabinogion, the Welsh book of legendry, tells that

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[49]See Argument, *supra* note 46.

[50]See Dienner, *supra* note 43.

[51]Robert Bakewell was the first of the scientific breeders (though working without a knowledge of Mendelian genetics), and developed several valuable breeds of cattle during his life.

Drafting Considerations

Animal husbandmen may have trouble satisfying the enablement requirement of Section 112, as *Merat* and RED DOVE show that it is very difficult to satisfy this requirement by means of a phenotypic selection system.[60]

Merat first crossed "females of a cooking breed of poultry having good growth and fattening characteristics with cocks of small size which carry" a dwarfism gene. He then inbred the crossbred chickens, and selected from their progeny the dwarf hens. Finally, he crossed these dwarf hens with "any desired breed of normal heavy meat cocks, thereby obtaining, as an industrial product, a chick to be raised as a cooking chicken of normal heavy meat size."[61]

The first problem with Merat was its definition of "normal." If the dwarfism gene ("nr") was recessive, then *Nr Nr* and *Nr nr* chickens would both appear to be normal. "Since the claim language is not precise enough to indicate which kind of cock to use to produce the result required by the claims, it fails to comply with § 112, second paragraph."[62]

The CCPA also felt that the claim suggested that all of the final product chickens would be "normal," when in fact some would be "normal," some would be "subnormal," and some would be "dwarf."[63] The CCPA's reasoning was faulty: it does not require 100% yields in chemical cases, and it would have been obvious to any person of ordinary skill in the commercial poultry art (who would presumably be familiar with Mendelian genetics) that the yield would not be 100%.

Finally, the CCPA pointed to the fact that:

> . . . appellant's invention cannot be practiced unless chickens with the nr gene are available. *Cf. In re Argoudelis*, 434 F.2d 1390, 58 CCPA 769 (1970); *Feldman v. Aunstrup*, 517 F.2d 1351 (CCPA 1975). The specification contains no disclosure of where chickens having the nr gene may be obtained, nor does it indicate that breeding stocks of nr-bearing chickens are presently being maintained.[64]

In RED DOVE, the single patent claim read:

> Method for breeding a dove with red plumage, which is considerably larger with respect to other doves of the same color, has a considerably larger wing-spread, the colors of the plumage of the wings being considerably more beautiful and more intense, and having a craw which is extremely large in relation to the size of the body, in which an *Altdeutscher Kropfer*

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[60]Here it is perhaps necessary to define certain terms commonly employed by animal breeders. A typical animal mating system involves some combination of *inbreeding* and *outbreeding*. Inbreeding is the mating of individuals more closely related than the average members of the population. It increases the appearance of unfavorable as well as favorable traits. (Line breeding is a mild form of inbreeding). Outbreeding is the mating of individuals less closely related than the average members of the population. An outbred animal will possess, to some degree, the superior traits of each of its parents, and, thanks to "hybrid vigor," it may be somewhat superior overall. (*Crossbreeding* is a synonym for outbreeding). *Backcrossing* is the crossing of crossbred offspring with one of the parental breeds.

Once the mating scheme is chosen, the breeding animals must be selected, for the breeder is well advised to match "best with best." Currently, *phenotypic* selection systems are used: the breeding animals are examined for their possession of the particular trait (color, weight, milk production, speed, etc.) the breeder wishes to enhance or transfer. The breeding pairs are then selected on the basis of either their own performance, or the performance of their parents, progeny, or siblings.

1 Ency. Britt. 905-6 (1975). And see generally J. L. Lush, Animal Breeding Plans (1945).

[61]519 F.2d at 1593.

The enablement problem attaches mainly to animals produced by traditional breeding methods. Animals produced by cloning should be patentable without difficulty. However, until cloning becomes *de rigeur,* animal husbandmen will need legislative relief of some kind. Such relief could easily take the form of an extension of 35 U.S.C. § 162 to animal patents.[69]

A second Section 112 problem for animal husbandmen is the requirement that the applicant "particularly point out and distinctly claim" the subject matter which he regards as his invention. If an applicant claims, for example, a "new breed of dove," he may run into some serious trouble. "Breed" is one of those words which defy definition. The various animal pedigree associations, who are the experts in distinguishing breeds, do not always see eye-to-eye when confronted with what is allegedly a new breed of cat, dog, horse or cow. In any biological patent legislation, Congress would be well advised to make use of the term "novel variety," which it defined in the Plant Variety Protection Act as a variety having characteristics as follow:

> (1) Distinctness in the sense that the variety clearly differs by one or more identifiable morphological, physiological or other characteristics . . . from all prior varieties . . . .
>
> (2) Uniformity in the sense that any variations are describable, predictable and commercially acceptable; and
>
> (3) Stability in the sense that the variety, when sexually reproduced or reconstituted, will remain unchanged with regard to its essential and distinctive characteristics with a reasonable degree of reliability commensurate with that of varieties of the same category in which the same breeding method is employed.[70]

While this definition was drafted to serve the purposes of the Plant Variety Protection Act of 1970, it is remarkably similar to Article 31 of the Hungarian Patent Regulations, which, though it refers to "plant varieties," applies *mutatis mutandis* (under Article 36) to "animal breeds."[71]

Even if multicellular organisms were thought patentable under 35 U.S.C. § 101, most applications would fall afoul of 35 U.S.C. § 112. If the devisers of new forms of multicellular life are to be accorded the benefits of the patent system, and thereby encouraged to benefit the public,[72] it would be best to amend 35 U.S.C. § 161 to read:

> Whoever invents or discovers, and reproduces, any novel variety of living organism (including viruses, but excluding man and other primates) may obtain a patent therefor.

and apply 35 U.S.C. §§ 162-64, *mutatis mutandis* to living organisms generally.

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[69] 7 U.S.C. § 2401.

[70] 2C SINNOTT Hungary-39.

[71] "No plant patent shall be declared invalid for non-compliance with section 112 of this title if the description is as complete as is reasonably possible."

[72] The importance of patents as an incentive to the commercial exploitation of scientific discoveries is best shown by two articles remarking on its sluggishness in fields in which patents are less available. See Time, April 20, 1970, at 46 (lithium carbonate as a chemotherapy for mania) and Chemical & Engineering News, October 6, 1975, at 21 (bacteria and

In *TVA v. Hill,*[78] the "snail darter" case, the Supreme Court recognized that this concern for our genetic heritage was felt by Congress when it enacted the Endangered Species Act of 1973:[79]

> As we homogenize the habitats in which these plants and animals evolved, and as we increase the pressure for products that they are in a position to supply (usually unwillingly) we threaten their—and our own—genetic heritage.
>
> *The value of this genetic heritage is, quite literally, incalculable.*
>
> * * * * *
>
> From the most narrow possible point of view, *it is in the best interest of mankind to minimize the losses of genetic variations.* The reason is simple: they are potential resources. They are keys to puzzles which we cannot solve, and may provide answers to questions which we have not yet learned to ask.
>
> To take a homely, but apt, example: one of the critical chemicals in the regulation of ovulations in humans was found in a common plant. Once discovered, and analyzed, humans could duplicate it synthetically, but had it never existed—or had it been driven out of existence before we knew its potentialities—we would never have tried to synthesize it in the first place.
>
> Who knows, or can say, what potential cures for cancer or other scourges, present or future, may lie locked up in the structures of plants which may yet be undiscovered, much less analyzed?. . . Sheer self-interest impels us to be cautious.
>
> *The institutionalization of that caution* lies at the heart of H.R. 37. . . .

Recombinant DNA research has given us the tools we need to unlock the secrets of life, to fulfill the special demands of our civilization by bringing special forms of life into being. The patent system ought to promote the progress of the useful art of genetic engineering by recognizing the patentability of its creations. The mineral reserves of our planet have dwindled drastically; but its genetic reserves have barely been tapped by a few thousand years of more or less haphazard domestication and breeding.

In the absence of strong patent protection, it is quite clear that industry will follow the trade secrets route. A microbiological process cannot be "reverse-engineered." The Chas. Pfizer & Co. citric acid process was exploited for more than 17 years before it was finally revealed that *Aspergillus niger* was the biological agent involved.[80]

If the microbiologist will henceforward stand shoulder-to-shoulder with the plant breeder, the animal husbandman must certainly be allowed to join them. All should be allowed to benefit from the patent system, and, through the patent system, benefit our economy.

Mr. Robert Kleberg crossbred Shorthorn and Brahman cattle to obtain hybrids having the quality beef value of the former and the heat and parasite resistance of the latter. The most ideal specimen, "Monkey," was linebred, and a progressive weeding-out process resulted in the eventual establishment of a stable new breed, the Santa Gertrudis cow, and its official recognition by

CORPORATE CRIMINAL LIABILITY: A PRINCIPLE EXTENDED TO ITS LIMITS

By Samuel R. Miller

Over the past several years, federal law enforcement officials have devoted increasing attention to complex business crimes and corporate wrongdoing.[1] This new focus on corporate crime makes it important to examine the principles which govern corporate criminal liability.

This article will discuss the present state of the law governing corporate criminal responsibility. The expansion of the doctrine of enterprise liability will be traced.[2] As will be seen, common-law notions of corporate immunity from criminal sanction have given way to tort concepts of vicarious liability.[3] The prevailing view today is that a corporation is criminally liable for the conduct of its agents and employees acting within the scope of their employment and for the purpose of benefiting the company.[4]

This article will examine the circumstances in which the acts and intent of lower-level employees are imputed to the corporation. As will be noted, criminal acts need not be committed by an officer or other high management personnel to sustain the conviction of the corporation. Most courts are willing to search far down the corporate ladder to identify an employee whose criminal conduct binds the company.[5]

The article will focus on the issue of whether a corporation should be held criminally liable when its managers and directors have exercised due diligence to prevent violations of the law. As will be discussed, courts have generally rejected the defense that the unlawful activities of lower-level employees have

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[1]*See*, "Justice Agency Asks More Funds to Fight 'White Collar' Crimes," *Wall Street Journal*, Jan. 19, 1977; "I.R.S. Account — Many Big Corporations Face Tax Fraud Cases in Slush Fund Audits," *Wall Street Journal*, Dec. 10, 1976;- "Williams Cos. Fined in Case Involving Foreign Payment," *Wall Street Journal*, March 27, 1978.

[2]The extension of corporate criminal liability has proceeded without extensive analysis. *See*, Elkins, *Corporations and the Criminal Law: An Uneasy Alliance*, 65 Ky. L.J. 73, 124-25 (1976); Comment, *Corporate Criminal Liability for Acts in Violation of Company Policy*, 50 Geo. L.J. 547, 551-52 (1962); Mueller, *Mens Rea and the Corporation*, 19 U. Pitt. L. Rev. 21, 23-28 (1957).

[3]*See* generally, W. LaFave & A. Scott, *Criminal Law* §33 (1972). Vicarious liability is liability imposed upon a faultless defendant for the misconduct of another. *See, LaFave & Scott, supra*, §32. Imposing criminal penalties on a corporation for the acts of its agents and employees results in vicarious punishment on the shareholders, who bear the burden of paying the penal fine. *LaFave & Scott, supra*, §33 at 231. Acceptance of the doctrine of *respondeat superior* as the basis of corporate criminal liability is a departure from the basic premise of criminal jurisprudence that guilt requires personal fault. As one court stated: "The distinction between *respondeat superior* in tort law and its application to the criminal law is obvious. In tort law, the doctrine is employed for the purpose of settling the incidence of loss upon the party who can best bear such loss. But the criminal law is supported by totally different concepts. We impose penal treatment upon those who injure or menace social interests, partly in order to reform, partly to prevent the continuation of the anti-social activity and partly to deter others. If a defendant has personally lived up to the social standards of the criminal law and has not menaced or injured anyone, why impose penal treatment?" *Commonwealth v. Koczwara*, 397 Pa. 575, n.1, 155 A.2d 825, 827 (1959). However, the federal courts have had little difficulty in incorporating tort notions of *respondeat superior* into the corporate criminal context. *See New York Central & Hudson River Railroad v. United States*, 212 U.S. 481 (1909); *Standard Oil Company of Texas v. United States*, 307 F.2d 120, 127-28 (5th Cir. 1962).

[4]*See, United States v. Hanway One, Inc.*, 563 F.2d 1155, 1158 (5th Cir. 1977); *See also*, W. LaFave & A. Scott,

Elkins Act,[12] a statute prohibiting rebates which specifically made corporations liable for the acts of their officers, agents or employees acting within the scope of their duties. The corporation argued that holding it liable would have the effect of punishing innocent shareholders. It further argued that neither the board of directors nor the shareholders had authorized any of the illegal acts. The court rejected these arguments, noting that a corporation can only act through its agents and, thus, should be charged with their knowledge and purposes.[13]

In upholding the corporation's conviction, the court observed that the statute in question prohibited certain business practices which by their very nature would be committed by business entities.[14] The court further stated that granting a corporation immunity from such a regulatory offense "would virtually take away the only means of effectually controlling the subject matter and correcting the abuses aimed at."[15] Moreover, the court recognized that public policy weighed in favor of fining a corporation which benefited from the illegal acts of its agents.

Central Railroad left no doubt that a corporation could incur criminal liability, at least where the statute in question did not require a showing of specific criminal intent.[16] Since then, courts have had no difficulty holding corporations liable for strict liability or "public welfare" offenses.[17]

Some courts and commentators have been troubled by the conceptual difficulty of attributing personal fault to an entity existing only as a legal

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[12]49 U.S.C. §41(1).

[13]In *New York Central & Hudson Railroad v. United States*, 212 U.S. 481 (1909), the court stated: "[T]here is a large class of offenses, of which rebating under the Federal statutes is one, wherein the crime consists of purposely doing the things prohibited. . . . [W]e see no good reason why the corporation may not be held responsible for and charged with the knowledge and purposes of their agents, acting within the authority conferred upon them. . . . If it were not so, many offenses might go unpunished and acts be committed in violation of law where, as in the present case, the statute requires all persons, corporate or private, to refrain from certain practices, forbidden in the interest of public policy." 212 U.S. at 494-495.

[14]212 U.S. at 494-95.

[15]*Id.* at 496.

[16]Courts called upon to impose corporate criminal liability generally consider as a threshold question whether the statute which creates the offense charged contemplates corporate wrongdoing. The criminal statute involved may, by its terms, expressly apply to corporations. Such statutory provisions expressly imposing criminal liability on corporate entities are scattered throughout the United States Code. See, *e.g.*, Federal Election Campaign Act, 2 U.S.C. §441b; Sherman Act Penalty Provisions, 15 U.S.C. §1 (imposing fines up to $1 million on corporations violating the Act); 18 U.S.C. §402 ((corporations expressly liable for criminal contempt). However, even where a statute does not expressly apply to corporations, entity liability may still be authorized. Title I, Section 1, of the United States Code provides that in acts of Congress, the words "persons" and "whoever" include corporations and partnerships "unless the context indicates otherwise." This statute has frequently been used by courts to apply criminal sanctions to corporations and other entities in the absence of an express congressional intention to exempt corporations from the scope of the statute in question. See, *e.g.*, *United States v. A & P Trucking Co.*, 358 U.S. 121 (1958). Furthermore, courts have long held that the words "any person" in a statute may be construed to include corporate entities. See, *e.g.*, *United States v. Union Supply Co.*, 215 U.S. 50, 54-55 (1909); *Western Laundry and Linen Rental Co. v. United States*, 424 F.2d 441 (9th Cir.), *cert. denied*, 400 U.S. 849 (1970); *United States v. Hougland Barge Line, Inc.*, 387 F. Supp. 1110 (W.D. Pa. 1974). (For an extensive listing and classification of federal statutes under which corporations may be held criminally liable, see *Appendix to Staff Memoranda on Responsibility for Crimes Involving Corporations and Other Artificial Entities*, §§402-406, in *Working Papers of the United States National Commission on Reform of Federal Criminal Laws*, 163, 207 (July 1970).

[17]Strict liability offenses are crimes in which no proof of motive, intent, knowledge, or other culpable state of mind is required. *See, W. LaFave & A. Scott, Criminal Law*, §31 (1972). "Public welfare offenses" are those statutory regulations that seek to protect the public health or safety and dispense with the requirement of criminal intent. *See generally*, Sayre, *Public Welfare Offenses*, 33 Colum L. Rev. 55, 70-73 (1933). Corporations have long been subject to criminal liability under such statutes. See, *e.g.*, *United States v. Park*, 421 U.S. 658 (1975) (violation of federal Food and Drug Act); *United States v. Dotterweich*, 320 U.S. 277 (1943) (violation of federal Food and Drug Act); *Sherman v. United States*, 282 U.S. 25

One crucial question is determining the individuals within the corporate structure who may subject the corporation to criminal sanctions by their actions.

A. The Acts and Intent of Officer and High-Managerial Agents Bind the Corporation.

A corporation will certainly be held criminally liable for the illegal acts of its president or other officers.[23] The special position of corporate officers and other high-managerial officials — the so-called "inner circle" — is such that these persons may be considered the "alter ego" of the corporate enterprise so that their acts and intent represent corporate policy and bind the company.[24]

B. The Acts and Intent of Lower-Level Employees Are Generally Imputable to the Corporation.

The prevailing view under federal law is that a corporation may not escape criminal liability by showing that high-level managers, officers or directors of a corporation had no knowledge of what was occurring. Courts have searched deep into the corporate hierarchy to pinpoint an employee whose criminal acts may be imputed to the company.

A leading case on this point is *United Stats v. George F. Fish, Inc.*[25] This case involved violations of price control regulations by a company salesman. The court applied the principle that a corporation may be held criminally liable for the acts of its agents within the scope of their employment regardless of their positions in the corporate hierarchy. The court noted that to deny the possibility of corporate responsibility for the acts of minor employees would immunize the offenders who really benefit and would open wide the door for evasion.[26]

A similar approach was followed in *C.I.T. Corp. v. United States.*[27] In this case, the corporation was convicted of conspiracy to make false credit statement applications to the Federal Housing Administration. The govern-

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[23]*See, e.g., United States v. Empire Packing Co.*, 174 F.2d 16 (7th Cir.), *cert. denied*, 337 U.S. 959 (1949); *United States v. Carter*, 311 F.2d 934 (6th Cir.), *cert. denied sub. nom., Felice v. United States*, 373 U.S. 915 (1963).

[24]Professor Mueller has called the officers, whether elected or appointed, who direct, supervise, and manage the corporation within its business sphere the company's "inner circle." According to Mueller, they are the *mens*, the mind or brain, of the corporation, and thus, as a matter of policy, logic, and convenience, the acts of this group m ay be imputed to the corporate entity and subject the corporation to criminal liability. *See*, Mueller, *Mens Rea and the Corporation*, 19 U. Pitt. L. Rev. 21, 40-41 (1957). The Model Penal Code defines "high managerial agent" as "an officer of a corporation or an unincorporated association, or, in the case of a partnership, a partner, or any other agent of a corporation or association having duties of such responsibility that his conduct may fairly be assumed to represent the policy of the corporation or association." Model Penal Code, §2.07(4)(c). It takes no great conceptual leap to impute to the corporation the criminal acts of directors or other corporate officers or agents sufficiently high in the hierarchy to make it reasonable to assume that their conduct in some substantial sense reflects the policy of the corporate body. Model Penal Code, §2.07, Comment at 151 (Tent. Draft No. 4, 1955).

[25]154 F.2d 798 (2d Cir.), *cert. denied*, 328 U.S. 869 (1946).

[26]As the court pointed out in discussing earlier cases: "No distinctions are made in these cases between officers and agents, or between persons holding positions involving varying degrees of responsibility. And this seems the only practical conclusion, in any case, but particularly here, where the sales proscribed by the Act will almost invariably be performed by subordinate salesmen, rather than corporate chiefs . . . . The purpose of the Act is a deterrent one; and to deny the possi-

manded, . . . or recklessly tolerated by the board of directors or by a high managerial agent acting in behalf of the corporation within the scope of his office or employment."[35]

The comments to the Model Penal Code make clear that the drafters intended to reject the *respondeat superior* approach for crimes other than strict liability regulatory offenses and to confine corporate liability for such crimes to situations in which the criminal conduct is performed or participated in by the board of directors or by corporate officers and agents sufficiently high in the hierarchy to make it reasonable to assume that their acts are in some substantial sense reflective of corporate policy.[36]

The approach outlined in the Model Penal Code has been adopted by at least one state court. In *State v. Adjustment Department Credit Bureau, Inc.*,[37] a corporation's conviction for extortion, a specific intent crime, was reversed on the grounds that a bill collector's extortion could not be charged to the corporation without establishing that the employee held a managerial position or that a corporate officer or high managerial agent had authorized the act.[38]

This more limited standard of corporate criminal liability has met with approval from some commentators.[39] Those espousing this position argue that it offends traditional notions of criminal responsibility to convict the corporate entity when those mangerial agents deemed capable of thinking for the corporation are not involved and thus do not harbor a "guilty mind."[40]

However, as noted, the Model Penal Code approach is not the prevailing view, and a clear line of federal and state decisions hold corporations crim-

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[35]Model Penal Code §2.07(1) (Proposed Official Draft 1962).

[36]Model Penal Code §2.07, Comments at 151 (Tent. Draft No. 4, 1955). The agents having the power to bind the corporation criminally are those responsible for the formation of corporate policy and those having supervisory responsibility over the subject matter of the offense. *Id.* Under this approach, the corporation would be liable for the conduct of the corporate president or general manager but not for the conduct of a foreman in a large plant or of an insignificant branch manager in the absence of participation of persons at higher levels of corporate authority. *Id.*

[37]483 P.2d 687 (Idaho 1971).

[38]In *State v. Adjustment Department Credit Bureau, Inc.*, 483 P.2d 687 (Idaho 1971), the Supreme Court of Idaho adopted the view that: "A corporation may be convicted if (a) legislative purpose plainly appeas to impose absolute liability on the corporation for the offense; or (b) the offense consists of an omission to perform an act which the corporation is required by law to perform; or (c) the commission of the offense was authorized, requested, commanded or performed (i) by the board of directors, or (ii) by an agent having responsibility for formation of corporate policy, or (iii) by a 'high managerial agent' having supervisory responsibility over the subject matter of the offense and acting within the scope of his employment in behalf of the corporation." *Id.* at 691.

[39]Professor Gerhardt Mueller is of this view. He objects to the extension of corporate criminal liability to acts of subordinate employees on the grounds that only directors, officers, and other top management personnel — to so-called "inner circle" — are capable of acting and thinking for the corporation. Mueller, *Mens Rea and the Corporation*, 19 U. Pitt. L. Rev. 21 (1957). This argument has also been espoused by other legal writers. *See,* Winn, *The Criminal Responsibility of Corporations*, 3 Cambridge L. J. 398 (1978) ("Primary representatives") and Welsh, *The Criminal Liability of Corporations*, 62 L.Q. Rev. 345 (1946) ("governing body"). In their text on criminal law, Professors LaFave and Scott state: "Under the better view, called the 'superior agent' rule, corporate criminal liability for other than strict-liability regulatory offenses is limited to situations in which the conduct is performed or participated in by the board of directors or a high managerial agent. *W. LaFave & A. Scott, Criminal Law*, §33 at 229 (1972).

D.C.;[46] *Inland Freight Lines v. United States.*[47] Such cases, however, have not involved crimes requiring specific intent, but rather *malum prohibitum* offenses.

This author suggests that it would be inappropriate to impute a "collective intent" to a corporation based on the acts and intent of various employees where the crime involved is a specific intent offense. Typically, *malum prohibitum* offenses involve public welfare or economic regulation where the very commission of the prohibited act constitutes the sanctioned harm.[48] The primary purpose of punitive penal provisions for such offenses is to require a certain standard of conduct.[49] Where the standard of conduct is not maintained, courts tend to impose sanctions regardless of intent. This may be justified because it is the very commission of the act, intentional or not, which generally results in a direct harm to the public which Congress explicitly intended to prevent.

In the case of an offense involving specific intent, on the other hand, the focus is shifted from the conduct to the actor's state of mind. Conviction of such a specific intent offense requires a showing that the defendant new his actions were unlawful and consciously chose to disobey the law.[50] The imposition of a criminal penalty for a specific intent crime is aimed at deterring such a willful rejection of society's values.[51] For example, in the case of conspiracy, a classic specific intent crime, it has been recognized that the harm to society lien not in the objective act of cooperation between the individuals, but in the *subjective* illegal purpose behind such cooperation, regardless of whether the end sought is achieved.[52]

The requirement of *conscious* wrongdoing in the case of a specific intent crime renders the "collective intent" concept totally inappropriate. There cannot be willful and deliberate wrongdoing if the actor is unaware of the consequence of his acts. Thus, it would vitiate the necessity of showing conscious wrongdoing to aggregate the collective knowledge of various persons within the corporate structure, none of whom fully appreciated that their actions were unlawful.

In the case of *United States v. T.I.M.E.-D.C., supra,* the court recognized this distinction between regulatory offenses and specific intent crimes. In *T.I.M.E.,* the corporation was convicted of violating a provision of the Interstate Commerce Act,[53] which imposes criminal penalties for knowing and willfull violations of any highway administration regulation. Specifically, the corporation was found to have violated a provision which prohibits a carrier from permitting or requiring a driver to operate a motor vehicle while the driver's ability is impaired.

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[46]381 F. Supp. 730, 738-39 (W.D. Va. 1974).

[47]191 F.2d 313 (10th Cir. 1951).

[48]*See, e.g., Bowles v. Farmers National Bank,* 147 F.2d 425 (6th Cir. 1945) (Emergency Price Control Act); *United States v. Brumfield,* 85 F. Supp. 696 (W.D. La. 1949) (Connolley Hot Oil Act); *Porter v. Sand,* 66 F. Supp. 153 (W.D.N.Y. 1946) (Emergency Price Control Act).

[49]See Comment, *Corporate Liability for Acts in Violation of Company Policy,* 50 Geo. L.J. 547, 561-62 (1962).

[50]*See,* Mueller, *Mens Rea and the Corporation,* 19 U. Pitt. L. Rev. 22, 36-38 (1957).

[51]*See* Comment, *Corporate Criminal Liability for Acts in Violation of Company Policy,* 50 Geo. L. J. 547, 561-62

This position draws strong support from *Ingram v. United States.*[56] That case involved a prosecution of various individuals for conspiracy to evade and defeat payment of federal taxes imposed on lottery operations. The court upheld the convictions of two defendants who were proprietors of the operation. However, the conviction of two lower-level employees were overturned because the court found no evidence that these employees had knowledge that federal taxes were due by reason of the gambling operations. Although these employees might well have known that the lottery operation was illegal under state law, the court drew no inference from the fact that they also knew that their employers owed federal taxes.

Other courts and commentators share the view that conviction of a specific intent crime requires a showing that the accused intended to violate the statute in question and not some other law.[57]

E. Purpose to Benefit the Corporation is Required to Uphold Corporate Criminal Liability for Specific Intent Offenses.

As noted, the imposition of corporate criminal liability requires a showing that the company employee was acting in the course of his employment and within the scope of his authority.[58] A further requirement limiting corporate criminal responsibility is that the company employee must have intended to benefit the corporation. This principle was established in *Standard Oil Company of Texas v. United States.*[59] In the *Standard Oil* case, employees of the corporate defendants operated an oil pipeline. These employees falsified records to inflate the amount of oil supposedly passing through the pipeline from the oil wells of a third party who was bribing these employees.

On appeal, the Fifth Circuit posed the issue before it as follows: "May a corporate employer be held liable for a crime committed by employees who, though ostensibly acting in performance of their duties, were really cooperating with a third person in the accomplishment of a criminal purpose for the benefit of that third person, and whose acts not only did not benefit the employer but in some instances, at least, result in a theft of its property?"[60]

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[57]It is hornbook law that the tort theory of transferred intent has no place where specific criminal intent must be established. LaFave and Scott in their treatise provide: "An intention to cause one type of harm cannot serve as a substitute for the statutory or common law requirement of intention as to another type of harm. . . . While a defendant can be convicted when he both has the *mens rea* and commits the *actus reus* for a given offense, he cannot be convicted if the *mens rea* relates to one crime and the *actus rea* to another." *W. LaFave & A. Scott, Criminal Law,* §47, at 356 (1972).

This principle has been applied in the tax area. Thus, where the only evidence of intent shows an intent to violate alcohol beverage control laws, the taxpayer may not be convicted of filing a false income tax return. See J. Williams Schultze, 18 B.T.A. 444 (1929). There, the imposition of a civil tax fraud penalty was set aside where the only evidence of fraudulent intent was related to the violation of a national Prohibition Act by the taxpayer who was a notorious bootlegger.

[58]*United States v. Northside Realty Associates, Inc.*, 474 F.2d 1164, 1168 (5th Cir. 1973); *United States v. American Radiator & Standard Sanitary Corp.*, 433 F.2d 174, 204-205 (3rd Cir. 1970), *cert. denied*, 401 U.S. 498 (1971). The "scope of employment" requirement has absolved corporations from criminal liability for acts of personal violance committed by employees. See *State v. Pacific Powder Co.*, 226 Ore. 502, 360 P.2d 530 (1961). In surveying the case law of corporate criminal responsibility, the drafters of the Model Penal Code found no case in which a corporation was sought to be held criminally liable for crimes such as murder, treason, rape or bigamy. Model Penal Code §2.07, Comment (Tent. Draft No. 4) (1955); but *see People v. Rochester Ry. & Light Co.*, 88 N.E. 22 (N.Y. 1909), in which a corporation was

case involved the criminal conviction of a trucking company on the grounds that its truck drivers were falsifying records to log more hours than permissible under Interstate Commerce Commission regulations. The court suggested that the liability of the company could only be upheld upon a finding that there was knowledge on the part of agents and employees of the corporation other than the truck drivers who were acting for their own benefit. As the court stated: "This necessarily follows from our holding in *Standard Oil of Texas, supra,* for if the falsifications were for the benefit of the truck drivers only, and unknown to any other agent or employee of the corporation, they could not rise to the level of proscribed violations."[70]

Although it is necessary to show that a company agent intended that the corporation receive some benefit from his illegal act, it is not necessary to show that the corporation *actually* benefitted from the employee's acts. As the court in *Standard Oil* stated:

> If [the act in question] is done with the view of furthering the master's business, of doing something for the master, then the expectation or hope of a benefit, whether direct of indirect, makes the act that of the principal. The act is no less the principal's if from such intended conduct either no benefit accrues, a benefit is undiscernible, or, for that matter, the result turns out to be adverse.[71]

Thus, benefit to the corporation is not a touchstone of corporate criminal liability. It is an evidential, not an operative, fact.[72]

The requirement that the corporate agent intend to benefit his employer would preclude corporate criminal liability where the employee was embezzling or misappropriating company funds. In such a case, the company would be the victim of the crime, rather than a perpetrator. However, where the employee utilized corporate funds for an illegal purpose within the scope of his employment and with the intention of furthering the business of the company, the corporation would be a potential codefendant.

CORPORATE LIABILITY FOR ACTS OF EMPLOYEES IN VIOLATION OF COMPANY POLICY

One of the most troublesome issues in the area of corporate criminal liability is the question of whether a corporation should be liable for the criminal acts of its employees in violation of company policy. Some courts and a number of commentators have taken the view that due diligence and care by the corporation in preventing criminal acts of employees and agents should be a defense to a criminal action.[73] However, a clear line of federal authority has

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[70] *Id.* at 723.

[71] 307 F.2d at 128-29.

[72] *Old Monastery Co. v. United States,* 147 F.2d 940 (4th Cir.), *cert. denied,* 326 U.S. 734 (1945); *United States v. Empire Packing Co.,* 174 F.2d 16 (7th Cir.), *cert. denied,* 337 U.S. 959 (1949).

[73] *See, e.g., Holland Furnace Co. v. United States,* 158 F.2d 2 (6th Cir. 1946); *John Gund Brewing Co. v. United States,* 204 F. 17 (8th Cir.), *modified,* 206 F. 386 (1913); *Nobile v. United States,* 284 F. 253 (3rd Cir. 1922); *See* also Note,

in selling liquors since the agent's acts were within the general scope of his agency. The Eighth Circuit ruled that the defendant corporation should have had the opportunity to show that its agent acted not only without the knowledge and consent of the corporation but in direct violation of express instructions given to the agent by his employer.[78]

Other courts, however, have rejected the defense asserted by corporations charged with crimes that the unlawful acts of its agents were committed without the knowledge of corporate officers and in violation of the corporation's good-faith instructions. The Ninth Circuit addressed this issue in *C.I.T. Corp. v. United States.*[79] In this case, the defendant corporation was charged with conspiracy to violate the National Housing Act by submitting knowingly false credit statement applications to the Federal Housing Administration ("FHA") for the purpose of obtaining loan guarantees. The evidence established that a local branch manager of the defendant corporation had conspired with others to prepare or cause to be prepared false applications for the prohibited purpose. The evidence further showed that the branch manager had been under pressure by other officers of the corporation to relax his credit ratings and increase his applications to the FHA.

In such circumstances, the conviction of the corporation was upheld. The Ninth Circuit rejected the corporation's contention that the branch manager was too low in the corporate hierarchy to bind the corporation and held that the acts and intent of the area manager could be imputed to the corporation since the manager had been delegated the full responsibility for passing upon such credit statement applications in his area.[80] The court further ruled that the trial judge properly excluded evidence that higher corporate officials knew nothing of the area manager's unlawful acts or that the manager violated company instructions to use care in the preparation of credit-statement applications.[81]

Elaborate good-faith precautions to enforce adherence to the Emergency Price Control Act were held not to be a defense to corporate criminal liability in *United States v. Armour & Co.*[82] This case involved violations of regulations promulgated under the Emergency Price Control Act prohibiting tie-in sales. The culprits were salesmen at three Pennsylvania branches, one branch manager, and one assistant branch manager. The company conceded that its salesmen had made prohibited tie-in sales. However, it argued that it had made good-faith efforts to instruct its managers and salesmen not to make such sales and asserted that this should be a defense to corporate liability. The company produced evidence that it had disseminated written instructions to its managers not to force the customers to buy one product in order to obtain

[78] *Id.* at 23. Other courts have also recognized that the principal may not be held criminally liable for the acts of its agents, contrary to his orders. Thus, in *Nobile v. United States,* 284 F. 253 (3rd Cir. 1922), the court stated: "Criminal liability of a principal or master for the act of his agent or servant does not extend so far as his civil liability. He cannot be held criminallyliable for the acts of his agent, contrary to his orders, and without authority, express or implied, merely because it is in the course of his business and within the scope of the agent's employment, though he might be liable civilly." 284 F. at 255. *See* also *Paschen v. United States,* 70 F.2d 491, 503 (7th Cir. 1934); *United States v. Food & Grocery Bureau of Southern California,* 43 F. Supp. 966 (S.D. Cal. 1942).

[79] 150 F.2d 85 (9th Cir. 1945).

purchasing agent who had engaged in this unlawful conduct.

The Ninth Circuit upheld the corporation's conviction, concluding: "[A]s a general rule, a corporation is liable under the Sherman Act for the acts of its employees in the scope of their employment, even though contrary to general corporate policy and express instructions to the agent."[89]

It must be emphasized, however, that the holding in *Hilton Hotels* was premised on the court's interpretation of the Sherman Act as sanctioning the imposition of corporate criminal liability for acts in violation of company policy. At the outset, the court noted that Congress may constitutionally impose criminal liability upon business entities for acts or omissions of its agents within the scope of their employment. The court then noted that the Sherman Act was concerned with the activities of business enterprises and is aimed at certain consequences considered undesirable by Congress.[90] The court was careful to point out that in its view, specific intent was not an element of the Sherman Act offense at issue and that criminal liability for the acts of agents is more readily imposed under a statute directed at the prohibited act itself — one that does not make specific intent an element of the offense.[91]

The *Hilton Hotels* holding that a corporation is criminally liable for acts in violation of company policy has been reaffirmed in the antitrust area.[92] It has also been applied to uphold corporate liability for violations of a regulatory offense in *United States v. Gibson Products Co., Inc.*[93] In this case, a department store corporation was found liable for violating federal firearms laws for knowingly making false entries on forms in connection with the sale of firearms to foreign citizens. The evidence indicated that the defendant corporation's sporting goods manager falsified gun registration forms in return for a bribe or kickback from the purchaser. The court found that the manager's sales were within the scope of his duties and with the intention to benefit the company. The court rejected the corporation's defense that the company president gave specific instructions to the manager and to all gun sales personnel prohibiting them from making false entries on federal forms. Relying on *Hilton Hotels,* the court stated: "This argument is of no legal persuasion. . . ."[94]

In the regulatory context, other courts have also rejected the position that a corporation should be absolved from criminal responsibility where it has made good faith efforts to insure compliance with the law. In *St. Johnsbury Trucking Co. v. United States.*[95] Chief Judge Magruder, in a concurring opinion, noted that with regard to certain Interstate Commerce Commission regulations requiring the labeling of motor vehicles and trailers transporting dangerous substances, the corporate defendant could not absolve itself from

[89] *Id.* at 1007.

[90] *Id.* at 1004-5.

[91] It should be noted that the United States Supreme Court has recently ruled that intent is an essential element of a Sherman Act violation. *United States v. United States Gypsum Co.*, 46 U.S. L.W. 4937 (U.S., June 29, 1978).

[92] *See, United States v. Cadillac Overall Supply Co.*, 568 F.2d 1078, 1090 (5th Cir. 1978).

to a criminal charge has been recognized. As the author of the Georgetown article on this issue states: "Where the corporation has acted in good faith and taken all reasonable steps to prevent the commission of the crime, an acquittal on these grounds should give it greater incentive to continue its efforts of self-inspection and law enforcement."[101]

The drafters of the Model Penal Code have also provided that in cases where a corporation is charged with the violation of an offense defined by statute in which a legislative purpose to impose liability on the corporation plainly appears, it shall be a defense if the defendant corporation proves by a preponderance of the evidence that the high managerial agent having supervisory responsibility over the subject matter of the offense employed due diligence to prevent its commission.[102]

The drafters of the Model Penal Code reasoned that a showing of due diligence by corporate managers should exculpate the company since this will foster the primary aim of encouraging diligent supervision.[103]

Moreover, holding a corporation liable for the unlawful acts of a subordinate employee in violation of company policy in effect imposes vicarious liability twice removed upon the corporate entity and stretches the concept of *mens rea* beyond an acceptable limit.[104] It is conceptually difficult to maintain that the unauthorized, independent act of a subordinate employee in violation of company policy reflects the "guilty mind" of the company. There is no intellectual justification for such a position and it is useless as a deterrent of future criminal conduct.[105]

Accordingly, this author suggests that the principles enunciated in the *Holland Furnace* case, discussed above, merit serious consideration. Imposing a standard of almost absolute liability on corporations is counterproductive. Recent efforts by major companies to promote in-house compliance efforts through audit committees and other devices should be promoted.[106] Permit-

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[101]Note, *Corporate Criminal Liability for Acts in Violation of Company Policy*, 50 Geo. L. J. at 564.

[102]Model Penal Code §2.07(5) (Proposed Official Deaft 1962). However, §2.07(5) goes on to say that the "due diligence" defense may not be asserted "if it is plainly inconsistent with the legislative purpose in defining the particular offense." This limitation on the "due diligence" defense has been severely criticized. See Mueller, *Mens Rea and the Corporation*, 19 U. Pitt. L. Rev. 21 (1957).

[103]Model Penal Code §2.07, Comments at 154 (Tent. Draft. No. 4, 1955).

[104]As Professor Mueller points out, holding a corporation liable for the acts of its employees is a form of vicarious liability which enures to the detriment of the company's shareholders. In the case where an inferior employee commits a crime within the scope of his employment, albeit with the intention of furthering the interests of the company, the imposition of a criminal sanction against the corporation results in a penal fine against the will of the "brain" of the corporation — its management — and without the knowledge of its shareholders. Mueller, *Mens Rea and the Corporation*, 19 U. Pitt. L. Rev. at 42.

[105]*See*, Mueller, *Mens Rea and the Corporation*, 19 U. Pitt. L. Rev. at 44.

[106]The importance of promoting such self-policing functions has been recognized by the Securities and Exchange Commission ("SEC"). The Commission has extensively analyzed the question of corporate "questionable" payments. See, *Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices*, submitted to the Senate Committee on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. (1976). As an outgrowth of the Commission's investigation, numerous consent decrees were negotiated with major American corporations in which one element of the decree was the establishment of an adult committee composed of outside directors with the function of investigating company activities and insuring compliance with the law. Recently, one Congressional subcommittee stated that "it strongly believes that the accounting profession or the SEC should immediately require publicly owned corporations to establish audit committees composed of outside directors . . . ," Subcommittee on Reports, Accounting and Management of the Senate Committee on Governmental Affairs, *Improving Accountability of Publicly Owned Corpora-*

GAMBLING AND INTERSTATE COMMERCE

By Thomas Farrell

The past decade has witnessed an unprecedented proliferation of legalized gambling throughout the United States. In anticipation of this development, Congress in 1970 created the Commission on the Review of the National Policy Toward Gambling, a body of legislators and presidential appointees with the mandate to study all forms of wagering activity, and to report its findings and conclusions to the President and the Congress for appropriate action.

Two years have now passed since the Commission issued its final report. The Commission's findings have been repeatedly cited in the national media, and its recommendations have been carefully analyzed by state government agencies—notably the New Jersey Casino Control Commission—charged with the implementation of legalized gambling operations. Yet the Commission's central recommendation—that Congress protect the states' continued jurisdiction to regulate gambling—has not been effected. The inertia of the federal government is not surprising; indeed, it has historically been a fundamental impediment to the orderly evolution of sound gambling policies. As will be shown below, it also foretells continued frustration by state governments as they try to compete with illegal gambling operations while shackled with federal restrictions on their ability to attract the wagering market away from organized criminal groups.

After conducting an exhaustive review of all aspects of gambling at all levels of government, the Commission reached the conclusion that the federal government, "which represents the nation as a whole," should not "substitute its judgment for that of the individual states in this area. Gambling has customarily been controlled by state agencies, which can be flexible and responsive to local demands; the Commission finds no public interest in preempting this authority by the imposition of binding national standards."[1] Once it had made its decision to recommend a limited federal role, the Commission faced a dilemma: how to square its policy with the historical development of a burgeoning federal presence based upon the Commerce Clause of the Constitution. This clause has been the basis for a seemingly inexorable expansion of federal jurisdiction over all types of matters at the expense of the legislative jurisdiction of the states.[2] The method chosen by the Commission to alleviate this potential conflict was not new, as it has been utilized in the past to remove other types of activities from the reach of the fedeal bureaucracy. This method is the so-called consent law.

Consent laws represent perhaps the purest creation of the American constitutional system. Their purpose is to secure state jurisdiction over specified areas which would otherwise be subject to exclusive federal control by virtue of

lation. Congress reacted immediately with a statute consenting to the regulation of the insurance business by the states,[12] and the Supreme Court upheld the legislation, observing that the purpose of Congress was to declare that state regulation of insurance "is in the public interest and that the business and all who engage in it shall be subject to the laws of the several states."[13]

A consent law can thus be seen as a legislative means of preventing judicial invalidation of state regulations of specified aspects of interstate commerce. Over the years, the variety of activities determined by Congress to constitute interstate commerce has greatly increased, and the courts have generally upheld Congress in its expansion of federal regulatory power.[14] In fact, the Commerce Clause has served as a potent remedy for a wide range of problems which could only be regulated successfully on a national basis. The Gambling Commission recognized the need for a federal law enforcement presence to "prevent interference by one state with the gambling policies of another," and to protect "identifiable national interests."[15] Congress should act to suppress gambling which is related to interstate criminal syndicates, for example; it would also assist the states in combatting gambling-related corruption of local officials, and should see to it that the facilities of interstate commerce are not used to frustrate state gambling policies.

Prior to 1970, federal antigambling statutes were limited to freeing the channels of interstate commerce from selected types of gambling activity. In the celebrated 1903 case of *Champion v. Ames,* the Supreme Court upheld the ability of Congress to use the Commerce Clause to prevent the interstate carriage of lottery tickets,[16] and legislation enacted a half-century later prohibited the interstate shipment of gambling devices and wagering paraphernalia when they were illegal under state law.[17]

In 1970, however, Congress went one step farther, by declaring that certain *intrastate* gambling operations by their very nature had a deleterious impact upon interstate commerce, and by making participation in such a gambling business a federal offense regardless of the presence of any interstate element.[18] The courts have upheld such legislation under the theory that "where Congress has the power to regulate a clearly defined class of activities, it is not necessary to show an interstate connection in any particular case."[19] Thus, even purely local gambling activity may be characterized as interstate commerce, and may be made the subject of federal controls.

The Gambling Commission advised against a federal preemption of state gambling powers, and recommended that the states be encouraged to pursue their own gambling policies. At a time when there is much imprecise discussion of the concept of "states' rights," it is critical to recognize that, so far as

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[12]59 Stat. 34 (1945).
[13]*Prudential Insurance Company v. Benjamin,* 328 U.S. 408 (1946).
[14]See *Perez v. United States,* 402 U.S. 146 (1971); *United States v. Ceraso,* 467 F.2d 653 (3rd Cir. 1972).
[15]Final Report, *supra,* at 5; 6.
[16]*Champion v. Ames,* 188 U.S. 321 (1903).
[17]15 U.S.C. 1171-1177; 18 U.S.C. 1952-1953.

The Commission also believed that, except for cases involving large gambling operations affecting interstate commerce or using interstate facilities, the criminal prohibition and enforcement of gambling should be left to the states and localities. This conclusion may reflect a developing trend in other areas of law enforcement as well.

In recent years, the growth of federal criminal jurisdiction based upon the Commerce Clause has caused some to question whether an enlarged federal presence will be truly good for law enforcement. Commentators have expressed a wariness of the trend to "a wholesale expansion of federal police power and a wholesale destruction of state responsibility and autonomy in the preservation of public order and the administration of criminal laws."[27] It is true that Congressional enactments in such areas as firearms control, dangerous drugs, and extortionate transactions have not eliminated state jurisdiction over these matters. Nevertheless, Justice White has warned that "while there has been no legal preemption by the federal government, the fear is often expressed that merely by enacting criminal legislation, Congress will encourage state officials to relax their law enforcement efforts, and in effect, turn crime control over to the Federal government."[28] Moreover, the potential will always exist that a federal court might rule a state criminal gambling statute invalid on the grounds that it unduly interfered with an aspect of interstate commerce already regulated by Congress. The Gambling Commission sought to remedy this situation by recommending the enactment of a consent statute.

The Commission was concerned that the evolution of gambling policies at the state level might be drastically undercut by an adverse federal court decision concerning the validity of state jurisdiction over gambling. Although the possibility of such an occurrence was not immediately foreseen, the Commission felt that, as part of its mandate to recommend gambling policies for the future, it had the responsibility to base its recommendations upon a sound jurisdictional foundation. The Commission wished to prevent a duplication of the chaos which had threatened the insurance industry in 1945.

To illustrate the problem, it may be helpful to examine the Commission's recommendations for federal statutes governing the interstate movement of lottery materials. At present, federal law prohibits the mailing or carriage of lottery tickets and advertisements across state lines.[29] The Commission, in keeping with its policy of allowing the states to determine their own gambling policies, recommended that this approach be changed to permit lottery materials to be mailed or shipped between states in which their sale was legal. "Lottery tickets and advertisements," the Commission concluded, "should not be barred from the facilities of interstate commerce when they are legal both in the state of origin and in the state of destination."[30]

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[27]Liebmann, "Charting a National Police Force," 56 A.B.A.J. 1070 (1970).

Consent legislation could also serve to encourage the adoption of comprehensive state regulatory schemes. By inserting language similar to the *proviso* in the McCarran Act,[33] Congress could make general federal statutes applicable to gambling that was not the subject of specific state measures. Such a law would provide the states with an additional incentive to enact thorough regulatory programs, thereby further enhancing the quality of state gambling controls.

Congress, of course, would always retain the authority to enact any gambling-related legislation which it determined the national interest to require. But where Congress had not acted, the authority of the states to regulate gambling activity within their respective borders would be unquestioned. And change at the federal level would be marked not by the issuance of a policy statement by a federal agency, but by an Act of Congress signed into law by the President, with all of the procedural safeguards and opportunities for public comment which that entails.

The Gambling Commission's consent statute recommendation can thus be seen as an integral part of the Commission's overall finding that gambling is best regulated at the state level, and that the states should be assisted and encouraged in their efforts to control it. What is truly significant about the Commission's approach is that, for perhaps the first time, such a panel anticipated the problems that could arise because of future judicial trends, and attempted to head them off by way of remedial legislation. Whether Congress will prove the Commission right by continuing to ignore its recommendations, and whether the Commission's approach will be adopted in other areas of social policy where the federal government has demonstrated its incompetence, remains to be seen. So long as the Commission's *caveats* go unheeded, the potential will remain for conflict and uncertainty as legalized gambling continues to proliferate in the coming decades.

hope that neither government officials nor private plaintiffs will ever discover the corporate crime.

The actions of the corporation that did come forward have received attention in the trade press. Of course, I cannot and will not comment on the specific facts of this case. But because I believe corporations must confront these issues, I believe it is appropriate to discuss generally our view toward corporations that voluntarily report their violation of the antitrust laws to the Antitrust Division. The bottom-line question raised by this still-novel situation is this: Will the Antitrust Division consider leniency toward a confessing corporation or its officers, and in what circumstances?

Public prosecutors traditionally have exercised discretion in granting and recommending leniency toward potential and actual defendants who cooperate with the government. The rationale for such leniency is straightforward—cooperation is important and should be encouraged. It is important because cooperation, if timely and useful, can save the government time and money and improve the chances of convicting the guilty and eradicating the illegal conduct. To the extent that it improves the government's enforcement ability it may also increase the deterrent effect of enforcement actions. Rewarding cooperation serves as an incentive to others to cooperate and affirms the government's duty to treat all parties fairly and justly.

In the context of antitrust enforcement, I'm convinced that fair treatment to a cooperating party also has procompetitive effects. Not only is the instant price-fixing stopped—an achievement that may result in savings of hundreds of millions of dollars to consumers, but in addition, the uncertainty created by the prospect that a co-conspirator may defect is likely to cause others to forebear or discontinue participation in price-fixing schemes. We have observed that conspirators' policing of price-fixing is as much a part of the crime as the initial agreement and anything that makes their policing more difficult is likely to break down the conspiracy at an early date.

Therefore, to answer the question I posed earlier, the Antitrust Division will give serious consideration to lenient treatment of corporations or officers voluntarily reporting their wrong-doing prior to our detection of it. I hasten to add, however, that we will not limit our prosecutorial discretion nor will leniency be automatic. There are several important factors that must be weighed in the decision-making process.

First and foremost, only the first corporation to come forward will be considered for leniency in the initiation of prosecution. If other corporations involved in the same conspiracy subsequently come in to confess wrong-doing, or if all the involved corporations come forward as a group, they cannot be given the same consideration. Their cooperation could be given some weight, of course, at the stage of recommendations for sentencing.

In addition, in order for the corporation to be considered for such treatment the voluntary confession of wrong-doing must be a truly corporate act, as opposed to the confessions of individual executives or officials. Of course, if individual executives cooperate with the government in the same manner as

must now be taken very seriously by corporate management. The Antitrust Division is willing to take a step that will, we hope, decisively tilt the balance of decision toward making a clean breast of price-fixing violations. I urge all corporations and their counsel to weigh carefully the Division's commitment on the one hand to consider giving them lenient treatment in an indictment if they voluntarily report their illegal conduct before detection, and our commitment on the other hand to pursue in an unrelenting way violations we detect to the point of conviction and appropriately severe sentence.

On behalf of the Division, I feel strongly that criminal prosecution of hard-core violations of the antitrust law is absolutelynecessary. The willingness to consider special treatment in a narrow category of cases is no departure from that policy of vigorous criminal antitrust enforcement.

We will continue to emphasize the investigation and prosecution of price-fixing cases. We will continue our efforts to persuade judges to levy appropriately severe sentences when convictions are obtained. Price-fixing is a willful violation of the criminal law—a major white collar crime. It takes money directly and dramatically from the pocketbooks of consumers and should not go undetected and unpunished.

Our prosecution results for fiscal 1978 showed a sharp movement upward in severity of sentences. In fiscal 1977, total individual fines were $755,200; in fiscal 1978, $1,093,750. Total corporate fines in 1977 were $2,642,000; in 1978, almost $11,000,000 — for a total of corporate and individual fines of $12,024,750. In fiscal 1977, total days of jail sentences was 1,561 for 24 individuals; in 1978, 2,921 days for 29 individuals, or almost twice as much. In short, the courts are listening closely to the policy message sent by Congress in changing criminal antitrust violation from a misdemeanor to a felony in December of 1974. And we will continue strongly to urge increasingly severe sentences in appropriate cases.

The recent Supreme Court decision in the *Gypsum* case has raised some questions about our criminal enforcement policy that I would like to clarify. As I'm sure you are aware, the Court held that intent is an element of a criminal antitrust offense and must be established by the evidence and inferences drawn from the evidence. Intent exists when the defendant has carefully planned and calculated his conduct and understands the consequences of that conduct. The Court stated the business behavior involved in antitrust charges is such planned and calculated conduct because it usually would be undertaken only after weighing the costs, benefits and risks.

I do not think *Gypsum* represents any significant change in the law—at least not as to *per se* offenses—nor does it create any new requirements for the Division's criminal enforcement efforts. *Per se* offenses are those for which no justification or defense can be offered. In that context, I believe that conduct that clearly constitutes a *per se* offense carries with it its own intent. In practice, my policy and that of my predecessors has been to initiate criminal prosecution, as opposed to a civil suit, only if the evidence indicated a willful violation of the law. In the words of *Gypsum*, we prosecute criminally only when we

notification to be expensive and burdensome. Those who come to us in the spirit of cooperation and affirmatively respond to the program's document and data requests will find that premerger notification remains procedural.

And so, the theme of this talk is that a great deal depends on you. I have said that success of the premerger notification procedure depends on your willingness to be cooperative. I have also said that you are the first line of prevention on which your client will depend to see that it does not violate the antitrust laws. And perhaps—most excruciatingly for you—you are the one who must frequently make the first recommendation to your client to come forward to voluntarily disclose prior wrong-doing.

I do not minimize any of these obligations and duties. Rather, I emphasize them out of a feeling for their difficulty and gravity that comes from my own personal experience as a private practitioner. I know that a great deal of the policing of the antitrust laws is done by the private bar. I believe that much more can be done in this area. And I now believe that with premerger notification and with the Division's willingness to consider leniency for voluntary disclosure, a set of mechanisms exist whereby your client can wipe out past violations, get into full compliance with the law—and stay there.

revision of the Rules was to draw upon the Federal Rules of Civil Procedure to the extent that they were thought to be suitably adaptable to the special nature of litigation in the Tax Court, while at the same time retaining the essential features of the Court's existing Rules which had proved to be sound and which appeared to be more appropriate for the Court.

What is the purpose of discovery? The basic purpose is to reduce surprise by providing a means for the *parties* to obtain knowledge of all RELEVANT FACTS. What is relevant is the factual information which may either reveal evidence that will be admissible at trial or lead to the discovery of such evidence.

How may discovery be obtained? It may be obtained under Rule 71, which provides the procedures to obtain answers to written interrogatories; under Rule 72, which provides the mechanics for obtaining documents and things; under Rule 73 (providing for examination by transferees), which rule apparently has never been used; and under Rule 70(c), which provides the means to obtain a party's statement. At the present time discovery is *not* available under the Rules through depositions. Depositions may be taken *only* for the limited purpose and under the conditions provided in Title VIII and they are not permitted for discovery purposes. In that respect, the Tax Court's Rules do not follow the Federal Rules. Basically, the reason for that is that the Court felt that the new discovery procedures adopted were sufficient to enable a party to obtain the information needed to prepare for trial. Further, whatever additional benefits might be obtained by the use of discovery depositions would appear to be outweighed by the problems and burdens they entail for the parties as well as the Court. In *Gauthier v. Commissioner,* 62 T.C. 245 (1974), petitioner made application to take the deposition of an Internal Revenue Agent and requested the production at the deposition of his workpapers upon which respondent based his deficiency determination. The Court, in denying the application as an abuse of the Court's procedures, held that a deposition for the purpose of discovery is neither permitted nor authorized under the Rules. A deposition's use is limited to the preservtion and perpetuation of evidence under Rule 81. It was further held that the failure to provide for pre-trial discovery depositions is not a denial of "due process". Section 7453 of the Internal Revenue Code of 1954, as amended, provides that the Court may prescribe its own rules of practice and procedure. In *Estate of Woodard v. Commissioner,* 64 T.C. 457 (1975), it was pointed out that discovery is not as broad in the Tax Court as it is in the Federal District Courts. There, petitioners' Motion for Protective Order that it not be directed to produce documents that were not relevant was granted with the Court stating, "The Statutory Notice of Deficiency and the pleadings frame the issue presented to the Court and the respondent should not be permitted to use discovery to raise new issues or formulate additional adjustments to petitioner's tax returns." Thereafter, upon consideration of a motion filed by respondent in which the Court was "enlightened" for the first time as to respondent's position, the Court filed a Supplemental Opinion, 64 T.C. 999

letter advising that they were interested in accomplishing a mutually-satisfactory resolution of the issues involved and to that end would like to schedule a conference. However, they noted that for the conference to be effective they needed to be furnished certain information necessary to clarify the adjustments in the Statutory Notices. They then set forth in that letter 42 paragraphs of questions. The questions included procedural matters such as the dates on which petitioners filed income tax returns, whether the statute of limitations had been extended, and if so, under what statutory provisions. Beyond mere procedural matters, petitioners posed questions of greater complexity including requests for all legal theories and positions relied upon in support of respondent's determination; all facts and describe all documentary evidence relied upon in support of the legal theories and positions; all sections of the Code, Treasury Regulations, all Revenue Rulings, Court cases and other legal authorities relied upon in support of the legal theories and positions. Finally, petitioners advised respondent that their letter constituted their informal request for information under Rule 70(a)(1) and that if it were preferred to supply the information personally that their conference room would be made available for whatever date convenient.

Respondent, in answering that letter, noted the dates the returns were filed; that no exception to the statute of limitations was being relied upon; and that he was not relying upon any unpublished rulings or other authorities not available to petitioners. He then scheduled a conference for resolving the issues.

Petitioners thereupon responded by letter objecting to the perfunctory treatment given to their questions and declined the conference invitation unless the requested information was made available to them one week in advance of the conference.

The matter eventually was presented to the Court upon the filing of petitioners' motions (Interrogatories motions and admissions motions).

The Court noted that, despite respondent's offer to meet informally with petitioners, they refused. In short, the Court felt petitioners had not made good faith efforts to comply with Rule 70(a)(1). That rule, the Court opines, does not speak of making informal "requests" prior to making formal "requests" under Rule 71. If that were all Rule 70(a)(1) was intended to accomplish, it would serve little purpose. Rather, Rule 70(a)(1) contemplates "consultation or communication", words that connote discussion, deliberation, and an interchange of ideas, thoughts, and opinions between the parties.

When can discovery be commenced? Rule 70(a)(2) says it shall not be commenced, without leave of Court, before the expiration of 30 days after joinder of issue, and shall be completed, unless otherwise authorized by the Court, no later than 75 days prior to the date set for call of the case from a trial calendar. To my knowledge, no pre-joinder discovery has been allowed. In *Kabbaby v. Commissioner*, 64 T.C. 393 (1975), a taxpayer's request for

earlier statement. Some states have followed this same practice, that is, permitting a party to obtain his statement, even without a showing of disadvantage, for example, Mass. Gen. Laws, Ann. Ch. 271, section 44. The attitude of "fair play" seems to prevail in the Courts.

For those, who in the future may need to seek a ruling from the Court with regard to a statement sought, the following four cases may be helpful to you in determining whether to file an appropriate motion for relief:

1. *Phelps v. Commissioner,* 62 T.C. 513 (1974).

   Petitioners sought a Court order directing respondent to produce to them "all statements including all transcripts of interviews by either or both" of them during the course of an investigation of their income tax returns. Respondent acknowledged that his agents interviewed one or both of the petitioners on 10 separate occasions. He submitted to the Court for "in camera" inspection a copy of the *memorandum* of each such interview, but objected to the delivery of all but one to petitioners on the grounds that they were not "statements" within the purview of Rule 70(c) and otherwise not discoverable under Rule 72 since they "constituted material prepared in anticipation of litigation and they contain the agent's mental impressions and conclusions". The Court, in its excellently-reasoned opinion, which I would urge that you read, held the memoranda of interviews to be statements of the parties to that proceeding and must be produced.

2. *Dvorak v. Commissioner,* 64 T.C. 846 (1975). Where the Court directed respondent to produce three affidavits *of third parties* holding that those affidavits were not prepared in anticipation of litigation and, thus, not protected by the "Work Product" doctrine.

3. *Industrial Electric Sales & Service, Inc., v. Commissioner,* 65 T.C. 844 (1976). Petitioners wished to have the Court direct production from respondent of third-party statements and memorandums of interviews with 16 people questioned by the Commissioner's agents. The only reason raised by respondent to bar disclosure is that the third-party statements *may* be used for impeachment purposes. The Court directed that the documents must be produced but that their production could be delayed until after petitioners responded to respondent's request for admissions which had theretofore been served upon them.

4. *Barger v. Commissioner,* 65 T.C. 925 (1976), where the Court, while directing that copies of statements of petitioner and another, third party statements and records be produced to petitioner, also directed, in the context of that case, that copies of statements of an individual concerning transactions with petitioner and copies of a statement of petitioner

other person from annoyance, embarrassment, oppression, or undue burden and expense. Finally, Rule 104, which concerns enforcement action and sanctions, may also be resorted to if appropriate in connection with discovery matters.

It is of the utmost importance to remember that answers to interrogatories are to be made in good faith and as completely as the answering party's information shall permit. In that regard, the answering party is required to make reasonable inquiry and ascertain readily obtainable information. An answering party may not give lack of information or knowledge as an answer or as a reason for failure to answer, unless he states that he has made reasonable inquiry and that information known or readily obtainable by him is insufficient to enable him to answer the substance of the inquiry.

Rule 72 clearly sets forth how a party may, without leave of court, obtain documents and things and needs no further recounting today. However, the Rule is not intended to be a license for a fishing expedition. It must always be kept in mind that the underlying purpose of all discovery techniques is a search for the truth. Another purpose, of course, is to narrow a controversy to the real points in dispute, thus, eliminating frivolous and immaterial matters.

What has the Court held to be discoverable and not discoverable under Rules 71 and 72? The *Barger* case earlier mentioned concerning Rule 70(c) also ruled upon the discoverability of Special Agent's Reports, Revenue Agent's Reports, and no further comment will be made with respect to that case.

In *Marsh v. Commissioner,* 62 T.C. 256 (1974), where almost all of the documents sought were not in respondent's possession, custody, or control and one apparently didn't even exist, request for their production was denied. Since most of the documents requested were in the possession of other federal agencies, the Court, after painstakingly detailing how they could be obtained, noted that petitioner is in the best position to specify those she seeks from agencies whose rules provide for the production of such documents.

Petitioners were directed to answer respondent's interrogatories where refusal to do so was predicated upon petitioner-husband's state of ill health and the fact that respondent had the burden of proof. *Piscatelli v. Commissioner,* 64 T.C. 424 (1975). In so ruling, the Court commented that the burden of proof argument bordered on the frivolous in view of the explicit language contained in Rule 70(b).

Respondent was directed to produce third-party statements where documents requested were not privileged and were relevant to subject matter of the case. *Morris v. Commissioner,* 65 T.C. 324 (1975). In that connection, the Court stated that Rule 72 does not require any showing of good cause as a prerequisite to production of documents. Your attention is likewise directed to *P. T. & L. Construction Co. v. Commissioner,* 63 T.C. 404 (1974), where a third-party statement was also held to be discoverable. That case, which should also be read, contains a good discussion of the "work product" doctrine, which is given negative recognition in the Court's Rules, and

randum opinions dealing with discovery, there are three other cases which I believe will be of considerable interest to you. One involves a fifth amendment plea and the other sanctions imposed by the Court. In *Brod v. Commissioner,* 65 T.C. 948 (1976), which was reviewed by the Court, a Fifth Amendment plea was held not valid in a civil fraud case where there remained no possibility of criminal prosecution and petitioner was required to answer respondent's interrogatories. In *Ryan v. Commissioner,* 67 T.C. 212 (1976), petitioners' disobedience in refusing to comply with the Court's orders directing them to answer respondent's interrogatories, resulted not only in civil sanctions being applied under Rule 104, i.e., respondent's proffered answers to his first interrogatories were taken as established for the purpose of that case, but also a criminal sanction was imposed upon petitioner-husband in that he was held in contempt of Court and fined $1,000. In *Robert C. Eisle,* Docket No. 5283-76, decision was entered against petitioners for refusal to produce records to respondent. That decision was affirmed by the Fifth Circuit at 580 F.2d 805.

It is interesting to note that while discovery rulings sought increased each year up to the end of 1976, they began to taper off by the end of 1977 and with the exception of Rule 71 rulings sought (which have increased) up to June 30, 1978, they have dropped off sharply. I would like to feel that the Court had a helping hand in that decrease through issuance of its many opinions ruling on discovery matters.

My remaining topic is how can you members of the Federal Bar Association, and for that matter, members of the Bar and Tax Practitioners admitted to practice before our Court all over the country, assist the Court in expediting the processing of its cases.

Each year for the past six years the number of petitions filed has increased significantly. In the 1977 calendar year 12,728 law suits were filed with the Court. In calendar year 1978 to date 13,475 petitions have been filed. It appears certain that by the year's end that total will reach or exceed 14,000. With those increased filings, it goes without saying that the amount of interlocutory work has increased in proportion.

The Court has in its employ approximately 190 dedicated employees who are constantly aware of the importance of moving the Court's case load and I must say do just that in an expeditious and competent manner. There are ways, however, that their work load can be alleviated somewhat with the help of a cooperative and willing Tax Bar. Some of those ways are—

(1) Be sure that all documents mailed to the Court are addressed "U.S. Tax Court, 400 Second Street, N.W., Washington, D.C. 20217".

(2) A copy of the Notice of Deficiency should be attached to the original and all copies of each Petition filed.

(3) The Request for Place of Trial should be a *separate* document filed with each Petition. If an entry of appearance is to be for one petitioner only the entry should be captioned in the names of both petitioners as in the petition or as amended by Court order. You can state in the body of that entry of

in those cases, for example, the docket number in an exempt organization case would be appended by an "X" and the docket number in a retirement plan case would be appended by an "R". Accompanying each petition whould be a separate document entitled "Request for Place of Submission", not "Request for Place of Trial".

I am certain that with your cooperation the Court will be able to process its cases more quickly to trial or other disposition.

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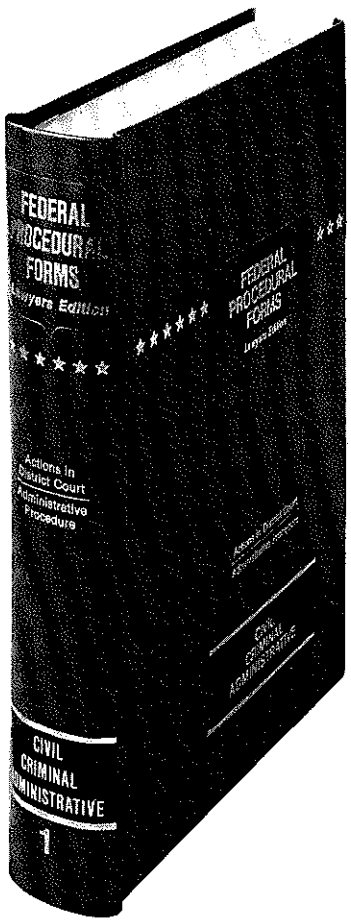

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1815 H Street, N.W.
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Continuing Legal Education Calendar

or more information about the following CLE programs of the Federal Bar Associa-on, contact the Conference Secretary at the national office, 1815 H Street, N.W., Vashington, D.C. 20006 (101/638-0252):

pt. 24-28	1979 Annual Convention, Hilton Palacio del Rio, San Antonio, Texas
ct. 3-5	FBA/BNA Conference on Equal Employment and Collective Bargaining, Shoreham Americana Hotel, Washington, D.C.
ct. 4-5	Third Annual Air Law Conference, Stouffer's National Center Hotel, Arlington, Va.
ct. 11-12	Antitrust and Trade Regulation Law Conference, Stouffer's National Center Hotel, Arlington, Va.
ct. 19-20	Conference on the New Federal Bankruptcy Code, Bonaventure Hotel, Los Angeles, Cal.
ov. 8-9	Fourth Annual Administrative Law Workshop, Four Seasons Hotel, Georgetown, Washington, D.C.
ec. 6-7	U.S./Mexico Trade Law Conference, Loew's Anatole Dallas, Dallas, Texas
ec. 14-15	FBA/WBA Second Annual Conference on Rules of Civil Procedure, Hyatt Regency Hotel, Washington, D.C.
80	
eb. 22	Third Annual Grant Law Conference, Four Seasons Hotel, Georgetown, Washington, D.C.
ar. 10	Third Annual Copyright Law Conference, Hyatt Regency Hotel, Washington, D.C.
pr. 21-22	U.S./Canada Trade Law Conference, Four Seasons Hotel, Georgetown, Washington, D.C.
pr. 28-30	Fourth Annual Tax Law Conference, Four Seasons Hotel, Georgetown, Washington, D.C.

in all documents transmitted to the Court for filing. Where more than one address is listed on any document filed, be sure to designate the address at which you wish to receive service.

(5) Whenever you change your address be sure to notify the Court by filing a notice of change of address with respect to each case you have pending in the Court.

(6) On all motions filed with the Court, you should incorporate therein a paragraph advising the Court as to whether your adversary has an objection to that motion or concurs therewith. This is an extremely important request and would save the Court's employees an immense amount of time. Motions for reconsideration of Opinion and to vacate decision should be separate and each should have its own certificate of service attached. Motions moving for more than one thing (according to the Court's Rules) should, likewise, be separate and distinct with certificates of service attached. They should not be stapled together.

(7) Additionally, motions should be transmitted to the Court for action at the earliest expedient time. This is true with respect to all motions but, more importantly, with respect to motions for continuance. Any motion for continuance which is received within 30 days of the calendar call date may very well be set for hearing at that Trial Session. Such late-filed motion is really of no help to either side because they have no idea until the date of Calendar Call whether that motion will be granted or denied. Motions to withdraw as counsel of record should be signed by *each* attorney wishing to withdraw as counsel. The Court does not recognize law firms.

(8) In connection with Trial Status Requests which are issued to you by the Court, it would be very helpful if those requests would be returned to the Court 10 days prior to the date indicated for their return in that document. Further, it would be an assist to the Court if advised as to whether your adversary concurs in your report or not. This simply means that prior to returning that Request to the Court that counsel get together with one another to determine the readiness of the case for trial at the session indicated. Of course, where there is disagreement as to the readiness of the case, the Court does not expect to receive agreed replies. However, I must point out to you that agreed replies are a material assist to the Court in approving its trial calendars. If you have lost or misplaced your Trial Status Request, you may wish to call the Court's Calendar Section (376-2734) to obtain a duplicate rather than not responding.

(9) When transmitting documents to the Court, be sure that you always include the proper number of copies as required by the Court's Rules.

(10) When filing a Petition with the Court under its new title, be sure that the petition is properly titled for the relief requested, for example, "Petition for Declaratory Judgment - Retirement Plan", "Petition for Declaratory Judgment - Exempt Organization". Otherwise, the petition very likely may be filed as a regular petition. While the people employed in the Court's Petition Section are most competent they are not lawyers and your assistance in this

subject to a qualified privilege which protects the decisional process and, I assume, not discoverable and that the Special Agent's Report be produced with portions excised pertaining to the recommendation of the Revenue Agent and the recommendations of the Special Agent and his deliberations that led him to his recommendation.

In *Singleton v. Commissioner,* 65 T.C. 1123 (1976), another case you should read, the Court after reviewing the documents requested from respondent by petitioner "in camera", in its discretion, made available to the parties copies thereof it "deemed appropriate for petitioner to have available for the hearing". In denying respondent's motion to stay proceedings under the conclusion of the criminal trial the Court initially pointed out, "We did not permit unlimited discovery but only very limited discovery under the careful scrutiny of our in camera inspection of respondent's files".

Technical Advice Memorandum issued to a person other than a party was not discoverable by petitioner, *Teichbraeber v. Commissioner,* 64 T.C. 453 (1975). The Court followed a ruling in *Tax Analysts & Advocates v. IRS,* 505 F.2d 350 (C.A. D.C. 1975), wherein a Technical Advice Memorandum of the same type was not discoverable as exempt from disclosure under the Freedom of Information Act. Further, private letter rulings that *may* have been issued to other taxpayers held not to be discoverable. The Court was not advised as to whether private letter rulings had been issued. In this respect, the Court felt that while private letter rulings were not privileged nor within the "work product" doctrine, they were not relevant in the pending case and, hence, not discoverable.

However, in *Corelli v. Commissioner,* 66 T.C. 220 (1976), we held a private ruling letter issued to an applicant other than petitioner was not privileged, was relevant to that proceeding and discoverable. There, the private ruling letter covered contractual arrangements among petitioner and others relating to compensation which petitioner did not report as income. There the negligence penalty had been asserted by respondent for two of the years at issue because of petitioner's alleged negligence or intentional disregard of rules and regulations. In the circumstances, the Court ruled that the private letter was discoverable only because the matters sought by petitioner relating to that ruling are relevant to the imposition of the negligence penalty.

In our second *Branerton v. Commissioner* case at 64 T.C. 191 (1975), petitioners sought two revenue agent's reports, two district conferee's reports, an Appellate Conferee's report, two conference memoranda and each and every other document pertaining to the audit of petitioners' income tax returns for 1967, 1968 and 1969. The Court found as not discoverable the conferee's reports, the Appellate Conferee's report, the conference memoranda and the "other documents" on the ground of governmental privilege. Further, the request for the "other documents" was determined too broad, vague, and ambiguous. The revenue agent's reports, including T-letters, were held to be discoverable and, thus, to be produced, where, in the circumstances, petitioner bore a heavy burden of proof on the issue of whether its claimed bad

Virtually all of the discovery sought insofar as the Court is aware pertains to requests for interrogatories (Rule 71) and requests for production of documents and things (Rule 72).

I can't emphasize too strongly that Rules 71 and 72 are self-executing rules between the parties alone without intervention on the part of the Court. When a party serves a request upon another party, neither the original nor a copy thereof should be sent to the Court. We will only have to return it. Rule 71(c) advises that the burden shall be on the party submitting the interrogatories to move for an order with respect to any objection or other failure to answer an interrogatory, and in that connection the moving party *shall annex to his motion the interrogatories,* with proof of service on the other party, *together with the answers and objections, if any.* This the first time that the Court is to be apprised that such a request was earlier served. Although Rule 72 contains no similar language, it goes without saying that any motion for an order filed pursuant to that rule should have attached thereto a copy of the request for production, together with the response and objections, if any.

Are there other rules which have a direct bearing on the discovery rules which you must always keep in mind? There certainly are.

Rule 91(a)(2), in connection with *stipulation for trial,* provides—

"The fact that any matter may have been obtained through discovery or requests for admissions or through any other authorized procedure is not ground for omitting such matter from the stipulation. Such other procedures should be regarded as aids to stipulation, and matter obtained through them which is within the scope of paragraph (1) must be set forth comprehensively in the stipulation, in logical order, in the context of all other provisions of the stipulation."

Rules 100 to 102 should be always kept in mind—Rule 102 particularly, which provides, in pertinent part—

"A party who has responded to a request for discovery * * * in a manner which was complete when made, is under no duty to supplement his response to include information thereafter acquired, except as follows:

"(1) A party is under a duty seasonably to supplement his response with respect to any matter directly addressed to (A) the identity and location of persons having knowledge of discoverable matters, and (B) the identity of each person expected to be called as an expert witness at trial, the subject matter on which he is expected to testify, and the substance of his testimony.

"(2) A party is under a duty seasonably to amend a prior response if he obtains information upon the basis of which he knows that (A) the response was incorrect when made, (B) the response, though correct when made, is no longer true and the circumstances are such that a failure to amend the response is in substance a knowing concealment.

"(3) A duty to supplement response may be imposed by order of the Court, agreement of the parties, or at any time prior to trial through new requests for supplementation of prior responses."

Rule 103 dealing with protective orders may be used to seek relief for

the ground that he could not properly frame his Reply because of certain information in the possession of respondent which respondent apparently used in preparing the Answer. In answer to that contention the Court stated—

"Respondent's Answer in the instant case is remarkably complete and detailed. It adequately meets the 'fair notice' requirement of Rule 31(a) and follows the form required by Rule 36(b). The facts alleged by respondent in his Answer should be within the knowledge of petitioner or at the very least susceptible of ascertainment by him because of the detail pleaded by respondent. The purpose of the Reply is to determine which facts alleged in the Answer are in dispute. To permit discovery at this point would not materially narrow the issues because petitioner either knows whether the facts pleaded in the Answer are true or false or he has no knowledge of the facts. He should, therefore, reply to respondent's Answer, based upon his own knowledge and belief."

Completion of discovery has been allowed with leave of Court within the 75-day period prior to Calendar Call.

What is the scope of discovery? Rule 70(b) advises that the information or response sought through discovery may concern any matter not priviledged and which is relevant to the subject matter involved in the pending case. It is not ground for objection that the information or response sought would be inadmissible at trial, if that information or response appears reasonably calculated to lead to discovery of admissible evidence, regardless of the burden of proof. If the information or response sought is otherwise proper, it is not objectionable merely because the information or response involves an opinion or contention that relates to fact or to the application of law to fact. As can be seen from the wording of this subparagraph of Rule 70, the scope of examination is quite broad and even permits inquiry into matters which in themselves may not be admissible into evidence but which may lead to the discovery of facts or other matters which will be admissible in evidence. It must always be remembered, the Court is still in control and may direct that certain information need not be furnished. This follows the pattern set by the Federal Rules of Civil Procedure wherein the Courts have recognized interests in privacy and have accorded appropriate protection for such interests, *Wiesenberger v. W. E. Hutton & Co.*, 35 F.R.D. 556 (S.D.N.Y. 1964).

At this point, rather than risk overlooking it, I would like to bring to your attention a discovery procedure which could have a significant impact in a case, especially at trial. Rule 70(c) provides that upon request to the other *party* and without any showing except the assertion in writing that he lacks and has no convenient means of obtaining a copy of a statement made by him, a *party* shall be entitled to obtain a copy of any such statement which has a bearing on the subject of matter of the case and is in the possession or control of another *party* to the case.

A statement by a party may have been given at the time when he is without the benefit of counsel and he may not have understood the legal consequences of his action. Also, he may not have been given, or have retained, a

sented. However, the Court continued to adhere to the "rationale" in its prior opinion.

Beginning on March 5, 1974, and continuing up to the present time the Court has issued a considerable number of opinions interpreting the discovery provisions of its Rules. In *Branerton Corporation v. Commissioner,* 61 T.C. 691 (1974), it was made unmistakably clear that the Court expects the parties to attempt to attain the objectives of discovery through informal consultation or communication *before* utilizing the discovery procedures provided in the Rules, as required by Rule 50(a)(1). In that case, respondent's Motion for Protective Order was granted where prior to any informal consultation or communication between the parties, petitioner, on January 2, 1974, the day after the new Rules became effective, had served written interrogatories on respondent. The *Branerton* Opinion is short and well worth your reading. In contrast, in *Pearsall v. Commissioner,* 62 T.C. 94 (1974), where respondent in reply to a request for admissions filed by petitioners moved for a protective order, the Court enunciated that the requirement in Rule 70(a)(1) for informal consultation or communication before utilizing the discovery procedures does not apply to requests for admissions under Rule 90 and respondent was directed to file a response to the request for admissions. In so directing the court stated—

"It is the aim of the request for admissions rule to establish as quickly as possible those matters which are not disputed, thus avoiding the time and effort needed to prove them at trial. Such requests may also aid the discovery process and may assist materially in the stipulation process—the acknowledged 'bedrock' of Tax Court practice * * * But contrary to respondent's contention, the requirement in Rule 70(a)(1) for 'informal consultation or communication before utilizing the discovery procedures' does not apply to requests of admissions under Rule 90; nor does our opinion in Branerton Corp. compel it. Under the request for admissions procedure, this Court simply requires that there be a 'succinct and clear statement of the request, and an answer which is not evasive'.

"* * * Like its counterpart in the Federal Rules of Civil Procedure, Rule 90 is meant to accomplish 'the relatively limited purpose of eliminating the necessity of putting on formal proof of essentially uncontroverted facts, not as a substitute for trial'."

It is very important to remember that where a party wishes to invoke the request for admissions rule that the *party* making the request shall serve a copy of that request upon the other party, and shall *file* the original with proof of service with the Court. This is *not* the case with requests served under Rules 71 and 72 which I will discuss a bit later.

The Court, in its Opinion in *International Air Conditioning Corporation v. Commissioner,* 67 T.C. 89 (1976), in emphasizing its prior *Branerton* holding, made it crystal clear as to what did not constitute informal consulta-

TAX COURT DISCOVERY AND HOW THE TAX BAR MAY BE OF ASSISTANCE TO THE COURT IN EXPEDITING CASES*

*By Francis J. Cantrel***

Recently the Honorable John L. Kane, Jr., a United States District Judge for the District of Colorado, published an article entitled "The Risk of Non-Persuasion: An Irreverant View". In it he compiled some of the choicer bits of non-persuading utterances actually made on the record. A sample from this compilation is as follows:

Counsel: Your Honor, the rules require you to modify the pre-trial order in order to prevent mammoth injustice.

The Court: They do?

Counsel: Rule 16 says so.

The Court: I didn't know that. What is mammoth injustice?

Counsel: It's great injustice.

The Court: I should think so. Is it anything like manifest injustice?

Counsel: Oh, yeah. It's the same thing.

The Court: Well then, we'll do our best to prevent it.

In 1957, after I had been admitted to practice before the Court of Appeals of the state of Maryland, I went into the private practice of law with my father, who, at his death in 1964, had been in the private practice law in the Washington, D.C. metropolitan area continuously for a period of 42 years. He was my idol and ideal and he still is. I remember so vividly, in the early days of struggling to find out what my new profession was all about, that he took me aside one day as I was in the process of preparing my first case for trial and said, "Son, as long as you practice law you should always keep in mind three indispensable factors:

"(1) In every case in which you are called upon to assist a client, first and foremost, be sure that you get *all* the facts.

"(2) Once you are in possession of all the facts, then research the law and you will find, in almost every instance, an answer to your legal problem.

"(3) Lastly, and most importantly, remember the old adage, 'If you don't know the rules, you can't play the game'."

The significance of that last factor, which is more salient today than ever before, has been indelibly imprinted in my mind during the 10 years I served as Assistant Clerk of the Court, and it is my wish today to share a part of that experience with you.

Beginning on January 1, 1974, the Court promulgated its new rules, which for the first time in its long history, provided for discovery procedures. Those Rules, together with accompanying notes, may be found in Volume 60 of the Tax Court's Reports, beginning at page 1057. A major objective in the

expect any change in policy or reduction in price-fixing prosecution because of the *Gypsum* decision.

As you know well, we have a new procedural tool to help us in the merger enforcement area with implementation of the premerger notification program on September 5th. Premerger notification is authorized by Title II of the Hart-Scott-Rodino Antitrust Improvement Act of 1976. We have already received reports on some one hundred twenty proposed merger transactions. As a result, the Division has begun 18 formal investigations while the FTC has initiated 13. Although both agencies simultaneously receive the initial premerger notification reports, only one agency will formally investigate a transaction. After a quick look by both agencies, each transaction is cleared to one agency or the other for investigation under our established clearance procedure. Any request for further information will come from the agency responsible for reviewing the proposed merger. When interpretive questions arise, the Division and the FTC will consult and develop a common position.

I want to emphasize that we will make the most serious effort to ensure that premerger notification remains only a procedural program. We realize that acquisition transactions are often fragile. Requests from the Division for additional information that are impossible to complete or cause undue delay can stop a merger just as effectively as an injunction. Consistent with our responsibility vigorously to enforce the antitrust laws, we will assess the need for the scope of such additional requests very carefully. I, personally, must be involved with each such additional request. If the parties to proposed transactions initially cooperate by fully and fairly completing the report form, requests for more data can be rare occurrences.

I would also like to note that the Act requires the parties to provide complete responses to all information requests on the initial report form as well as complete responses to all requests for additional information. If a complete response is not provided, the Act calls for a statement of the reasons for noncompliance. By rule we require such a statement to furnish reasons why a complete response cannot be given, specify the information which would have been required for a complete response, and give the names of persons who, if anyone, have the required information. Again, I believe it will be in the reporting person's interest to answer the statement of reasons for noncompliance candidly and completely. Where a complete response cannot be given on the initial form, our decision on whether to make a second request will often hinge on the completeness of the explanation for noncompliance.

On the other side of the coin, if a reporting person does not cooperate—if we believe the initial form or a second request has not been satisfactorily completed and the reason for noncompliance have not been adequately detailed—we will not hesitate to use our full powers under the Act. In the event that we believe an incomplete response does not constitute substantial compliance with our information requests, we are prepared to seek injunctive relief or civil penalties.

Congress has given us a powerful investigatory tool. The decision whether

There are other factors that must bear on any such decision: (1) whether the Division could have resonably expected that it would have become aware of the price-fixing scheme in the near future if the corporation had not reported it; (2) whether the corporation, on the discovery of illegal activity previously unknown to it, took prompt and effective action to terminate its part in the conspiracy; (3) the candor and completeness with which the corporation reports the wrong-doing and continues to assist the Division throughout the investigation; (4) the nature of the violation and the confessing party's role in it—e.g., was the corporation's conduct coercive toward its co-conspirators, was it the originating party and did it have actual exclusionary effects on others in the marketplace; and (5) whether the corporation has made, or stated its intent to make, restitution to injured parties.

We believe it is important to consider such measures as an incentive to reporting violations of the antitrust laws. We are clear that Congress considered violations of the Sherman Act sufficiently serious to impose felony penalties. As prosecutors, we must balance that policy judgment as part of the equities in each case, and we must consider also the procompetitive effects of early terminations of the economically corrosive crime of price-fixing, in reaching any decision that will reflect both fairness to the confessing party and the gravity of the party's conduct.

In the indictment this past week, a confessing corporation, as a matter of prosecutorial discretion, received lenient treatment. I believe it is important to explain how that action and future actions can serve our enforcement policy of general deterrence by providing an incentive for corporations engaging in illegal activity to come forward. At the same time it is important to avoid raising false hopes of lenient treatment where that would not be appropriate.

I leave aside discussion of the many obligations—legal or ethical—that may already compel or persuade corporations and corporate officials to make disclosure to the appropriate authorities. The price of failing to disclose is high. Considering the issue from the antitrust perspective alone, the corporation risks indictment and prosecution for price-fixing and stiff fines for it, with fines and jail sentences for involved employees. Our record in felony cases to date is good—fourteen wins in fifteen felony cases. Thus, the risk of conviction, fines and jail sentences following indictment is approaching a certainty. As an example, the penalties imposed in the recent *Consumer Bag* case are illustrative of the results we have been getting. Four corporations were fined $200,000, $500,000, $600,000 and $750,000 respectively. Three individuals were fined $25,000, $30,000 and $40,000 respectively. Two of these individuals received four months in jail and 32 months probation; the third individual, a two-year suspended sentence and two years probation.

In addition, the corporations subsequently discovered and convicted have the prospect of severe tax consequences. A convicted corporation can deduct only one-third of any treble damage awards assessed against it. A corporation that is named only as an unindicted co-conspirator can deduct the full amount

THE DISCLOSURE OF ANTITRUST VIOLATIONS AND PROSECUTORIAL DISCRETION*

*By John H. Schenefield***

I value this opportunity to address the Seventeenth Annual Corporate Counsel Institute especially because I recognize that in this audience are those of you in the bar who can be termed the first line of prevention for a corporation against the violation of the antitrust laws. It is to you that questions about lawfulness will first come. To you also are likely to come the first evidence of past violation. That means that you will have an early and influential voice in the corporation's decisions as to what to do with such evidence—evidence that raises the prospect of criminal prosecution, corporate liability, damaged careers, and, just as clearly, injured consumers. Because you are likely to be involved in those kinds of decisions, I have chosen this audience to outline for you a new approach that we are adopting in the Antitrust Division to voluntary disclosure of antitrust violations.

Decisions on whether or not to request indictments from a grand jury are among the most difficult faced by a prosecutor. They are frequently difficult because the issues of fact and law themselves are intricate and complex. They are difficult also because they involve enormous consequences, even in the absence of conviction, for those indicted. Nowhere is the weight of prosecutorial discretion heavier than in the decisions to indict individuals, some of whom may have persuasive reasons that would appeal to any humane conscience why indictment in the particular case is inappropriate.

In the world of antitrust, we have now seen—really for the first time—a new fact that makes some of these pre-indictment decisions even more difficult. In recent months, a corporation voluntarily came forward to reveal its complicity and that of some of its officials in price-fixing. This step was taken in the arguable absence of any legal or ethical compulsion to disclose the wrong-doing, and at the risk of both indictment and substantial liability to injured parties.The corporation apparently undertook this step despite the absence of any apparent prospect that the government would learn of the facts of the case and undertake enforcement action.

The appearance at our door of a corporation wishing to confess to something we don't know about is for us a novel occurrence. We would like, of course, to have it occur more often. But we are not pollyannish enough to expect a stampede of confessing corporations, certainly in the present state of the law. And yet many of us who have practiced law in the private sector know by experience and intuition that price-fixing is not infrequent and that many corporations have faced and are facing daily the excruciating issue whether to come forward and reveal the existence of corporate wrong-doing, or whether, on the other hand, to conceal—or at least fail to reveal—its existence in the

In order for this policy to be effected, it becomes necessary to provide the states with the authority to regulate all aspects of the sale of lottery tickets within their borders. For example, a state should be able to permit participation in its own lottery, while banning out-of-state lottery materials of which it disapproves. At the present time, such a treatment would be challengeable on Commerce Clause grounds, although it might serve to further legitimate state interests. Chief Justice Fuller, dissenting in the 1903 case which first extended Commerce Clause jurisdiction to gambling activities, observed that "if lottery tickets had been deemed articles of commerce" in a case which had been recently before the Court, the state statute involved "would have been invalid as a regulation of commerce." The Chief Justice went on to ask whether "if a State should. . .engage in the business of lotteries could it enter another State, which prohibited lotteries, on the ground that lottery tickets were the subjects of commerce? On the other hand, could Congress compel a State to admit lottery matter within it, contrary to its own laws?"[31] These questions are still very much unanswered. A consent statute would ensure that state measures designed to control the sale of lottery tickets, or other gambling activities, could not be challenged on the grounds that they discriminated against, or unduly burdened, a subject of interstate commerce.

A second effect of such legislation would be to assure the states of the exact limits of their authority to regulate gambling within their borders. The Commission realized that the orderly development of state gambling policies would require a climate in which those responsible for the design and implementation of gambling measures were free from uncertainty about the constraints imposed by federal law. A properly drafted consent statute could provide that, if a state had undertaken to regulate specific gambling-related activities, federal laws could not be construed to supersede these state measures unless the federal laws specifically referred to gambling. Consider the language of the McCarran Act: "No Act of Congress shall be construed to invalidate, impair, or supercede any law enacted by any State for the purpose of regulating the business of insurance. . .unless such Act specifically relates to the business of insurance: *Provided,* that (certain named Acts of Congress) shall be applicable to the business of insurance to the extent that such business is not regulated by State law."[32] The meaning is clear: no federal agency may take any action against a state-regulated insurance business unless expressly authorized to do so by Congress. A similar statute applied to gambling would assure the states that federal agencies could only challenge their gambling policies on the basis of federal statutes which explicitly mentioned gambling, thereby relieving state policymakers of any uncertainty about the possible scope of federal laws. A state lottery director, or a casino operator, would not have to worry about whether state regulations governing the publication of the odds against winning satisfied the Federal Trade Commission, so long as Congress has passed no law on the subject.

gambling is concerned, a states' rights approach is a progressive approach. It is the states which have been the source of innovation in this field, with the federal government often retarding their progress despite Congress' enunciated policy of noninterference with state gambling measures.

The experience of the state lotteries is illustrative. During the past fourteen years, fourteen state governments, acting independently, have commenced the operation of lotteries, which are designed to raise revenues for state purposes. These lotteries, while not without fault, have generally maintained high standards of security and control, and have been popular among the citizenry. To the player, the most confusing aspect of these games was that for years the televised drawings were based upon numbers depicting the outcome of horse races run sometime in the past. This absurd fiction was necessary in order for the states to escape a crushing federal excise tax.[20] The elimination of this technicality effected no real change in federal policy; indeed, the horserace rule was designed by Congress to accommodate the New Hampshire Sweepstakes when it was introduced in 1964.[21] Despite the fact that all of the lotteries had since become computerized, and that the repeal of this technicality was supported by the Internal Revenue Service,[22] the rule remained in force for years.[23] Nor is this an isolated instance; too often, the federal government had needlessly stifled initiative at the state level. Afraid to act decisively in an area as controversial as gambling, Congress and the federal bureaucracy fool around at a distance, unwilling or unable to adapt to changing circumstances, and insensitive to the practical difficulties caused by their neglect.

The irony is that the very intransigence of the federal government may be counterproductive to the achievement of its goal of suppressing organized crime. The FBI has long maintained that gambling is the "lifeblood of organized crime."[24] Presently, a number of lottery states have introduced numbers games designed to capture a share of the illegal gambling market. To the extent that Congress, through the exercise of its commerce and taxing powers, renders the states unable to compete with the illegal operators, such as by subjecting legal winnings to federal income tax withholding requirements,[25] it frustrates the realization of its own objectives. The Gambling Commission concluded that "from a purely pragmatic standpoint," a national policy giving the states the ability to set their own gambling policies "should result in the most efficient evolution of gambling policies in the United States, as different states experiment with different approaches, discarding those that are unsuccessful and emulating those that have been effective in other states."[26]

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[20]First Interim Report, Commission on the Review of the National Policy Toward Gambling (1975), p. 41.

[21]*Supra* at 19.

[22]Testimony of Donald Alexander, Comm'r of Internal Revenue, Commission Hearings, Washington, May 15, 1974.

[23]Congress finally repealed this requirement in the Tax Reform Act of 1976 (90 Stat. 1520), characterized by the Los Angeles Times as the "Lawyers', Accountants', and Bookmakers' Relief Act." The last reference is to the newly-imposed requirements that winnings at the racetrack and from state lotteries above a specified amount are now subject to withholding at the time of payment, thereby improving the competitive position of illegal bookmakers and numbers operators.

the constitutional grant of power to Congress "to regulate Commerce. . . . among the several States."[3] Actually, it was neither the Congress nor the states, but the federal courts which created the impetus for the enactment of the first consent statute in the 1880s, by striking down state laws prohibiting the sale of alcohol. The Supreme Court held that such state statutes were unconstitutional to the extent that they barred the sale of liquor which had travelled in interstate commerce, since "a subject matter which has been confined exclusively to Congress is not within the police power of the state."[4] The Court inferred from Congress' silence on the matter its intent to maintain a free traffic in alcohol.

As it turned out, the Court had misread the feelings of the Congress on this controversial issue, and both houses quickly sought a way to remedy the situation. Within a year Congress had enacted the Wilson Act, giving effect to state prohibitions by forbidding the sale of liquor in a state, even though it had been brought in through interstate commerce, when state law forbade the sale of alcohol.[5] The Supreme Court in 1891 agreed that this action had "removed the impediment" to the enforcement of state prohibitions on the sale of alcohol.[6] The ultimate effect was to subject to the police power of the states something that had previously been excluded from their reach by reason of its being a subject of interstate commerce.

The Supreme Court was careful to observe that the Wilson Act did not result in an unconstitutional delegation of power, although that is of course precisely what it amounted to. Such legislation has been utilized from time to time in the 20th Century when Congress has found it necessary to protect state legislation of which it approves from the threat of invalidation by the federal courts on Commerce Clause grounds. It should be noted that judicial analysis of the Commerce Clause has become more refined over the years, and state regulations of interstate commerce are now considered to be permissible so long as they do not unduly burden, or discriminate against, such activity.[7] When politically popular state legislation has been held to transgress this boundary, Congress has not hesitated to protect it. Thus the Lacey Act, enacted in 1900 to permit states to restrict the hunting of migratory game birds;[8] the Hawes-Cooper Act, passed in 1929 to authorize state bans of the sale of goods made by forced labor in prisons;[9] and the Renovated Butter Acts of 1902, allowing dairy states to impose prohibitive restrictions on the sale of oleomargerine.[10] Most recently, Congress passed the McCarran Act after the Supreme Court held in 1944 that insurance was an activity of interstate commerce.[11] This holding, long overdue from both a conceptual and practical standpoint, threatened to wreck the entire structure of state insurance regu-

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[4] *Leisy v. Hardin*, 135 U.S. 100 (1890).
[5] 26 Stat. 313 (1890).
[6] *Wilkerson v. Rahrer*, 140 U.S. 545 (1891).
[7] See, e.g., *Southern Pacific v. Arizona*, 325 U.S. 761 (1945); *Bibb v. Navaho Freight Lines, Inc.*, 359 U.S. 520 (1959).
[8] 31 Stat. 188 (1900).
[9] 45 Stat. 1084 (1929).

ting a corporation to raise its "due diligence" as a defense to a criminal charge fosters the goal of encouraging these self-policing efforts. Blindly applying tort principles of *respondeat superior* in the criminal context will only undermine the complex and difficult task of insuring corporate compliance with the law.

CONCLUSION

As noted, the doctrine of corporate criminal liability has proceeded from the point where a corporation was thought immune from criminal sanctions to the present view that a corporation may be held criminally liable for a specific intent crime based on the unlawful acts of even a menial employee, as long as such acts were committed within the scope of the employee's authority and for the purpose of benefiting the corporation. The expansion of corporate criminal law liability has proceeded with little analysis and appears based upon functional concerns. In the case of specific intent offenses, the imposition of the criminal sanctions against corporations for the acts of subordinate employees in violation of company policy does violence to traditional notions of criminal *mens rea*. There are certainly strong public policy reasons for holding corporations criminally responsible. However, the refusal of courts to accept a "due diligence" defense where the top managers of a corporation have made every effort to insure compliance with the law undermines the goal of deterring future criminal conduct by corporations. The doctrine of corporate criminal liability has been pushed to its limits. A reappraisal of the doctrine is now in order.

liability by showing that high executives of the corporation "took the utmost care to lay down for the guidance of subordinate employees procedures designed to insure compliance with the regulation."[96]

The reationale adopted by courts in antitrust cases and in the context of regulatory offenses should not be carried over to a specific intent offense where it is the actor's state of mind, rather than the act itself, which triggers criminal sanctions. In the case of a specific intent crime, the corporation, like any other defendant, may only be found guilty if it possesses the requisite state of mind. A corporation should not be held vicariously liable for a specific intent offense based upon the unauthorized acts of a guilty employee. To do so offends basic notions of faicness and does nothing to promote future lawful conduct mn the part of the corporation.[97]

The rationale for absolving a corporation of criminal responsibility where the company has made good faith efforts to insure compliance with the law and where the corporation's agents act in violation of company policy has been discussed by the commentators.[98]

One of the principal justifications for the imposition of corporate criminal liability is that the corporate fine will encourage diligent supervision of corporate employees by managerial personnel.[99] This goal is obviously furthered by encouraging corporate management to engage in self-policing functions. If corporate managers know that the company faces criminal sanctions despite their best efforts to insure compliance with the law, their motivation to undertake such efforts would be chilled. As Professor Mueller has pointed out: "The imposition of punishment despite the exercise of due care, when the efforts were unsuccessful, creates frustration. If punishment followed as a matter of course upon every *discovered* technical breach of the law, no matter whether due care has been exercised or not, the managerial agents may well conclude that it is far more simple to let things take their own course, than it is to exercise care."[100]

This author suggests that corporate managers would be encouraged to undertake in-house compliance efforts if they were aware that their "due diligence" would be a defense to a prosecution against the company. Recognition of such a defense would impose upon the corporation the positive duty of policing itself at the risk of incurring criminal sanctions for any breach. Certainly, a corporation should not be permitted to evade criminal responsibility by self-righteous pronouncements regarding the importance of complying with the law while at the same time company management is "winking" at illegal business practices by subordinate employees. However, such evasion would not be possible if the issues of the corporation's good faith and due diligence are presented to the jury.

The efficacy of allowing a corporation to assert a "due diligence" defense

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[96]*Id.* at 397.

[97]*See,* Mueller, *Mens Rea and the Corporation,* 19 U. Pitt. L. Rev. at 43-44.

[98]*See,* Coleman, *Is Corporate Criminal Liability Really Necessary?* 29 Southwestern L.J. 908; Mueller, *Mens Rea and the Corporation,* 19 U. Pitt. L. Rev. 21 (1957); Note, *Corporate Criminal Liability for Acts in Violation of Company Policy,* 59 Geo. L.J. 547 (1969).

another product that the prohibitions against such tie-in sales had been discussed at sales meetings. Indeed, the district court found that the defendant corporation in good faith had instructed its district managers and salesmen never to make any tie-in sales.

Upholding the corporation's conviction, the Third Circuit noted that the responsible company employees had been acting within the scope of their authority and stated: "It appears that appellants' main office had repeatedly cautioned against such conduct, but this corporation, while extremely large in the vital food industry, cannot evade its responsibility by referring to its elaborate inter-branch correspondence and its meetings."[83]

The court went on to state that the duty to abide by the price control regulations was a "non-delegable" one and that the corporation must stand or fall with those whom it selects to act in its behalf.[84]

Courts have been particularly unwilling to allow corporations to escape liability for criminal antitrust violations by showing company efforts to comply with the law. This issue was addressed by the Sixth Circuit in *Continental Baking Co. v. United States.*[85] This was a prosecution under Section 1 of the Sherman Act,[86] in which the court rejected the corporation's defense that the antitrust violations of a general manager were without corporate authority and in contravention of the express orders to the contrary. The court stated:

> A corporation which employs an agent in a reasonable position cannot say that the man was only 'authorized' to act legally and the corporation will not answer for his violations of law which inure to the corporation's benefit. . . .
>
> If in the performance of his corporate principal's business, he engaged in illegal price-fixing agreements and condoned or encouraged activities of those under his supervision in contravention of written directions from the 'Home Office,' the corporation cannot deny its liability for his actions. Continental cannot divorce itself from its responsible agent to insulate itself from criminal prosecution.[87]

The Ninth Circuit recently accepted this view in *United States v. Hilton Hotels Corp.*[88] This was a Sherman Act prosecution in which the defendant hotel operators allegedly agreed to do business only with suppliers who made contributions to a promotional fund. At trial, the defendant corporation's president testified that it was contrary to corporate policy to engage in any such boycott. Similarly, the hotel's manager and assistant manager testified that a boycott was against company policy and that they had so instructed the

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[83] *Id.* at 343.

[84] *Id.* at 343-44. The court further noted that the employer should have been aware of the unlawful acts of its employees since the practice of requiring tie-in sales was pervasive in the geographical area at issue. *Id.* at 343. Thus, the court raises the inference that higher level company management must have condoned or acquiesced in the practice.

[85] 281 F.2d 137 (6th Cir. 1960).

[86] 15 U.S.C. §1.

[87] *Id.* at 150. The court approved a jury charge to the effect that: "When the act of the agent is within the scope of his apparent authority, the corporation is held legally responsible for it, although it may be contrary to his actual instructions and although it may be unlawful." *Id.* at 151. Similarly, in *United States v. American Radiator & Sanitary Corp.*, 433 F.2d 174 (3rd Cir. 1970), *cert. denied*, 401 U.S. 948 (1971), the Third Circuit approved a jury instruction which stated: "If you conclude that an agent of a defendant corporation, acting on behalf of the corporation and within the scope of his employment or his apparent authority, engaged in a price-fixing conspiracy, then it is no defense that the corporation had

rejected the due diligence defense and upheld corporate criminal liability for acts of agents in violation of company policy.[74]

The case of *Holland Furnace Co. v. United States*[75] is one of the few cases of fairly recent vintage holding that a corporation may defend itself by showing that the unlawful acts of its employees were in violation of company policy. In that case, the corporation and Boyd, one of its salesmen, were convicted of violating a War Production Board regulation by fraudulently selling a customer a new furnace on the misrepresentation that the customer's old furnace was damaged beyond repair. The evidence at trial revealed that the defendant corporation's salesman fraudulently obtained the customer's signature on a certificate required under War Production Board regulations stating that his furnace was irreparably damaged. The evidence further established that other company employees had no knowledge of its salesman's deceit and acted in complete reliance of the certificate. Moreover, the corporation showed that it had taken extensive precautions to insure that its employees strictly adhered to the Board's regulations. These measures included the corporation's issuance of bulletins informing its employees of applicable regulations and scheduling of meetings at which these regulations were discussed.

On appeal, the Holland Furnace Company argued that the trial court erred in refusing to grant its motion for a directed verdict. The government argued that the conviction of the company should be sustained under the general principle that the corporation was criminally responsible for the acts of its agents while acting within the scope of their employment. However, the Sixth Circuit rejected the government's position, refusing to extend corporate criminal liability to a situation where the company had made extensive efforts to insure compliance with the law. The court stated:

> In the case before us, the unlawful action of Boyd in procuring delivery of a new furnace to Bowen had been shown, with no evidence to the contrary, to have been, not only without the knowledge of appellant corporation of his illegal conduct, but also in express violation of its specific instructions to him and to all its agents. In the circumstances, the conviction of the corporation should not be upheld. Its motion for a directed verdict should have been granted.[76]

Similar principles were recognized by the Eighth Circuit in *John Gund Brewing Co. v. United States.*[77] In that case, the conviction of a non-resident brewing corporation for engaging in business as wholesale dealer in malt liquors in North Dakota without paying the required tax was reversed upon the ground that the defendant corporation was entitled to show that the acts of its agent in selling liquor in North Dakota were in violation of express instructions. The court held that the trial judge erred in instructing the jury that the company was responsible, as a matter of law, for the acts of its local agent

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[74] *See, e.g., United States v. Cadillac Overall Supply Co.*, 568 F.2d 1078, 1090 (5th Cir. 1978); *United States v. Hilton Hotel Corp.*, 467 F.2d 1000 (9th Cir. 1972), *cert. denied*, 407 U.S. 1125 (1973); *United States v. Harry L. Young & Sons*, 464 F.2d 1295 (10th Cir. 1972); *Continental Baking Co. v. United States*, 281 F.2d 137, 149-151 (6th Cir. 1960); *United States v. Armour & Co.*, 168 F.2d 342 (3rd Cir. 1948); *United States v. Gibson Products Co., Inc.*, 426 F. Supp. 768 (S.D. Tex. 1976); *United States v. E. Brooke Matlack, Inc.*, 149 F. Supp. 814 (D. Md. 1957).

[75] 158 F.2d 2 (6th Cir. 1946).

In holding that the corporate employer could not be found guilty under the circumstances, the Fifth Circuit began by noting that Congress can subject corporations to criminal accountability for acts committed by unfaithful servants.[61] However, the court noted that the statute in question, the Connally Hot Oil Act, required a showing of a "knowing" violation.[62] The statute was thus unlike those laws prohibiting public welfare crimes, where injury to the public interest comes from the act itself without regard to the motivation of the actors. In such circumstances, the court ruled that the corporation did not acquire the knowledge or possess the requisite state of mind through the acts of unfaithful agents whose conduct was undertaken to benefit parties other than their corporate employer.[63]

The court in *Standard Oil* thus held that a corporation cannot be held criminally liable for the acts of its agent unless the agent is acting with the intention of furthering the company's business. As the court stated, "The purpose to benefit the corporation is decisive in terms of equating the agent's action with that of the corporation."[64]

The principle enunciated in *Standard Oil* has been reaffirmed in subsequent cases. For example, in *United States v. Ridglea Estate Bank*,[65] the government sought to hold two banks, Ridglea Estate Bank and the Bank of Commerce, liable under the Federal False Claims Act for the dishonesty of a former employee of both banks. The employee, named Hubbard, knowingly approved false FHA loan insurance forms. The evidence indicated that none of the employees of either bank except Hubbard had actual knowledge of the falsity of the documents.

The government's case rested on imputing to the banks Hubbard's knowledge of the falsity of the forms, on the theory that he was acting as agent of the banks at the time he approved the loans.[66]

The Fifth Circuit held that the imputation of Hubbard's guilty knowledge to the banks in such circumstances was improper. The court reaffirmed that an employer may not be held liable for the criminal acts of an employee unless the agent acted within the scope of his employment and not if the agent acted for some other purpose than serving his employer.[67] The court noted in the instant case, Hubbard's guilty acts were not for the benefit ofhis employer, and, accordingly, the banks could not be held liable for the penal fines based on Hubbard's activities.

Other courts have similarly insisted that a company employee act with intention to benefit the corporation before his employer may be held criminally liable for the agent's unlawful acts.[68] The Fifth Circuit again addressed this issue in *Steere Tank Lines, Inc. v. United States*.[69] The *Steere Tank Lines*

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[61] *Id.* at 125.
[62] *Id.* at 126.
[63] *Id.* at 129.
[64] *Id.* at 128.
[65] 357 F.2d 495 (5th Cir. 1966).
[66] *Id.* at 498.
[67] *Id.* at 498.
[68] *See, United States v. Hangar One, Inc.*, 563 F.2d 1155, 1158 (5th Cir. 1977); *United States v. Hilton Hotels Corp.*,

The court found that the company had the collective knowledge that one of its drivers was ill and hence violated the statute by permitting him to drive. This knowledge was said to be derived from a telephone call from the driver's wife to the company dispatcher informing him that her husband was ill and a later call from the sick driver requesting reinstatement for duty so as not to suffer an unexcused absence. The court noted that the company had a policy of marking absence from work as unexcused unless the driver submitted a doctor's certificate or similar verification of illness. The court found this policy encouraged drivers to work while ill.

Under the circumstances, the court found the company had acted knowingly and willfully in violating the statute in spite of the fact that no one employee acquired sufficient information to comprehend its full import. Because the company as a whole had sufficient information to know that the driver's ability was impaired, making it unsafe for him tod rive, the company was convicted of knowingly and willfully violating the regulations.

In so ruling, however, the court expressly recognized that the "willfullness" requirement under the Interstate Commerce Act required proof of a lesser *mens rea* than statutes requiring specific criminal intent.[54] Under the statute in question, the court found that "willfully" meant voluntarily as opposed to accidental.[55]

By distinguishing the offense at issue from crimes involving specific criminal intent, the court in *T.I.M.E.* implicitly recognized that the "collective knowledge" theory employed could not be applied where the crime involves specific intent. As discussed above, the purpose of criminal sanctions for specific intent crimes is to punish a defendant who knows his actions are criminal and consciously chooses to act in the face of that understanding. On the other hand, since regulatory statutes such as that presented in the *T.I.M.E.* case are aimed at protecting society from the mere act, *i.e.*, unsafe drivers on the road, there is no requirement that knowledge and intent be combined in a single individual.

D. Identification of the "Specific" Intent at Issue.

It must also be emphasized that a conviction of a specific intent crime requires a showing that the defendant possessed the requisite specific intent to violate the statute in question. Thus, a corporation should not be held criminally liable for a specific intent offense where its employees unwittingly violate the provision in question by knowingly engaging in activities made unlawful by other laws. Such a situation might arise, for example, where corporate employees were violating state pricing laws which also had federal tax consequences of which these employees were not aware. It would seem that in such a situation, the corporation could not be held liable unless at least one employee had the specific intent to evade the tax laws.

[54]The court explained: "The statute under construction is of the *malum prohibitum* class, rather than *malum in se*, and, therefore the government need not prove an evil purpose or specific criminal intent in order to establish willfulness. Judicial interpretation of regulatory statutes of this nature indicate lesser proof is sufficient to establish this element of the

inally liable for specific intent crimes committed by subordinate employees.[41]

This author suggests that in some circumstances, a corporation should be liable to raise as an affirmative defense to a specific intent crime the fact that the criminal act of a subordinate employee was not authorized, ratified or at least acquiesced in by the board of directors or high managerial agents of the corporation.[42] Such a defense of "exceptional occurrence without fault in supervision or management" would be appropriate where the corporation faces criminal charges based on the single, isolated criminal act of a subordinate employee and where the company has made diligent efforts to insure compliance with the law.

The deterrent impact of holding a company liable for an isolated criminal act of a subordinate employee is questionable. Pursuing criminal charges against the responsible individual would seem a much more effective individual deterrent.[43] Corporations may well be discouraged in their own efforts to investigate and rectify questionable practices by subordinate employees if one incident uncovered and disclosed by the corporation may expose the company to criminal sanctions.[44] Moreover, where the corporation has made diligent efforts to comply with the law and there is no suggestion that company management condoned the illegal practices, the imposition of criminal liability upon the corporation for the isolated act of a subordinate employee raises real questions of fairness.[45]

C. Imputation of Collective Intent.

One intriguing question is whether knowledge may be imputed to a corporation when it is derived from the collective knowledge of several employees rather than a single agent. At least in cases involving regulatory offenses, courts have held that a corporation cannot plead innocence by asserting that information obtained by several employees was not acquired by any individual who would have comprehended its full import. *United States v. T.I.M.E.-*

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[41]In *Commonwealth v. Beneficial Finance Co.*, 275 N.E. 2d 33 (Mass. 1971), *cert. denied*, 407 U.S. 914 (1972), the Massachusetts Supreme Court refused to adopt the corporate defendant's position, based on the Model Penal Code, that a corporation should not be held criminally liable for the acts of subordinate employees or agents unless authorized, ratified, adopted or tolerated by corporate officers or other high managerial agents sufficiently high in the corporate hierarchy to warrant the assumption that their acts in some substantial sense reflected corporate policy. However, the court did approve of jury instructions which "did preserve the underlying corporate policy rationale [of] the code by allowing a jury to infer 'corporate policy' from the *position* in which the corporation placed the agent in commissioning him to handle the particular corporate affairs in which he was engaged at the time of the criminal act." *Id.* at 73. Numerous federal cases have upheld criminal convictions of corporations for specific intent crimes committed by subordinate employees. See cases cited in Elkins, *Corporations and the Criminal Law: An Uneasy Alliance*, 65 Kent L.J. 73, 108 n. 124 (1976), and Coleman, *Is Corporate Criminal Liability Necessary?*, 29 S.W.L.J. 908, 909 n. 10 (1975).

[42]The Working Papers of the National Commission on Reform of Federal Criminal Laws suggest that it may be appropriate to limit corporate liability for unauthorized offenses in the case of an "exceptional occurrence without fault in supervision or management." *Staff Memorandum, supra*, at 165.

[43]Coleman, *supra*, note 3 at 924.

[44]A corporation has no Fifth Amendment privilege against self-incrimination. *Bellis v. United States*, 417 U.S. 85, (1974); *United States v. White*, 322 U.S. 694 (1944). Thus, information gathered by a corporation regarding the conduct of its employees is subject to grand jury subpoena or administrative summons.

[45]See *United States v. Thompson-Powell Drilling Co.*, 196 F. Supp. 571, 578 (N.D. Tex. 1961), *rev'd on other grounds*

ment claimed that a local branch manager of this national money-lending corporation had falsified credit information for borrowers seeking FHA loan insurance. The corporation argued that a branch manager was too low in the corporate hierarchy to bind the corporation. The court rejected this argument, holding that a corporation may be liable for criminal acts done by agents within the scope of their corporate duties.

Other federal cases have similarly held corporations liable for the illegal acts of middle-level and lower-level employees.[28] Only recently, in *United States v. Hangar One, Inc.*[29] the Fifth Circuit reaffirmed that a corporation will be liable under the penal-type provisions of the Federal False Claims Act[30] for the illegal acts of employees acting within the scope of their employment and for the purpose of benefiting the corporation. The court expressly rejected the position espoused by the trial judge to the effect that: "Where someone less than a corporate officer is involved, corporate criminal liability is imposed *only* where the criminal employee has a position of substantial responsibility and broad authority."[31]

Some courts, however, have refused to impute the criminal intent of a lower-level company functionary to the corporate entity where the crime at issue requires a showing of specific criminal intent. Thus, in *People v. Canadian Fur Trappers Corp.*,[32] the conviction of a corporation for larceny was reversed where the acts were not authorized by an officer.

This approach was also followed in *United States v. Thompson-Powell Drilling Co.*[33] There, the court held a corporation liable for its employee's willful violations of the Connally Hot Oil Act, but acquitted the corporation where the charge was conspiracy to violate the Act. The court emphasized that the crime of conspiracy requires knowledge and consent of the accused, and it concluded: "It may be that the assent of some agent in a supervisory or executive authority would be necessary to commit a corporation to a conspiracy."[34]

The limitation of corporate criminal liability where the illegal acts were committed by a lower-level employee has been adopted in the Model Penal Code of the American Law Institute. Beyond the imposition of liability for acts of agents in violation of regulatory offenses and those statutes which are specifically made applicable to corporations, the Model Penal Code restricts the liability of corporations to conduct of agents "authorized, requested, com-

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[28] *See, e.g., United States v. Dye Construction Co.*, 510 F.2d 78 (10th Cir. 1975) (workers at trench site — violation of Occupational Health & Safety Act); *Steere Tank Lines, Inc. v. United States*, 330 F.2d 719 (5th Cir. 1963) (truck drivers and dispatchers — knowing falsification of records by motor carrier); *Continental Baking Co. v. United States*, 281 F.2d 137 (6th Cir. 1960) (plant manager at Memphis, Tennessee, depot managers and supervisors — Sherman Act Conspiracy to fix prices of bakery products in the Memphis area); *United States v. Milton Marks Corp.*, 240 F.2d 838 (3rd Cir. 1957) (general foreman — knowingly presenting a false claim to the United Stats); *United States v. Steiner Plastics Mfg. Co.*, 231 F.2d 149 (2d Cir. 1956) (production manager or either of three factory employees — conspiracy to falsify approval stamps on fighter plane cockpit canopies being manufactured for the Navy); *United States v. Armour & Co.*, 168 F.2d 342 (3rd Cir. 1948) (one branch manager, one assistant branch manager, and salesmen — violations of the Emergency Price Control Act prohibiting tie-in sales); *United States v. Van Riper*, 154 F.2d 492 (3rd Cir. 1946) (manager of gas station — violation of price control regulations established under War Powers Act).

[29] 563 F.2d 1155 (5th Cir. 1977).

[30] 31 U.S.C. §231 *et seq.*

[31] *Id.* at 1158.

[32] 248 N.Y. 159, 161 N.E. 455 (1928).

fiction. Thus, they have expressed concern about the conviction of a corporation of a crime requiring specific criminal intent.[18] However, the reluctance to impute *mens rea* to a corporation has been overcome and the clear weight of authority has upheld corporate liability for specific intent crimes.[19] As one court stated, "(a) corporation, through the conduct of its agents and employees, may be convicted of a crime, including a crime involving knowledge and willfulness."[20]

Thus, even in the case of specific intent crimes, it is now well settled that a corporation may be held criminally liable for the illegal acts of its agents and employees if such acts are done on behalf of the corporation and within the scope of the agent's employment.[21]

ACTS OF AGENTS WHICH GIVE RISE TO CRIMINAL LIABILITY OF THE CORPORATION

The criminal liability of corporations is theoretically based on imputing the acts and intent of corporate employees and agents to the entity itself.[22]

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[18]See Mueller, *Mens Rea and the Corporation,* 19 U. Pitt. L. Rev. 21 (1957); 19 Am.Jur.2d, *Corporations,* §1434 n. 14.

[19]See, *e.g., Boise Dodge, Inc. v. United States,* 406 F.2d 771, 772 (9th Cir. 1969) (violation of 15 U.S.C. §1233(c), making it unlawful to willfully remove labels affixed to new cars); *United States v. Carter,* 311 F.2d 934 (6th Cir.), *cert. denied sub. nom., Felice v. United States,* 373 U.S. 915 (1963) (corporation liable for president's unlawful payment to union representative); *Egan v. United States,* 137 F.2d 369 (8th Cir.), *cert. denied,* 320 U.S. 788 (1943) (corporation liable for violation of Public Utility Holding Company Act prohibiting corporate political contributions); *Mininsohn v. United States,* 101 F.2d 477 (3rd Cir. 1939) (corporation liable for conspiracy to defraud the United States by false claims); *Zito v. United States,* 64 F.2d 772 (7th Cir. 1933) (conviction of corporation for conspiracy to violate Prohibition Act); *United States v. Gibson Products Co., Inc.,* 426 F. Supp. 768 (S.D. Tex. 1976) (corporation liable for knowingly making false entries on forms in connection with sale of firearms).

Leading state authorities accord with the federal law on this point. See, *e.g., Commonwealth v. Beneficial Finance Co.,* 275 N.E.2d 33 (Mass. 1971), *cert. denied,* 407 U.S. 914 (1972); *W. T. Grant Co. v. Superior Court,* 23 Cal. App. 3d 284, 100 Cal. Rptr. 179 (1972); *People v. Wheatman,* 334 N.Y.S. 2d 842, 286 N.E. 2d 234 (1972), *cert. denied,* 409 U.S. 1027 (1972).

See also, Hermann, *Criminal Prosecution of United States Multinational Corporations,* 8 Loy. U.L.J. 465, 468 (1977); *Note, Decision-Making Models and the Control of Corporate Crime,* 85 Yale L.J. 1091, 1095-96 (1976); Note, *Criminal Liability of Corporations for Acts of Their Agents,* 60 Harv. L. Rev. 283 (1946).

[20]*Boise Dodge, Inc. v. United States, supra,* 406 F.2d at 772.

[21]*See, W. LaFave & A. Scott, Criminal Law,* §33 at 229 (1972); Coleman, *Is Corporate Criminal Liability Really Necessary,* 29 Southwestern L.J. 908, 909-910 (1975); *Staff Memorandum on Responsibility for Crimes Involving Corporations and Other Artificial Entities:* Sections 402-406 in *Working Papers of the United States National Commission on the Reform of Federal Criminal Laws,* at 169 n. 8 (1970). Indeed, in certain circumstances, a controlling parent corporation has been held criminally liable for the acts of employees of its subsidiaries. *United States v. Johns-Manville Corp.,* 231 F. Supp. 690, 698 (E.D. Pa. 1964); *Commonwealth v. Beneficial Finance Co.,* 275 N.E. 2d 33 (Mass. 1971), *cert. denied,* 407 U.S. 914 (1972).

[22]Of course, a corporate agent who engages in criminal conduct is personally liable notwithstanding the fact that he acted in behalf of the corporation. See, *United States v. Wise,* 370 U.S. 405 (1962); *W. LaFav & A. Scott, Criminal Law,* §33 at 230 (1972); Note, *Individual Liability of Agents for Corporate Crimes under the Proposed Federal Criminal Code,* 31 Vand. L. Rev. 965 (1978). In cases where both the corporation and the corporate agent have been tried together, most courts have not been troubled by inconsistent verdicts. An acquittal of the individual defendant is not grounds for the reversal of the conviction of the corporation. *See, e.g., Magnolia Motor & Logging Co. v. United States,* 264 F.2d 950 (9th Cir.), *cert. denied,* 361 U.S. 815 (1959); *United States v. Austin-Bagley Corp.,* 31 F.2d 229 (2nd Cir.), *cert. denied,* 279 U.S. 863 (1929). Similarly, an acquittal of the corporation will not absolve the individual of liability. *See, e.g., United States v. American Sociologist Society,* 260 F. 885 (S.D.N.Y. 1919), *aff'd* 226 F. 212 (2nd Cir.), *cert. denied,* 254 U.S. 637 (1920). The justification offered is that consistency in verdicts is not necessary; all that is required is that a conviction be supported by the evidence. *See, Magnolia Motor & Logging Co. v. United States,* 264 F.2d 950, 953 (9th Cir.), *cert. denied,* 361 U.S. 815 (1959). However, some courts have recognized the logical difficulty with upholding a corporate conviction where the allegedly responsible employees are acquitted. *See, United States v. General Motors Corp.,* 121 F.2d 376

been specifically forbidden and that the managers of the corporation exercised great care to prevent the illegal activities of lower-echelon agents.[6]

This author questions the efficacy of holding a corporation criminally liable where its management has diligently attempted to prevent unlawful conduct by its employees. Unquestionably, the main justification for holding corporations criminally liable is the deterrence of future criminal conduct and the encouragement of diligent supervision of corporate affairs by company managers.[7] This article will suggest that the expansion of corporate criminal responsibility to a near "strict-liability" standard undermines the deterrence function of criminal sanctions and discourages in-house corporate compliance efforts.

THE EXPANDING SCOPE OF CORPORATE CRIMINAL LIABILITY

The earliest common law authorities were of the view that corporations were not subject to criminal sanctions. Thus, Blackstone, in the *Commentaries,* noted that, "(a) corporation cannot commit treason, or felony, or other crime, in its corporate capacity; though its members may in their distinct individual capacities."[8] Early American decisions adhered to this position.[9]

However, as corporations began to play a more dominant role in American society, their immunity from corporate criminal liability began to erode, first emerging for acts resulting in a public nuisance.[10]

The leading case establishing modern doctrines of corporate criminal responsibility is *New York Central & Hudson River Railroad v. United States.*[11] In that case, the Supreme Court upheld the constitutionality of the

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[6]*See, e.g. United States v. Hilton Hotels Corp.*, 467 F.2d 1000 (9th Cir.), *cert. denied,* 409 U.S. 1125 (1972); *Continental Baking Co. v. United States,* 281 F.2d 137, 149-50 (6th Cir. 1960); *United States v. Armour & Co.*, 168 F.2d 342 (3rd Cir. 1948). A minority view, however, is that due diligence by corporate supervisors is a defense to a criminal charge against the company. *See, e.g. Holland Furnace Co. v. United States,* 158 F.2d 2 (6th Cir. 1946); Model Penal Code §2.07(5) (Proposed Official Draft 1962).

[7]*See, Coleman, Is Corporate Criminal Liability Really Necessary,* 29 S.W. L.J. 908, 919-20 (1975); *Edgerton, Corporate Criminal Responsibility,* 36 Yale L.J. 827, 833 (1927). The draftees of the Model Penal Code agree that the "ultimate justification" for imposing penal fines on corporations is the deterrence of illegal activities of corporate agents. Model Penal Code, §2.07, Comments at 148, 154 (Tent. Draft No. 4, 1955). Other arguments have also been offered in favor of corporate criminal liability. Most seem based on functional concerns. First, it is argued that the corporate business entity is so common that such liability is necessary to effectuate regulatory policy. *See* Model Penal Code §2.07, Comments at 149 (Tent. Draft No. 4, 1955). Second, it is suggested that the imposition of sanctions upon the stockholders of a corporation will prompt them to supervise the corporate business. *See* W. LaFave & A. Scott, *Criminal Law* §33 at 232 (1972). Third, it has been noted that in many cases, the corporation is the only conceivable target, either because the offense is an omission of a duty imposed only on the corporation or because the division of responsibility within the corporate hierarchy is so great that it would be difficult to fix the blame on an individual. *See,* Williams, *Criminal Law: The General Part* §283 (2nd ed. 1961); Elkins, *Corporations and the Criminal Law: An Uneasy Alliance,* 65 Ky. L.J. 73, 83 (1976). Fourth, there is concern that it may be unjust to single out one corporate employee for substantial punishment when the offense resulted from habits common to the organization as a whole. See *LaFave & A. Scott, supra,* §33 at 232. Fifth, the penal fine is seen as a device to deprive the corporation of the fruits of its illegal conduct so as to prevent unjust enrichment. Model Penal Code §2.07, Comments at 150 (Tent. Draft No. 4, 1955). Sixth, it is suggested that the imposition of vicarious liability on the corporation is less severe than if imposed upon a human principal, as the individual shareholders escape the opprobrium and incidental disabilities of a personal indictment or conviction and their loss is limited to the equity held in the corporation. Model Penal Code, §2.07, Comments at 148 (Tent. Draft No. 4, 1955). And, seventh, the importance of imposing the social stigma of a criminal conviction upon the corporation has been noted. See Elkins, *supra,* 65 Ky. L.J. at 78-80. *See* generally, *W. LaFave & A. Scott, Criminal Law,* §33 at 231-32 (1972).

[8]1 W. Blackstone, *Commentaries,* 476 (1765).

[9]See *State v. Great Works & Manufacturing Co.*, 20 Me. 41 (1841).

[10]See, *e.g. Commonwealth v. Proprietors of New Bedford Bridge,* 68 Mass. (2 Gray) 339 (1854); *State v. Morris & Essex Railroad Co.*, 23 N.J.L. 360 (1852).

the Department of Agriculture.[81] This writer strongly advocates legislation that would reward Mr. Kleberg's labors with a patent of some kind.

The development of a new breed of animal by intraspecific hybridization is a painstaking and demanding task. But it is still more difficult to create a viable (let alone fertile) interspecific, intergeneric, or interfamilial hybrid. The mule is the best-known of the hybrids, but asbras (donkey x zebra), zebroids (horse x zebra), ligers (lion x tigress), tiglons (lioness x tiger), and cattalo (cattle x bison) have been developed. Already the Canadian government maintains a small but thriving herd of cattalo. The difficulties of taking even the first step toward the development of a new breed of this kind is illustrated by the experience of the New Delhi circus, which caged a lion and a tigress together for three years before they were willing to mate.[82] The creative work involved in developing a new animal hybrid merits patent protection.

Explorers and inventors have always been a suspect lot. The general attitude toward them is evinced by the story of Pandora's Box, and by Shakespeare's conundrum, "striving to better, oft we mar what's well." In particular, the Pygmalions and the Dr. Frankensteins are distrusted.

As members of a society we will have to decide what limits, for the sake of preserving that society, must be placed on the exploitation of the New Genetics. But a patent confers only a right to exclude others from practising an invention. It does not permit an inventor to commit a prohibited act.[83] Patents on new forms of life will not, of themselves, alter our society. But I hope we will be permitted to taste the fruits of a biological technology cultivated by a sympathetic patent system.

According to Lucretius, "(e)very species that you now see drawing breadth of life has been protected and preserved. . . by cunning or by prowess or by speed. In addition, there are many that survive under human protection because their usefulness had commended them to our care."[84]

We cannot rely on natural selection to order the world for our special benefit. It is even doubtful that we can rely on Nature to assure the survival of "the fittest." The evolutionary process has sorted through only a very small percentage of the genetic possibilities; the ablest possible organisms probably have not yet seen the light of day. "Nature does not know best. Genetical evolution . . . is a story of waste, makeshift, compromise and blunder."[85]

Microbiologists, plant breeders, and animal husbandmen are continually attempting to "improve on nature." But they compete for venture capital with those technologists benefitted by patent protection, and thus far they have lost the unequal struggle. Only a comprehensive grant of biological patent protection can rectify the situation.

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[81]D. C. Rife, Hybrids 47-53 (1965).

[82]Id., 62-84.

[83]*See In re Hartop, supra* note 39, 135 USPQ at 430 (concur. op., Smith, J.) (thalidomide). *But cf. Isenstead v. Watson*, 157 F. Supp. 7, 9, 115 USPQ 408 (D.C. 1957).

Conclusion

> Nothing remains forever what it was. Everything is on the move. Everything is transformed by nature and forced into new paths. One thing, withered by time, decays and dwindles. Another emerges from ignominy, and waxes strong. So the nature of the world as a whole is altered by age.
>
> Lucretius
> DE RERUM NATURALIS

The quagga, the Moa, the dodo, the passenger pigeon, the auroch and the heath hen are already extinct. Only the conscious effort of mankind has kept the bison and the "whooper" from sharing their fate.[73]

But only the higher animals have been assured of accommodations on the Conservationists' Ark. David Richardson's THE VANISHING LICHENS[74] did not arouse a public outcry, and the conservationist movement is unlikely to mobilize to prevent the disappearance of a rare species of microorganism. Yet "every one of the arguments adduced by conservationists applies to the world . . . of microbes."[75] A microscope is necessary to appreciate the beauty of a hydra or a diatom, but they are beautiful nonetheless. The study of *Escherida coli* has greatly increased our understanding of biochemistry and genetics. The extinction of the mycorrhizial fungi would have grave ecological repercussions.

Under *Bergy,* the patent system provides incentive for efforts to preserve rare and unusual strains of microorganisms in "biologically pure" cultures, filed in public depositories.[76] These cultures are comparable to the game preserves and botanical gardens which conserve higher forms of life.

Thus far, the main motivation for protecting a particular strain of microorganism has been its individual industrial utility. The New Genetics, however, forces us to consider *every* organism a mine of genetic material, some of it perhaps unique to the organism under study. The extinction of an organism may be as unfortunate to us as a society as the loss of a piece of jigsaw puzzle would be to an enthusiast living alone in a wilderness cabin.

> What is clear is the importance of conserving existing microbial resources because of genetic potential that could at any moment prove of inestimable value for human welfare. In this context, the smallpox virus, the plague bacillus and the bacteria that cause VD are potentially as important as are microbes that fix nitrogen, photosynthesize, digest cellulose . . . We simply do not know what part of the genetic material of such microorganisms will suddenly become of vital practical importance.[77]

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[73]R. Silverberg, The Dodo, the Auk and the Oryx (1967).
[74]D. Richardson, The Vanishing Lichens (1974).

> is crossed in the first step of the process with a *Rote Romertaube,* the doves resulting from this crossing are selected according to size and color, a selected product of said crossing is bred in the second step with a *Roter Messenkropfer,* of the doves obtained one again is selected and bred in the third step with an *Altdeutscher Kropfer.*[65]

The claim was rejected on grounds akin to those espoused by the CCPA in *Merat.* The *Dundesgerichtshof* concluded:

> In the present case, as is evident from the findings of the Patent Office, the method for breeding a dove . . . is not repeatable . . . the disclosure of the breeding method in the patent specification and its characterization in the claim [will] not ensure a genetically identical repetition of such breeding method and under no circumstances can it be assumed that the same genetic results would be obtained with a high degree of certainty. The initial animal species are characterized in a general manner according to their kind without indicating individual hereditary characteristics. Therefore, in attempting to repeat the breeding method, a person skilled in the art would be required to use such animals that might correspond to the described kind with respect to their looks. The 2-step selection is directed to two characteristics which, however, are defined only in general terms (size and color). Carrying out the steps of selection thus still leaves room for many variations, also because the phenotypical approach does not promise a sufficiently predetermined result. The above reasons do not permit the conclusion with certainty that the breeding method can be repeated, particularly since we are here concerned with breeding an animal in the upper range of the evolutionary scale, and having complex hereditary characteristics.[66]

Those responsible for drafting patent applications directed to new breeds of animals would be well-advised to (1) state where the required breeding stocks (or sperm and egg banks) are *available;* (2) use a *genotypic* selection scheme if possible; (3) use a *quantitative* selection rule if a phenotypic selection scheme is used; and (4) claim that the breeding method is *statistically* reliable.

The reason, of course, why the selection scheme is so important, is that we cannot asexually reproduce the new animal breed from a cell culture, as we might a new strain of microorganism. Animal husbandmen cannot fully exploit the *Argoudelis*[67] route to enablement until cloning technology is perfected. While any cell holds within it the blueprint of the entire organism, and it is theoretically possible to grow a clone goose, horse, or elephant, practice has yet to merge with theory, but soon it may:

> Drs. King and Gordon of Oxford made carbon copies of frogs. . . . They took the nucleus from an unfertilized frog's egg and replaced it with another from a culture of cells from an adult frog. Then the egg was stimulated artificially—a needle prick is all it takes—and it began to develop. An adult did not grow immediately. The nuclear transplantation had to be repeated through a whole series of unfertilized eggs, but eventually adult frogs were produced—from one single cell in culture.[68]

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[65]1 IIC 136 (Bundesgerichtshof, March 27, 1966).
[66]Id., 141-2.
[67]*See In re Argoudelis,* 434 F.2d 1390, 1392-3 (CCPA, 1970): D. G. Daus, *Conditionally Available Cultures: An*

when Prince Gwydion learned that Pryderi, one of the rulers of the Welsh Hades, had received a new kind of animal as a gift, Gwydion stole these wondrous beasts—pigs—for "(a) new race of beasts might prove precious to Gwynedd," his kingdom.[55]

The invention of the stirrup made mounted shock combat possible, but a new breed of horse was needed to bear the heavily armored knight. Deliberate selective breeding for the chivalric market began at least as early as 1341.[56] The new war horses contributed to the development of the institution of feudalism.

In more recent times, pack mules made possible the construction of the transcontinental railroads.[57]

A very large number of animals have been domesticated. A partial list would include dogs, cats, goats, cattle, sheep, horses, pigs, chickens, rabbits, camels, reindeer, mink, elephants, bees and silkworms.[58] These domesticated animals differ greatly from their wild ancestors.

> The wild ancestors of cattle gave no more than a few hundred grams of milk; the best milk cow now can yield 12,000 to 15,000 liters of milk during its lactation period. . . . In the ancestors of domestic sheep, wool consisted mainly of thick rough hairs and a small amount of down; the total weight of wool never reached one kilogram. The wool of present-day fine-fleeced sheep consists of uniform, thin down fibers; the yearly total weight may reach 20 kilograms. . . . Even at the initial stages of domestication, some morphological changes in animals and plants are apparent. In mink, for example, which became the objects of breeding for fur in about 1920, there have already appeared more than 20 different variations of fur colour and several variations in fur texture.[59]

Domestication accelerates evolution, adapting wild creatures to serve Man's needs and desires.

In short, utility patent protection for "new" animals (and plants) is entirely consonant with the Constitutional purpose of the Patent System—the promotion of the progress of the useful arts. Since 35 U.S.C. § 101 does not expressly exclude them from protection as new manufactures, such protection should be accorded by the Courts, even under present law. However, as applicants for *utility* (35 U.S.C. § 101) patents must *strictly* comply with the requirements of Section 112, it behooves us to consider whether the patent law as presently constituted in fact offers any incentive to the development of new and useful multicellular organisms (other than a sexually reproduced plants). The flaws of the present system can, once recognized, be eliminated by carefully drafted reformatory legislation.

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[55]C. Squire, Celtic Myth and Legend, 308-11 (1975).
[56]L. White, Jr., Medieval Technology and Social Change, 62 and n. 1 (1962).

(Like Judge Rich, von Pechmann compares the usual microorganism to a "reagent or catalyst."[37])

Unfortunately, von Pechmann's reasoning does not comport with the real world. Bacterial or algal cells with especially high food value have been developed to directly satisfy human appetites just as do the fruits of new varieties of citrus trees. On the other hand, many multicellular organisms act as reagents or catalysts: honeybees, silkworms, milk cows and pearl oysters. The von Pechmann distinction between patentable and unpatentable organisms is untenable and unworkable.

The Constitutional Mandate

In *Bergy,* the Board of Appeals expressed its fear that "(i)f we were to adopt a liberal interpretation of 35 U.S.C. § 101, new types of insects, such as honeybees, or new varieties of animals produced by selective breeding and cross-breeding would be patentable."[38] In *Chakrabarty,* the Board elaborated on this theme by saying that if Section 101 encompasses genetically engineered microorganisms, "why would not 35 U.S.C. § 101 encompass living multicellular organisms (including human beings) which have been modified by the physical incorporation (as by artificial transplants) of additional organs such as the liver or heart?"[39] And Gerald Bjorgy, arguing *Chakrabarty* for the Office, said that while his children's cat might be "a better mousetrap," it surely should not be patentable.[40]

The PTO apparently expected that these comments would send shock waves of revulsion up and down the patent community. It had perhaps forgotten that Glascock,[41] Rossman,[42] Dienner,[43] Parker,[44] Thorne,[45] Walker,[46] and the A.B.A.[47] had all applauded efforts to protect the contributions of the animal husbandman. (And the Fifth and Fourteenth Amendments surely would frustrate any attempt to patent human beings, even genetically engineered human beings.[48])

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[37]Id., 300.

[38]Tr., 63.

[39]Tr., 95.

[40]Oral Argument, *Chakrabarty,* Pat. App. No. 77-535 (argued on December 5, 1977, before the CCPA).

[41]Glascock and Stringham, Patent Soliciting and Examining 591 (1934) citing Rossman, *The Preparation and Prosecution of Plant Patent Applications,* 17 JPOS 632, 643-4 (1935): "The plant law should . . . logically be extended to all forms of plants, . . . The next step would be to enact a law for patenting novel types of animal life."

[42]Id.

[43]Dienner, *Patents for Biological Specimens and Products,* 35 JPOS 286, 289-90 (1935).

[44]Hearings Before the Committee on Patents, House of Representatives on H.R. 11372, A Bill to Provide for Plant Patents, 71st Cong., 2nd Sess., at 4 (April 9, 1930): "Col. Francis W. Parker . . . felt that some day the patent law would be amended so as to give to the man who developed new forms of plant or animal life an opportunity to control reproduction."

[45]Thorne, *Relation of Patent Law to Natural Products,* 6 JPOS 23, 27-8 (1923).

[46]Arguments Before the Committee on Patents of the House of Representatives on H.R. 18851, 59th Cong., at 18 (May 17, 1906).

logical patent policy, clarifying the patent status of "mixed cultures,"[26] pathogenic organisms,[27] and multicellular organisms.[28] The most urgent task awaiting Congress—regulation of recombinant DNA research aside—is the resolution of the question, should multicellular organisms be patentable?

The Multicellular Organism Patent Question in the Courts

In 1969, a chicken breeder filed a claim on a new strain of chicken, obtained by cross-breeding dwarf hens with "normal" cocks of heavy meat strains. The claim, phrased in product-by-process form, was rejected by the examiner under 35 U.S.C. §§ 101, 112. The appeal, titled *In re Merat,* was denied by the CCPA without reaching the Section 101 issue.[29]

Bergy did not answer the question posed but not decided in *Merat:* whether living things, generally, are patentable. Judge Kashiwa, in his special concurring opinion, remarked, "while the PTO and the dissenting opinion raise the specter of patenting higher forms of living organisms, quite clearly the majority opinion does not support such a broad proposition. Each case must necessarily be considered on its own facts."[30]

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[26]In *Funk Bros. Seed Co. v. Kalo Inoculant Co.,* the Supreme Court invalidated Bond's claim to "an inoculant for leguminous plants comprising a plurality of selected mutually non-inhibitive strains of different species of bacteria of the genus *Rhizobium* said strains being unaffected by each other in respect to their ability to fix nitrogen in the leguminous plant for which they are specific. . . .(335 U.S. 127, 128 n. 1 (1948)). It was the general practice, prior to the Bond patent, to manufacture and sell inoculants containing only one species of root-nodule bacteria. The inoculant could therefore be used successfully only in plants of the particular cross-inoculation group corresponding to this species. Thus, if a farmer had crops of clover, alfalfa and soy beans he would have to use three separate inoculants. There had been a few mixed cultures for field legumes. But they had proven generally unsatisfactory because the different species of the Rhizobia bacteria produced an inhibitory effect on each other when mixed in a common base, with the result that their efficiency was reduced. Hence it had been assumed that the different species were mutually inhibitive." (Id. 137) Bond had discovered that mutually non-inhibitive strains existed, and developed techniques for identifying workable combinations. Justice Douglas' convoluted reasoning was that Bond had made two scientific contributions, the first of which *could* not be rewarded by the patent system, and the second of which was *unworthy* of reward. Douglas would not reward the discovery of the fact that mutually non-inhibitive species existed because "patents cannot issue for the discovery of the phenomena of nature." And he refused to reward the identification of workable combinations because ". . . once nature's secret of the non-inhibitive quality of certain strains of the species of Rhizobium was discovered, the state of the art made the production of a mixed inoculant a simple step." Even if Douglas' bifurcation of the inventor's contribution were justifiable, he built his syllogism on a false premise. The production of a *compatible* mixed culture remained a very difficult task. Casida, Industrial Microbiology 161-3 (1968): "Simultaneous growth of two fermentation organisms in a single medium presents a problem in microbial ecology. Each organism must contend with the physiological growth, and nutrient utilization activities of the other, and it is likely that their growth rates will differ so that one organism will outgrow the other. Thus, extensive studies of media and other fermentation conditions are required to balance the growth of the . . . organisms." Unfortunately, the Supreme Court, even when it is wrong, is still Supreme, and Congressional intervention may be necessary if the damage caused by *Funk Bros.* is to be repaired.

[27]In Europe, MPC Art. 53(a) prevents the issuance of patents on "inventions the publications or exploitation of which would be contrary to 'ordre public' or morality." Arguably, pathogenic organisms, even if they had prosaic industrial uses, would be unpatentable, because of the health risk to laboratory workers in particular, and the public in general. For studies of lab worker infections, see Frederickson *supra* note 3, Vol. I., at 372-405 and 528-9.

In this country, case law insists that inventions "injurious to the morals, health, or good order of society" are unpatentable. *Bedford v. Hunt,* 1 Mason 302, 3 Fed. Cas. 37 (No. 1217) (C.C.D. Mass. 1817) (J. Story). However, if the invention is only sometimes injurious, and possesses a beneficial use, it may be patentable. *Fuller v. Berger,* 120 F. 274 (7th Cir., 1903); *Cf. In re Hartop,* 311 F.2d 249, 135 USPQ 419 (CCPA 1962). The court will consider the risk to the operator as well as to the user, and balance the benefits against the risks. *Mitchell v. Tilghman,* 86 U.S. (19 Wall.) 396-7, 411-2 (1874). Surprisingly, no question was raised as to the safety of a patented process for manufcturing scarlet fever serum, even though some risk must have existed. *Dick v. Lederle Antitoxin Labs.,* 43 F.2d 628, 6 USPQ 40 (S.D.N.Y. 1930).

Congress may wish to condition the issuance of patents on pathogenic organisms on obedience to appropriate containment standards. Compare Section 6 of S. 621, *supra* note 20.

[28]Certain multicellular organisms (vascular plants) already receive a form of patent protection. See 35 U.S.C. § 161 et seq.

ment[14] provides that "vegetable varieties or animal breeds, (or) essentially biological procedures for obtaining them" are "not patentable." Arguably, microorganisms, which some scientists refuse to classify in either the animal or vegetable kingdom, could still be protected. But even microorganism protection is foreclosed in Brazil, where "varieties or species of microorganisms" were expressly made unpatentable in 1971.[15]

Japan and the United States are the most important industrial countries lacking statutory provisions dealing specifically with microbiological invention. However, Wegner suggests that Japan will allow microorganism patent claims:

> Generally, as pointed out by the German Federal Supreme Court in its [RED DOVE] and [BAKER'S YEAST] decisions, the patentability of a microorganism invention depends upon the question of whether the microorganism invention is patentable *as a chemical invention.* Accordingly, in those countries such as Italy where no patent protection is provided for even the traditionally synthesized organic compound, *a fortiori* the patenting of a microorganism, per se, would be out of the question. In Japan, the new law of May 29, 1975, provides for the protection of chemical products, per se, for the first time. . . .[16]

Domestic Overview: Congress

In the United States, Congress has only slowly awakened to the need for a definitive determination of the patentability of new forms of life. In 1930, it enacted the Plant Patent Act,[17] and, in 1970, the Plant Variety Protection Act.[18] Recently, several members of Congress have responded to the public debate over the advisability of recombinant DNA research[19] by proposing regulatory legislation.

S. 621, "A Bill to Provide for Guidelines and Strict Liability in the Development of Research Related to Recombinant DNA," provides for an important restriction on the patentability of recombinant DNA inventions:

> Notwithstanding any other law, no patent shall be granted on any procedure or organism which results from research on recombinant DNA unless all applicable guidelines have been strictly adhered to, and a full and complete disclosure had been made with regard to such process or organism.[20]

H.R. 7897, the other major legislative proposal, does not deal with the patent aspects of the recombinant DNA controversy.[21]

Domestic Overview: The Patent and Trademark Office (PTO)

Obtaining a patent may take several years, and the PTO has recognized

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[14]2G SINNOTT Andean Pact-3. For similar provisions, see 2E SINNOTT Poland-2; 2E SINNOTT Mexico-3.

[15]2B SINNOTT Brazil-4.

[16]Wegner, *supra* note 12, at 236.

[17]35 U.S.C. § 161 et seq.

[18]7 U.S.C. § 2321 et seq.

[19]The following is a proposed legislative definition of recombinant DNA: "molecules that consist of different segments of deoxyribonucleic acid which have been joined together in cell-free systems to infect and replicate in some host cell, either autonomously or on an integrated part of the host's genome."

PATENT PROTECTION FOR NEW FORMS OF LIFE

By Iver Peter Cooper

The patent system is the mechanism by which our society encourages progress in the "useful arts." In two recent cases, the Court of Customs and Patent Appeals (CCPA) rescued microbiological research from a situation of near neglect by the patent system, holding that "recombinant DNA organisms"[1] and "biologically pure cultures" of naturally occurring microorganisms, are patentable.[2] The CCPA decisions represented a commendable attempt to cope, within the preexisting legal framework, with the great advances in biological technology. The Supreme Court, troubled by CCPA's elastic interpretation of the patent statute, asked the CCPA to reconsider.[3] Even if, in the final stage of the litigation, the Supreme Court condones the liberal CCPA approach*, the courts will still be engaged in pouring new wine into old bottles. It is Congress which must answer the ultimate question, "under what circumstances should new forms of life be patentable?"

This question has been given some consideration, both here and abroad. A handful of foreign legislatures have squarely addressed the biological patents question, and there is at least a hope of domestic legislation in the near future.

International Overview

The Hungarian Law on the Protection of Inventions by Patents (No. 2 of 1969, Article 6(2)) provides that "plant varieties and animal breeds and processes for obtaining them shall be patentable if the variety or breed is new, homogeneous, and relatively stable."[4]

**Ed. Note*—On March 29, 1979, after this article had gone to press, the Court of Customs and Patent Appeals decided that *Parker v. Fleck* (cited by the Supreme Court) had no relevance to its *Bergy* and *Chakrabarty* decisions, and again reversed the Patent and Trademark Office's rejection of the "living matter" claims in *Bergy* and *Chakrabarty*.

Note: The following abbreviations are used below: CCPA, Court of Customs and Patent Appeals; USPQ, United States Patent Quarterly; JPOS, Journal of the Patent Office Society; IIC, International Review of Industrial Property and Copyright Law; PTO, Patent and Trademark Office.

[1] *In re Chakrabarty*, 571 F.2d 40, 197 USPQ 72 (CCPA 1978). The applicant claimed a *Pseudomonas aeruginosa* containing stable CAM, OCT, SAL and NPL plasmids, and a *P. putida* containing stable AM, SAL, NPL and RP-1 plasmids. *See Charkrabarty* Tr., 116-7. These were genetically engineered organisms created by transferring to a parental *Pseudomonas* cell plasmids (estrachromosomal genetic matter) taken from other organisms. By patented techniques, these plasmids were caused to function in their new home. The progeny of the genetically improved organism received the capability to degrade camphor, octane, salicylate, and napthalene. GE, the asignee of the application, planned to use the "GEO" to "clean up oil spills." Chakrabarty's patent disclosure is highly technical, and it may be advisable for the lay reader to first consult Cooke, Improving on Nature 152-63 (1977).

[2] *In re Bergy*, 563 F.2d 1071, 195 USPQ 344 (CCPA 1977). The applicant claimed "a biological pure culture of the microorganism *Streptomlyces vellosus*, having the identifying characteristics of NRRL 8037, said culture being capable of producing the antibiotic lincomycin in a recoverable quantity upon fermentation in an aqueous nutrient medium containing assimilable sources of carbon, nitrogen and inorganic substances." This was a naturally occurring organism isolated and nurtured by standard microbiological techniques. *See* Casida, Industrial Microbiology (1968).

[3] See J. D. Kiley, *Common Sense and the Uncommon Bacterium — Is "Life" Patentable*, 60 PJOS 468-74 (July, 1975).

municipal power supply agencies will seek membership in a power pool or access to coordinated operation and development.

Two areas of growth are possible. First, ten to twenty large tight pools could develop serving as many regions of the country. Interpool operations would be largely for reliability purposes because each pool would, by itself, be capable of achieving economies of scale. All utilities seeking access to coordinated operation and development would be forced to become full pool members. Each pool would function as a regional power supply monopoly. Over time, it may be anticipated that each pool would act more and more like a separate entity distinct from each pool member.

Under present rate regulation at the state level, the cost of power purchased from the pool, or obtained from the pool, would for all practical purposes simply flow through to the ultimate consumer. States would retain some measure of control through the power to deny certificates of convenience and necessity for the construction of pool facilities. However, states would be powerless to regulate the rates, terms and conditions of pool transactions.

The other alternative is the development of a number of loose pools in which transmission services are freely available, and firms are free to pick and choose their trading partners. Each firm's management would be free to develop what it believes to be the optimum mix of coordinated operations and development transactions to supply the firm's particular retail load. Increased competition among large firms to sell coordinating services to small firms would develop. The spur of competition should lead to increased efficiency, increased innovation and a decrease in reserve capacity. Management, long protected from the vigors of competition, would be forced to become more skillfull.[72]

As competition develops for coordination services, the ability of any one firm to accurately predict the demand for its product will decrease. Present rate regulation techniques presume that costs of production and demand can be predicted with reasonable accuracy. If the demand faced by the individual firm becomes more elastic, the ability of regulators to regulate diminishes. And as the degree of competition in the market increases the justification for regulation diminishes. Moreover, regulatory lag in the setting of rates for wholesale power and pooling transactions will make the rate offered for many proposed transactions uncertain. Where the rate at which a service is offered may not be determined until the regulatory commission renders a decision five years hence, the opportunities for price competition are diminished. Rather than comparing set prices, the shopper will be forced to compare zones of prices in which it guesses the final price might fall. Thus, rate regulation at this level will actually be a barrier to competition.

Other barriers to competition will have to be overcome also. Wholesale power supply contracts tend towards long term all requirements contracts. Such contracts do provide an element of certainty to power supply planning for both parties to the contract. At the same time, such contracts limit compe-

Otter Tail decision provides a legal basis for eliminating the transmission bottleneck.[63] The ability to transmit power among and between small utilities will permit them to aggregate their loads to jointly construct large scale generation of their own. In the alternative, small utilities wishing to purchase power at wholesale will be able to shop for power from several suppliers.

However, in most areas, even aggregating the loads of all municipal systems in economic transmission range will not permit economic utilization of the largest generating plants. To insure the optimum utilization of resources, small utilities must have the option of either joining power pools or participating as joint owners in certain pooled units together with the chance to participate in coordinated operations.

Large utilities have strongly resisted efforts of small utilities to join power pools or share ownership. The stated reason is that the transaction costs of including many small utilities in a pool far exceed any economic value to either the large pool members or the small utilities.[64] Frequently, the argument is made that pooling arrangements between large and small utilities lack mutuality. Thus, it is argued, a large utility can provide emergency power to a small utility in meaningful quantities while the amount of emergency energy which the small utility can provide the large utility is so negligible as to be valueless. The Federal Power Commission rejected the mutuality argument on the grounds that mutuality can be found in dollar payments made by the small utility for emergency energy taken.[65] In fact, the arguments advanced to defend exclusion of small utilities from power pools are, for the most part, camouflage for a philosophical dislike of public power and a desire to obtain a competitive edge.

There has been a strong trend in the law to pry open power pools to admission of small utilities. Since the Federal Power Commission was unwilling to take such action, its record in support of competition is unimpressive. The main arena has been the Nuclear Regulatory Commission, through its obligation to review applications for licenses to construct and operate nuclear power plants, to insure that the issuance of such a license will neither create nor maintain a situation inconsistent with the antitrust laws.[66]

Most of the antitrust review proceedings before the NRC have resulted in negotiated settlements in which the applicants agree to license conditions which permit small utilities to participate as joint owners of large nuclear power plants, to utilize the transmission lines and to transact for the various coordinating services available in power pools.

The legal theories supporting the opening of power pools are the traditional ones developed over the years in Sherman Act cases. Thus, individual pool members may be charged with various acts of monopolization and con-

[63] 410 U.S. 366.

[64] Such arguments were made before the Nuclear Regulatory Commission in the Davis-Besse license proceedings.

be equal to the capacity of the largest single unit on the system. Much more sophisticated measurements are available involving the application of probabilities, but the targeted level of reserves remains a judgment matter. For most power pools, reserves are targeted between 20-25%.

Reserve capacity is an expensive element of production which is capable of substantial reduction through reserve sharing. For example, two electrically isolated systems each serving a 10 MW load could do so by each having 10 MW of capacity serve the load, plus 10 MW of capacity in reserves. In total the two utilities would serve 20 MW of load with 40 MW of reserves. By interconnecting and sharing reserves, the two firms could serve 30 MW load with the same 40 MW of capacity and still meet the largest unit reserve standard.[53] Moreover, by sharing reserves, firms can install larger sized units to capture economies of scale.

Large scale generating units generally exceed in capacity the annual load growth of the firm installing the unit. To be economical, some means must exist for disposing of the excess capacity. This leads to joint planning and construction of large generating units. Typically this is done by shared ownership of units or by staggard construction.[54] In the latter case, firm A constructs a unit and sells excess power to B for several years and then firm B installs a unit and sells excess power to A. The joint planning and installation of power production and transmission facilities is commonly referred to as coordinated development.

Additional economies may be derived from coordinated operations. Neighboring utilities may face their peak demands during different seasons of the year. Since electricity cannot be stored, generating capacity must be available to meet peak demands which may occur for only two or three months and be 20% to 40% greater than the demand for the remainder of the year. Seasonal diversity power sales permit firms to reduce the amount of capacity required to meet seasonal peak demands.[55]

Firms may also exchange economy energy. Nearly every utility has several generating units each with a unique cost of operation. On a daily and hourly basis generation is assigned to the least costly units. An attempt is made to equate marginal cost for each plant.[56] For economy, energy exchange load dispatchers from firms will consult each other and the firm able to generate at the lowest cost will generate. Sales of economy energy are typically made on a split the savings basis.

Firms also buy and sell maintenance energy for periods when units are down for repair. Maintenance schedules maybe coordinated among firms.

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[53]Other examples of the economies available from reserve sharing may be found in Gainesville Utilities v. Florida Power Corp., 402 U.S. 515 at 519 fn. 3, and in Meeks, "Concentration in the Electric Power Industry", 72 Columbia Law Rev. 64, For a general discussion of the characteristics of the industry see Meeks, *op. cit.*, and the decision of the Nuclear Regulator Commission Appeal Board in *Consumers Power Company,* ALAB 452, _____ NRC _____ issued Dec. 30, 1977. For a discussion of power pooling see Edison Electric Institute, *Principles of a Coordination Agreement* and FPC, 1970, *National Power Survey.*

[54]Edison Electric Institute, *Methods of Owning and Selling Generating Capacity.*

[55]The same may be true for a municipal system peaking at 8 a.m. and a neighboring system with a large industrial load peaking at 2 p.m. Even time zone diversity sales may occur.

Franchise competition may be the most important type of competition at the distribution level. Competition for individual customers tends to be a one-time thing and a customer once acquired is served forever.[43] There are, of course, exceptions.

Dr. Stelzer has testified that yardstick competition, in the form of small independent utilities at the distribution level, may be an important incentive to efficiency for regulated companies.[44] Dr. Stelzer also testified that while local distribution remains a monopoly, the identity of the monopolist may be open to competition. He characterized this as a form of potential competition in that the utility currently serving a locality may be supplanted if it fails to perform adequately.[45]

If franchise competition provides a spur to better utility performance, it follows that territorial legislation which does not provide for franchise competition will have a tendency toward misallocating resources.

Even where franchise competition is permitted, it probably will not occur if transmission service over the existing suppliers transmission lines is not available. The expense of constructing new transmission lines is a strong disincentive to franchise competition. The limited power of the Federal Energy Regulatory Commission to order a utility to transmit power for another utility may not accommodate franchise competition.[46] Transmission services could be ordered to remedy an anticompetitive situation after a successful antitrust action.[47] Again the cost of an antitrust proceeding could easily surpass the economic gain to the plaintiff from obtaining the franchise.

Assuming natural monopoly at the distribution level, the benefits of territorial legislation apply only to direct head to head competition for retail customers. Such competition is rare. If natural monopoly exists, a utility will not ordinarily contest an existing supplier knowing that his costs will exceed those of his competitor at least until he captures 50% of the market. Even then, the existing supplier is likely to have lower embedded costs.

The competitor would be forced to subsidize the service in the competitive area from profits earned elsewhere. Head to head competition would only be expected where the existing supplier charges are too high or service is inadequate. It is in just such a situation that competition should be allowed.

More typically, head to head competition occurs on the fringes of service areas where new subdivisions are constructed or new industries locate. Otherwise head to head competition occurs when a large powerful vertically integrated utility hopes to drive a smaller utility out of business. In those situations, it is better to improve the competitive ability of the smaller utility than to preclude competition.

It has been observed that the present situation in the electric utility industry is an anomalous one. At the federal level, steps are being taken to pro-

[43] 5 NRC 133, p. 194.

[44] Dr. Stelzer testimony before the Nuclear Regulatory Commission, Consumers Power Company (Midland Plant, Units 1 and 2) Docket Nos. 50-329A and 50-330A.

Regulation of the electric utility industry is fragmented. The distribution function is, for the most part, subject to regulation by states or their political subdivisions.[27] States have no power to regulate sales or transmission of power in interstate commerce.[28] Thus, sales of bulk power for resale and other interconnected power pooling arrangements of electric utilities, connected directly or indirectly to an electric utility in another state, are subject to regulation by the Federal Energy Regulatory Commission under the Federal Power Act.[29]

No regulatory body has comprehensive authority to regulate the electric utility industry. At the federal level, Congress has rejected a pervasive regulatory scheme for interstate distribution of electricity in favor of voluntary commercial relationships,[30] while the states are limited in their power to regulate interstate commerce. Although regulation of distribution is primarily a matter for state regulation, the system of dual regulation does not follow functional lines. Despite federal regulation of sales and transmission associated with wholesale sales, the states also play a role in regulating the generation and transmission function. Typically, states regulate power plant siting and the right to construct generation and transmission facilities.[31]

It should not be surprising that the system of dual regulation often works in contradiction. Nonetheless, the vice-chairman of American Electric Power, one of the largest public utility holding companies, has argued that "the regulation of electric power supply has been effective in achieving its underlying objectives; and I believe the evidence is overwhelming that it has furthered the public interest."[32] Others have been more critical. It has been argued that the effects of regulation are a tendency towards excess capacity and peak period use, a tendency to hold off new competition and to stand in the way of formation of an efficient national power grid and a competitive bulk power supply.[33] At least one econometric study has shown that on the average the regulated rates of private utilities are only slightly below the expected level of monopoly prices.[34]

Professor Turner has noted that regulation tends to encourage uneconomical pricing of some services and may encourage a bias towards more extensive investment in capital than would otherwise be made.[35] Dr. Wein has testified that regulation can not make a firm more efficient; it cannot force innovation. Regulation does not provide those dynamic pressures for efficient operation faced by a firm in a competitive industry.[36]

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[27]Cohn, *op. cit.* pp. 217-18.

[28]Public Utilities Commission of Rhode Island v. Attleboro Steam & Electric Company, 273 U.S. 83 (1927).

[29]FPC v. Southern California Edison Co., 376 U.S. 205 (1964), rehearing denied 377 U.S. 913; Arkansas Power & Light Co. v. FPC, 368 F 2d 376 (1966).

[30]Otter Tail Power Company v. United States, 410 U.S. 366 (1973).

[31]Colorado Revised Statutes 1973, 40-5-101; Section 332, Title 48, Code of Alabama, 1940 (Recemp. 1958).

[32]Cohn, *op. cit.* p. 218.

[33]Wilcox and Shepherd, *op. cit.* pp. 417-18.

[34]Moore, "The Effectiveness of Regulation of Electric Utility Prices", 36 Southern Economic Journal 365 (1970).

[35]Turner, "The Scope of Antitrust and Other Economic Regulatory Policies", 82 Harvard Law Review 1207, 1232. Other writers have noted the tendancy towards overcapitalization of regulated utilities. Averch and Johnson, "Behavior of the Firm Under Regulatory Constraint", American Economic Review, vol. 53 (December 1962); Bailey and Malone, "Resources Allocation and the Regulated Firm," The Bell Journal of Economics and Management Science, vol. 1, No. 1 (Spring 1970).

quired to make service available to all in its service area to the extent desired by the consumers, at a fair and reasonable price.[7]

Current literature is calling into question the theoretical underpinnings of regulation by questioning the natural monopoly character of the electric utility industry. The electric utility industry performs three basic functions: generation, transmission and distribution to the ultimate consumer.[8] The economic characteristics at each functional level are different. About three quarters of the industry is privately owned by 200 firms in which all three functions are vertically integrated.[9] The remainder of the industry is comprised of hundreds of small systems frequently publicly owned and operating only at the distribution level and a few large vertically integrated public power systems such as TVA. There are also a few entities which operate primarily at the generation and transmission level such as the Power Authority of the State of New York. Each functional level must be considered separately in determining whether natural monopoly characteristics occur because economies of vertical integration are relatively moderate.[10]

At the distribution level it is generally assumed that natural monopoly most clearly exists due to the inefficiency of duplicating the supply network.[11] However, even at this level, the existence of economies resulting from horizontal integration of various distribution systems has been questioned.[12] More basic, the existence of natural monopoly cost structure at the distribution level has been questioned by a recent study by Walter Primaux. Primaux notes that while natural monopoly is widely assumed, the literature provides no empirical study to support the assumption. A study made by Primaux demonstrated that costs were actually less in cities having two electric suppliers, at least for cities of certain sizes.[13]

At the generation level the past two decades have seen a rapid increase in the economies of scale through larger generating units and boilers. However, it appears that the economies of scale have at least for a time reached a technological plateau.[14] Units in the magnitude of 1200 megawatts are on the technical frontier.[15] The important factor at the generation level is that the economies of scale may be exploited by a sharing of units by one or more electric utilities. The five utilities of the Central Area Power Coordination

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[7]Cohn, "The Rationale and Benefits of Regulation", 45 Antitrust Law Journal, p. 217.

[8]Meeks, "Concentration In The Electric Power Industry: The Impact Of Antitrust Policy", 72 Columbia Law Review 64, 67.

[9]Wilcox and Shepherd, *op. cit.* p. 395.

[10]*Ibid.* p. 397. See also, Weiss, "Antitrust In The Electric Power Industry", *Promoting Competition In Regulated Markets*, Almarin Phillips, Editor, The Brookings Institution 1975.

[11]*Ibid.* p. 397.

[12]Harold Wein, Testimony before the Nuclear Regulatory Commission, in Alabama Power Company (Joseph M. Farley Nuclear Plant, Units 1 and 2) Docket Nos. 50-348A and 50364A.

[13]Primaux, "The Monopoly Market In Electric Utilities", *Promoting Competition In Regulated Markets*, Almarin Phillips, Editor, The Brookings Institute, 1975.

[14]Wilcox and Shepherd, *op. cit.* p. 397.

Sherman and FTC Acts[164] permit state courts to scrutinize the need for state programs and competition. In this process *state* courts applying state laws favoring competition may properly employ "exemption" analysis to anti-competitive state regulation.[165] While exemption analysis is improper to resolve a conflict between federal and state regulatory schemes, it is appropriate on the state level since it requires the reconciliation of the statutes of a single sovereign—the state. Through this use of "exemption" analysis of state statutes, the goals of competition can be reconciled to the goals of regulation, with competition being displaced only where necessary to make a state regulatory system work, without infringing the concerns of federalism expressed in *Parker* and *National League of Cities.*

[164]The enactment of state antitrust laws antidates passage of the Sherman Act. Kansas enacted the first antitrust statute in 1889. J. VonKalinowski, *State Antitrust Laws,* 29 *ABA Sec. on Antitrust Law,* 256 (1965). When the Sherman Act was passed in 1890 thirteen states had enacted antitrust legislation. H. Thorelli, *The Federal Antitrust Policy,* 155 (1955). Senator Sherman recognized the potential impact of state antitrust laws, and their interface with the federal Act: "This bill [the Sherman Act] . . . has for its . . . single object to invoke the aid of the courts of the United States to deal with the combinations . . . when they affect injuriously our foreign and interstate commerce . . . and in this way to supplement the enforcement of the established rules of the common and statute law by the courts of the several states in dealing with combinations that affect injuriously the industrial liberty of the citizens of these States. It is to arm the Federal Courts within the limits of their constitutional power that they may cooperate with the State courts in checking, curbing, and controlling the most dangerous combinations that now threaten the business, property, and trade of the people of the United States." 21 Cong. Rec. 2457 (1890) (Remarks by Senator Sherman).

[165]For a federal analogy, *see* Silver v. New York Stock Exchange, 373 U.S. 341 (1963) (reconciling the Securities Exchange Act of 1934 with the Sherman Act).

but do not violate the Constitution. While the Supreme Court in *Goldfarb*[148] and *National Society of Professional Engineers*[149] has limited price fixing agreements among professionals, state regulations which met the criteria for state action[150] may be anticompetitive. The problem is illustrated by assuming that in *Goldfarb* the Supreme Court of Virginia had actively promulgated and supervised price fixing among lawyers. In this illustration, the antitrust laws would not apply since the criteria for state action would have been met, subject to any procedural due process requirements inherent in the antitrust laws.[151] The issue then becomes whether consumers can tolerate such anticompetitive activity. While Congress could enact laws to preempt specific anticompetitive practices, the Supreme Court's decision in *National League of Cities*[152] appears to limit Congress' authority over the states. The scope of the Court's ruling in *National Cities* is, however, unclear. The Court's failure to delineate the scope of state action in *City of Lafayette*[153] further compounds the uncertainty. Mr. Justice Stewart's dissent in *City of Lafayette v. Louisiana Power & Light Company* highlights this uncertainty:

> Stripped to its essentials, the counterclaim alleged that the petitioners engaged in sham litigation, maintained their monopolies by debenture covenants, foreclosed competition by long-term supply contracts, and tied the sales of gas and water to the sale of electricity. Broadly speaking, these actions could be characterized as bringing lawsuits, issuing bonds, and providing electrical and gas service, all which are activities authorized by state statutes. But in affirming the judgment of the Court of Appeals, the Court makes evident that it does not consider these statutes alone a sufficient "mandate" to the cities.[154]

The solution lies in the recognition by state officials that they must reexamine state regulations in an effort to displace competition only when absolutely necessary.[155] The role of the FTC, in such a case, should be to actively provide guidance on economic costs of regulation to states which are considering regulations affecting competition.[156] The burden of determining whether certain state regulations are prudent or necessary, however, rests with the state political process, absent infringement of the United States Constitution.

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[148]421 U.S. 733 (1975).

[149]435 U.S. 679 (1978).

[150]*See,* P. Areeda & D. Turner *Antitrust Law, An Analysis of* Antitrust Principles and Their Application §214 (Vol. I 1978). *See also,* Davidson & Butters, Federal Interdiction note 95 *supra* who properly identify the criteria as requiring "(1) a clear state policy to supplant competition; and (2) state supervision of the scheme chosen to replace the rules of the marketplace."

[151]*See* Goldfarb v. Virginia State Bar, 421 U.S. at 791 citing Gibson v. Berryhill 411 U.S. 564, 578-79 (1973). *See also,* Silver v. New York Stock Exchange, 373 U.S. 341 (1963).

[152]426 U.S. 833 (1976).

[153]435 U.S. 389 (1978).

[154]435 U.S. at 435-36.

[155]The Attorney General of West Virginia has promulgated state regulations (effective February 16, 1979) under the states "little Sherman Act", (West Va. Code §47-18-1) and "little FTC Act" (West Va. Code §46A-6-102) to increase competition in real estate title searches. *Antitrust Trade Reg. Rep.* No. 892, I-1 (Dec. 7, 1978). West Virginia is apparently the first state to propose "competition regulations". West Virginia's lead may protend an increase emphasis of

In *Parker,* the pro rata raisin program was held valid under the antitrust laws and the Commerce Clause.[126] *Parker* presents the possibility, however, that a particular agricultural program may be exempt from the antitrust laws, but invalid under the Commerce Clause.[127] While a detailed examination of the Commerce Clause is beyond the scope of this article, it is fundamental that a state may not "discriminate" against interstate commerce.[128] Moreover, while there is no absolute rule regarding the effect of state burdens on the free flow of interstate commerce, the Supreme Court has considered the interface of state and federal laws by balancing those interests under the test developed in *Pike v. Bruce Church:*

> Where the statute regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits. . .
>
> [T]he extent of the burden that will be tolerated will of course depend. . . on the nature of the local interest and on whether it could be promoted as well with a lesser impact on interstate activities.[129]

In *Exxon Corp. v. the Governor of Maryland,* the Court indicated that state regulations involving vertically integrated petroleum companies may not rise to the level of a Commerce Clause violation because the regulations were essentially intrastate, thus not requiring a balancing of interests.[130]

The Commerce Clause goal of fostering free trade among the states plays an important role in limiting state regulations.[131] The Supreme Court has struck down state regulations and laws which unjustifiably discriminate in favor of a state's own citizens,[132] forces out-of-state consumers to pay higher costs,[133] or restricts the flow of goods between states.[134] In *A & P v. Cottrell,*[135] for instance, the Court struck down a state program which prevented the free flow of milk between Mississippi and Louisiana. While the statute was purported to be based on the state's regulation of public health,[136] the Court held that the statute was an attempt to protect local milk producers and processors

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[126]317 U.S. at 350-52 (Sherman Act); 359-68.

[127]In Parker v. Brown, 39 F. Supp. 895 (S.D. Cal. 1941) the district court held the 1940 raisin marketing program invalid under the Commerce Clause.

[128]*See e.g.* Hughes v. Alexandria Scrap Corp., 426 U.S. 794 (1976); Great Atlantic & Pacific Tea Co. v. Cottrell, 424 U.S. 366 (1976); H.P. Hood & Sons, Inc., v. Du Mond, 336 U.S. 525 (1949); Milk Control Bd. v. Eisenberg Farm Products, 306 U.S. 346 (1939), Nebbia v. New York, 291 U.S. 502 (1934).

[129]397 U.S. 137-142 (1970).

[130]437 U.S. 117 (1978). *Compare,* Great Atlantic & Pacific Tea Co. v. Cottrell, 424 U.S. 366 (1976) (invalidating a state statute) with Exxon v. The Governor of Maryland, 437 U.S. 117 (1978) (holding that Commerce Clause did not apply). The leading article is Dowling, Interstate Commerce and State Power, 27 *Va. L. Rev.* 1, 22 (1940).

[131]*See e.g.* Great Atlantic & Pacific Tea Co. v. Cottrell, 424 U.S. 366 (1976); H. P. Hood & Sons, Inc. v. DuMond, 336 U.S. 525 (1949); Toomer v. Witsell, 334 U.S. 385 (1948); Shafer v. Farmers Grain Co. 268 U.S. 189 (1925); Pennsylvania v. West Virginia, 262 U.S. 553 (1923); Lenske v. Farmer Grain Co., 258 U.S. 50 (1922). *cf.* Exxon Corp. v. Governor of Maryland, 437 U.S. 117 (1978); Hughes v. Alexandria Scrap Corp., 426 U.S. 794 (1976).

[132]Gibbons v. Ogden, 22 U.S. (9 Wheat) 1 (1824).

[133]Nippert v. City of Richmond, 327 U.S. 416 (1945).

[134]H. P. Hood & Sons, Inc. v. Du 'Mond, 336 U.S. 525 (1949).

[135]424 U.S. 366 (1976).

the FTC Act to state action.[112] Although several proposals involving the preemptive force of trade regulation rules were introduced, none were enacted.[113] Legislation to give trade regulation rules preemptive effect and legislation to allow states or local governments to opt-out on trade regulation rules were not enacted by Congress.[114] As enacted, the Magnuson-Moss/FTC Improvement Act gives the FTC only the authority to prescribe:

> Rules which define with specificity acts or practices which are unfair or deceptive acts or practices in or affecting commerce; rules under this paragraph may include requirements, prescribed for the purpose of preventing such acts or practices.[115]

The report of the House Committee on Interstate Foreign Commerce contained only one reference to preemption which was limited to the jurisdictional scope of the Amendments.[116] The House Report provided:

> [T]he Amendment made by Section 201 will permit more effective regulation of the market by the FTC by placing within its reach unfair, deceptive acts or practices which, although local and *territorial,* affect interstate commerce. The expansion of the FTC's jurisdiction made by this Section 201 is not intended to occupy the field or in any way to preempt the state or local agencies from carrying out consumer protection or other activities within their jurisdiction which are also within the expanded jurisdiction of the commission.[117]

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[112]The legislative history of the Magnuson-Moss-FTC Improvement Amendments establish only by negative implication an attempt to allow the Commission to preempt contrary state law, State Regulation Task Force 52-72; Verkuil, *Preemption of State Law,* note 95 *supra* Note, State Action, note 95 *supra.* This "negative implication" is far from themandate of *Parker* that an unexpressed purpose to nullify state law should not be lightly attributed to Congress. *See also,* Hines v. Davidowitz, 312 U.S. 52, 71-71 (1941).

The legislative history of those bills which were considered prior to the enactment of the Magnuson-Moss Warranty-FTC Improvement Act demonstrates that the question or preemption was explicitly considered. Section 106 of §3201, a predecessor bill, provided: "The amendments made by this title shall not affect the jurisdiction of any court or agency of any state or the application of the law of any state with respect to any matter over which the Federal Trade Commission has jurisdiction by reason of such amendment insofar as such jurisdiction or the application of such law does not conflict with the provisions of the Federal Trade Commission Act, regulations thereunder, or the exercise of any authority by the Commission under such Act." S. Rep. No. 1124, 91st Cong., 2d Sess. 111 (1970). It is clear from this provision that state law would have been preempted only to the extent that it was in conflict with the FTC Act or regulations thereunder. This bill was reported out of the Senate Judiciary Committee without recommendation. It did not pass the Senate. In 1971, Senate Bill 986 was introduced. S. 986, 92d Cong., 1st Sess. (1971). This bill expanded the legislative proposal relating to rulemaking provisions to include the Magnuson-Moss Warranty legislation which was subsequently enacted. The bill did not, however, contain a preemption provision, as §3201 had done. The only explicit reference to preemption was in the Committee report. The Committee stated its view that the FTC would be empowered to prescribe, with speificity, legislative rules and in their promulgation, declare the extent to which comparable state law was preempted. S. Rep. No. 269, 92d Cong., 1st Sess. 29 (1971). Though S. 986 passed the Senate, it was sent to the House and received no further consideration prior to the end of the Ninety-Second Congress. In 1973, a third Senate bill touching upon this subject was introduced, S. 356, 93d Cong., 1st Sess. (1973). S. 356 was closely patterned after the previous bills, specifically S. 986, except that the Ninety-Third Congress inserted a provision dealing precisely with preemption by rule making. This broad grant of power of preemption to the FTC over non-conforming state laws and regulations was subsequently deleted along with the entire rulemaking section when the bill was reported out of Committee. The legislative history is clear thea the deletion was requested by then Chairman Lewis Engman of the FTC, S. Rep. No. 151, 93d Cong., 1st Sess. 32 (1973). The purpose for such deletion was that pending litigation was then under consideration to resolve the question of the inherent power of the Commission to pass sustantive rules, *Id.* Though that court decision ultimately decided that the Commission had substantive rule making jurisdiction, the decision did not in any manner comment upon the preemption issue. National Petroleum Refiners Ass'n v. FTC, 4892 F.2d 672 (D.C. Cir. 1973), *cert. denied,* 415 U.S. /951 (1974). The Court affirmed the Commission's substantive rule making power in delineating "unfair methods of competition". The House bill that paralleled S. 356 contained no reference to rule making, H.R. 7917, 93d Cong., 1st Sess. (1973). The rule making provision as ultimately enacted was added in Committee. The House Committee report is silent on specific references to preemption, *See* H.R. Rep. No. 1606, 93d Cong., 2d Sess. 32-33 (1974). There was no preemption clause included in the final bill as enacted.

[113]For a detailed discussion of the legislative history of the Amendments see Verkuil, *Preemption of State Law.* note 95 *supra.*

[114]*See e.g.,* S. 356, 93d Cong., 1st Sess. §206(2) (1973).

[115]15 U.S.C. §57a(a)(1)(A) (B) (Supp. 1977).

THE SEARCH FOR REGULATORY SOLUTIONS

Although the interplay of the state regulations with the federal antitrust laws has been the subject of much recent commentary,[95] very little effort has been directed to providing an adequate solution to the "dynamic tension" caused by the interface of federal and state regulations. The commentators who suggest that the case law on state action developed under the Sherman Act is inapplicable to the FTC Act fail to recognize that the policy considerations underlying *Parker* and *National League of Cities* express a fundamental concern for federalism.[96] The commentators, on the other hand, who argue that the states may regulate in any manner they deem sufficient so long as an articulate program exists which is supervised by the state, fail to consider that many state programs disrupt competition.[97] An examination of the interplay of state and federal regulations in three areas of current FTC and state concern illustrate the conflict. The remainder of this article will examine the FTC's attempt to promulgate trade regulation rules affecting the states' regulation of 1) the advertising of consumer goods and services; 2) wholesale and retail milk pricing; and 3) the professions.

A. State Regulation of Advertising

One of the most recent FTC efforts to preempt state laws has been the promulgation of trade regulation rules involving the advertising of consumer goods and services.[98] Purportedly acting pursuant to Sections 5[99] and 6(g)[100] of the FTC Act and the Magnuson-Moss/FTC Improvement Act,[101] the FTC has attempted to promulgate rules which would promote competition by removing, or limiting, state requirements against advertising.

Under Section 5 of the FTC Act, the FTC may declare an "unfair method of competiton" or an "unfair or deceptive actual practice" illegal.[102] The courts have given the FTC broad discretion in fashioning appropriate reme-

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[95]*See e.g.*, Note, *The State Action Exemption and Antitrust Enforcement Under the Federal Trade Commission Act*, 89 Harv. L. Rev. 715 (1976) [hereinafter "Note, *State Action*"]; Handler, *The Current Attack* on the Parker v. Brown State Action Doctrine, 76 Colum. L. R. (1976) [hereinafter Handler, *Current Attack*];Verkuil, *Preemption of State Law by the Federal Trade Commission*, 1976 Duke L.J. 225 [hereinafter Verkuil, *Preemption of State Law*]; Note, Parker v. Brown: *A Preemption Analysis*, 84 *Yale L.J.*; Verkuil, *State Action, Due Process and Antitrust: Reflections on* Parker v. Brown, 75 *Colum. L. Rev.* 328 (1975); Jacobs, *State Regulation and the Federal Antitrust Laws*, 25 *Case W. Res. L. Rev.* 221, 231-49 (1975); Slater, *Antitrust and Government Action: A Formula for Narrowing* Parker v. Brown, 69 *Nw. U.L. Rev.* 71 (1974); Posner, *The Proper Relationship Between State Regulation and the Federal Antitrust Laws*, 49 *N.Y.U.L. Rev.* 693 (1974). Handler, *Twenty-Fourth Annual Antitrust Review*, 72 *Colum. L. Rev.* 1, 4-18 (1972).

[96]*See e.g.* Donnem, *supra* note 95; Slater *supra* note 95; Note, *State Action, supra* note 95.

[97]*See e.g.* Davidson and Butters *supra* note 95; Handler *supra* note 95.

[98]*See e.g.* Advertising of Ophthalmic Goods and Services 16 C.F.R. 456, (June 1, 1978 trade regulation rule), 3 *Trade Reg. Rep.* (CCH) ¶ 10,162 (1976) (announcing initiation of FTC investigation into prescription eyeglasses advertising). *Cf.* Disclosure Regulations Concerning Retail Prices for Prescription Drugs (proposed trade regulation rule) 40 Fed. Reg. 24031 (June 4, 1975), withdrawn and proceedings closed 43 Fed. Reg. 54951 (Nov. 24, 1978).

[99]15 U.S.C. §45 (1976).

[100]15 U.S.C. §46(g) (1976).

[101]Magnuson-Moss Warranty-FTC Improvement Act, 88 Stat. 2183 (1975) (codified in 15 U.S.C. §§45, 46, 49, 50, 52, 56, 57a-c, 2301-12 (1976).

[102]15 U.S.C. §45(a)(2). Originally, the FTC Act of 1914 referred only to "unfair methods of competition". The

challenges to the states' administration of a state-mandated program. Similarly, the cases suggesting that the FTC Act does prohibit state-mandated programs are equally unpersuasive since the state action issue has only been considered in dicta[78] or in a case reversed on other grounds.[79] In two FTC advisory opinions, however, it is suggested that the *Parker* rule ought to extend to cases involving the FTC Act.[80]

In support of the view that *Parker* applies to the FTC Act, the analysis turns to the common history of the Sherman and FTC Acts, the common objectives of the Acts and the common interests of federalism which underlie both. The FTC Act, it is argued, was enacted in 1914 to achieve substantially the same objectives as the other antitrust acts, by preventing trade practices that might ripen into restraints violative of the Sherman and Clayton Acts.[81] If the result were otherwise, the FTC Act might be construed to prohibit acts which *Parker* would authorize, resulting in an incongruous construction of the antitrust laws. For example, it has been held that a price-fixing arrangement is a restraint of trade in violation of the Sherman Act,[82] as well as an unfair method of competition in violation of the FTC Act.[83] Thus, a state, even though authorized to engage in a price-fixing arrangement under the Sherman Act by virtue of *Parker*, could be prohibited from engaging in the same arrangements under the FTC Act, unless the two Acts are read in harmony. This result would invalidate a wide variety of state arrangements which have historically been held beyond the scope of the antitrust laws.

Arguments that *Parker* ought not extend to the FTC Act are twofold.[84] First, the Sherman Act includes private causes of actions for treble damages. The FTC Act, however, applies only to prospective relief,[85] with certain exceptions involving FTC enforcement actions.[86] Thus, the states will not be faced with "raids" on their treasuries from treble damage litigation. Second, under the Sherman Act, there is no governmental control over private liti-

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[78]Asheville Tobacco Board of Trade v. Federal Trade Comm'n, 263 F.2d 502 (4th Cir. 1959).

[79]Christensen v. Federal Trade Comm'n, 1974-2 Trade Cas. ¶ 75, 328 (N.D. Cal. 1974) *rev'd on other grounds*, 549 F.2d 1321 (9th Cir.) *cert. denied*, 434 U.S. 876 (1977).

[80]In advisory Opinion 154, the Commission advised, in response to whether a distributor who complied with a state's milk marketing order would be subject to a charge of violating the antitrust laws, ". . .that it was of the opinion that the distributor would not be subject to a charge of violating any of the laws it administers because of its compliance with the lawful orders of the State as to the minimum resale prices of dairy products. In the Commission's view, it is well settled that the antitrust laws have application to the actions of individuals, partnerships, and corporations and not the activities of a State." 16 C.F.R. §15.154 (1978). See also 16 C.F.R. §15.199 (1978) (discussing advisory opinion of Commission that agreement by milk processors to sell at higher price than minimum set by state regulation was illegal).

[81]*See, e.g.*, FTC v. Motion Picture Adv. Co., 344 U.S. 392, 394-95 (1953) (FTC Act intended to "supplement and bolster" the other antitrust acts, and "to stop in their incipiency the acts and practices which, when fullblown, would violate these acts. . .as well as to condemn as 'unfair methods of competition' existing violations of them.") *See also* Community Blood Bank v. FTC, 405 F.2d 1011, 1013 n. 2 (8th Cir. 1969) (FTC empowered to prevent corporations from engaging in unfair or deceptive practices in commerce); New Jersey Wood Finishing Co. v. Minnesota Mining & Mfg. Co., 332 F.2d 346, 351 (3d Cir. 1964), *aff'd*, 381 U.S. 311 (1965) ("These three acts [Sherman, Clayton & FTC Acts] are 'interlaced' remedially as well as substantively evincing a Congressional desire for a 'cumulative remedy' for the threats and dangers to trade and competition"). Id. at 352.

[82]United States v. Masonite, 316 U.S. 265, 274 (1942).

[83]Federal Trade Comm'n v. National Lead Co., 352 U.S. 419, 428 (1957).

[84]*See* Badal, Restrictive State *Laws and The Federal Trade Commission*, 29 *Ad. L. Rev.* 239 261-62 (1977).

Parker Revitalized

The rationale of *Parker* was reasserted in *Bates v. The State Bar of Arizona.*[57] In *Bates,* a special State Bar Committee found that two licensed attorneys had violated a disciplinary rule of the Arizona Supreme Court.[58] On appeal to the State Supreme Court, the Bar Committee's actions were upheld and the attorneys' claim that the disciplinary rule violated both the First Amendment and the Sherman Act were rejected.[59] Although the United States Supreme Court reversed the Arizona decision on First Amendment grounds, it unanimously reaffirmed the State Court's decision that the Sherman Actdid not apply to the disciplinary rule.[60] The Court distinguished *Goldfarb* on the grounds that the anticompetitive activity in *Goldfarb* was unprotected by the absence of a state direction to engage in the particular activity.[61] In *Bates,* however, an affirmative command of the Arizona Supreme Court existed.[62] Significantly, the Court reiterated the *Goldfarb* disclaimer that by "holding that certain anticompetitive conduct by lawyers is within the reach of the Sherman Act, we intend no diminution of the authority of the states to regulate its professions."[63] The Sherman Act challenge to the rule in *Bates* would have had precisely that undesired effect since the "real party and interests was the Arizona Supreme Court".[64]

The Court distinguished *Cantor* on three grounds: First, the Court noted the official nature of the disciplinary action activity, pointing out that "*Cantor* would have been an entirely different case if the claim had been directed against a public official or public agency, rather than against a private party".[66] Second, the Court contrasted the lack of independent regulatory interest on the part of Michigan in regulating lightbulbs with Arizona's interest in protecting the public through the direct regulation of attorneys licensed by its Supreme Court.[67] Third, the Court distinguished the state acquiescence and private activity found in *Cantor,* from the disciplinary rules which reflected a "clear articulation of the states' policy".[68]

The Need for a Factual Record

In its most recent considerations of state action, the Court reintroduced confusion into the state action analysis by not producing a majority opinion in *City of Lafayette v. Louisiana Power & Light Co.*[69] The case involved whether

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[57]433 U.S. 350.

[58]Disciplinary Rule 2-101(B) was incorporated into Rule 29(a) of the Supreme Court of Arizona, 17A *Ariz. Rev. Stat.* (Supp. 1977) 52.

[59]In Re Bates, 113 Ariz. 394, 396-99, 555 P.2d 640, 643-45 (1976).

[60]433 U.S. at 359, 365, 379.

[61]*Id.* at 360.

[62]*Id.* at 360-61.

[63]*Id.* at 360 n.11 (quoting Goldfarb v. Virginia State Bar, 421 U.S. at 793).

[64]*Id.* at 361. The Arizona State Bar was created by the Supreme Court of Arizona "[i]n order to advance the administration of justice according to law. . . ." Rule 27(a) of the Supreme Court of Arizona, 17A *Ariz. Rev. Stat.* (1973) 84.

[65]*Id.* at 361-63.

[66]*Id.* at 361.

Public Utilities and the Lack of State Action

The next Supreme Court cast to consider the Sherman Act and state action was *Cantor v. Detroit Edison Company.*[36] In *Cantor,* the Court determined that a public utility's program of offering free lightbulbs to its electricity customers was subject to the Sherman Act. In *Cantor,* an independent druggist charged the utility with effectively preventing him from competing in the sale of lightbulbs. The utility's defense, based on *Parker* was that the Sherman Act did not apply to a lightbulb exchange program which was included in its tariff rate approved by the Michigan Public Service Commission.

Six Justices agreed that summary judgment for the utility, based on *Parker,* had been improperly entered by the district court.[38] While the Court in *Cantor* did not develop a single opinion expressing a majority view, a plurality did agree that state action was not present. In deciding *Cantor,* the Court's plurality emphasized that: 1) no Michigan statute purported to regulate the lightbulb industry;[39] 2) neither the Michigan legislature nor the Public Service Commission had ever specifically examined the desirability of a lightbulb exchange program;[40] and, 3) other utilities regulated within the state did not have such a program.[41] The plurality concluded from its examination that the Commission's approval of the utility program did not "implement any statewide program relating to lightbulbs",[42] and that "the state's policy is neutral on the question of whether utilities should or should not have such a program".[43] The plurality emphasized that while compliance with the exchange program was required as long as the rates were in effect, Michigan law did not require the lightbulb exchange program initiated by the utility.[44]

Justice Stevens included in this opinion a discussion of whether it would be fair to subject a party to antitrust liability 1) when it was caught between inconsistent commands of state and federal governments,[45] or 2) when the state had regulated a particular area to the minimum extent necessary to make its regulatory scheme work.[46] It is unclear whether this dicta was intended to create grounds for state action or merely to provide policy reasons for not applying the antitrust laws. Justice Stevens' discussion in this part of the opinion is flawed since he confuses preemption with an analysis of exemptions used to reconcile two federal statutes.[47] Under an exemption analysis, the Court's task is to interpret two facially inconsistent statutes of a single

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[36]428 U.S. 579 (1976).

[37]*Id.* at 581.

[38]Mr. Justice Stevens delivered the Court's opinion, followed in whole by Justices Brennan, White and Marshall, and in substantial part by the Chief Justice. Justice Blackmun concurred in the result while Justices Stewart, Powell and Rehnquist joined in dissent.

[39]428 U.S. at 584.

[40]*Id.*

[41]*Id.*

[42]*Id.* at 585.

[43]*Id.*

[44]*Id.*

[45]*Id.* at 593-95.

[46]*Id.* at 595-98.

Sherman Act.[20] The Supreme Court declared that while the program would violate the Sherman Act if it were implemented by private persons, the Act was not intended to prohibit the state's pro rata[21] program. The Court found that any anticompetitive effect of the California pro rata program resulted from the state's command under which the state adopted, organized and enforced the program as an "execution of governmental policy".[22] Significantly, the Court found that the state was exercising its "legislative authority", even though the Commission established by the California Act was given broad discretionary powers concerning the Act's implementation.[23]

The Court's decision in *Parker* is not only important for its discussion of the applicability of the Sherman Act to governmental entities, but also for its discussion that the Sherman Act does not give immunity to private anticompetitive behavior authorized by the state.[24] The Court recognized that when state law merely purports to authorize unsupervised private action, the Sherman Act is applicable. The Court's citation of *Northern Securities Corp. v. United States*[25] illustrates the ineffectiveness of state "authorization" to shield private activity from the antitrust laws. In *Northern Securities,* the defendants attempted to obtain immunity from the antitrust laws by arguing that the merger under attack was outside the scope of the antitrust laws because the State of New Jersey had approved the articles of incorpoation for the merged company.

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[20]The holding in *Parker* was foreshadowed in two earlier decisions. In Olsen v. Smith, 195 U.S. 332 (1904) the Court, upheld, in the face of a Sherman Act challenge, a Texas statute that limited riverboat pilotage to licensed pilots, and thus conferred an oligopolistic advantage to licensed pilots by prohibiting entry of non-licensed persons into the market. *Id.* at 344-45. In Lowenstein v. Evans, 69 F. 908 (C.C.D. S.C. 1895), the Circuit Court sustained against attack under the Sherman Act a state liquor monopoly that prevented sale of distilled spirits by private parties within South Carolina. *Id.* at 911. The holdings in *Parker, Olsen* and *Lowenstein* are supported by the language of section 1 of the Sherman Act, which requires a plurality of actors. The essence of the proscription is a "contract, combination. . .or conspiracy, in restraint of trade or commerce. . ." 15 U.S.C. §1 (1973). The intra-enterprise conspiracy cases suggest the joint action between a corporation and officers acting on behalf of a corporation may not constitute a conspiracy or combination in restraint of trade. *See e.g.,* Joseph E. Seagrams & Sons, Inc. v. Hawaiian Oke & Liquors, Ltd., 416 F.2d 71, 82-83 (9th Cir. 1969), *cert. denied,* 396 U.S. 1062 (1970); Chapman v. Rudd Paint & Varnish Co., 409 F.2d 635, 643 & n. 9 (9th Cir. 1969); Cliff Food Stores, Inc. v. Kroger, Inc., 417 F.2d 203, 206 (5th Cir. 1969). The conclusion that the Sherman Act was not intended to apply to state action finds further support in section 2 of the Sherman Act. 15 U.S.C. §2 (1973). Essential to an offense of unlawful monopolization under this section is the possession of monopoly power in the economic sense, and a deliberateness to acquire, use, or preserve such power. *See, e.g.,* United States v. Grinnel Corp., 384 U.S. 563, 570-71 (1966); United States v. Aluminum Co. of America, 148 F.2d 416, 431-32 (2d Cir. 1945); United States v. United Shoe Mach. Corp., 110 F.Supp. 295, 346 (D. Mass. 1953), *aff'd per curiam,* 347 U.S. 521 (1954). Mere existence of monopoly power may not itself constitute unlawful monopolization, unless the power is coupled with a general or deliberate purpose to exercise that power. *See e.g.,* United States v. Griffith, 334 U.S. 100, 107 (1948). In the case of state-mandated activity, the legislative command to the agency may be considered as being "thrust upon" the agency, negating the element of deliberateness. (1946); United States v. United Shoe Mach. Corp., 110 F.Supp. 295, 342 (D. Mass. 1953), *aff'd per curiam,* 347 U.S. 521 (1954); United States v. Aluminum Co. of America, 148 F.2d 416 (2d. Cir. 1945) 1955 Att'y. Gen. Rep. 56-60.

[21]The court found that the state program: ". . .derived its authority and its efficacy from the legislative command of the State and was not intended to operate or become effective without that command. We find nothing in the language of the Sherman Act or in its history which suggests that its purpose was to restrain a state or its officers or agents from activities directed by its legislature. In a dual system of government in which, under the Constitution, the states are sovereign, save only as Congress may constitutionally subtract from their authority, an unexpressed purpose to nullify a state's control over its officers and agents is not lightly to be attributed to Congress. The Sherman Act makes no mention of the state as such, and gives no hint that it was intended to restrain state action or official action derived by the state." 317 U.S. at 350-51.

[22]317 U.S. at 352.

dicta, Chief Justice Marshal suggested that the Commerce Clause, alone, prevented the states from regulating interstate commerce.[6] Thirteen years later in *City of New York v. Miln,*[7] Justices Thompson and Story engaged in a classic debate over the meaning of the Chief Justice's dicta in *Gibson.* That debate continues and illustrates the problem of determining the extent of the federal government's authority to preempt state regulation.[8] In *Miln,* the majority held that New York was not violating the Commerce Clause by requiring the registration of immigrants, even though federal law also required their registration.

Justice Thompson, in a concurring opinion in *Miln,* refused to infer from Congress' lack of affirmative preemption an intent to invalidate the New York statute.[9] In the absence of any collision with an affirmative federal enactment, he concluded that the state law was valid. Justice Story, on the other hand, in a dissenting opinion, declared that the state law was a regulation of interstate commerce, and accordingly, the state law was preempted.[10] Justice Story rejected the doctrine that the states have concurrent jurisdiction with Congress when it had not legislated on a particular subject. This debate has remained unresolved since the Court has proceeded to resolve preemption issues on a case-by-case basis.[11]

Several commentators, including the FTC Staff, have relied on preemption to argue for the invalidation of state regulations which conflict with FTC trade regulation rules.[12] The search for preemptive capacity, however, fails to realize that the fundamental issue is one of statutory interpretation.[13] Does the coverage of the FTC Act include regulations promulgated by the states? If state regulations are within the coverage of the FTC Act, then an

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[6]22 U.S. (9 Wheat) at 209.

[7]36 U.S. (11 Pet.) 102 (1837).

[8]*See e.g.* Askew v. American Waterways Operators, Inc. 411 U.S. 325 (1973). In City of Burbank v. Lockheed Air Terminal Inc., 411 U.S. 624, 638 (1973) the Court noted: "[P]rior cases on preemption are not precise guidelines . . . for each case turns on the peculiarities and special features of the federal regulatory scheme in question."

[9]36 U.S. (11 Pet.) at 145-53.

[10]36 U.S. (11 Pet.) at 158-59.

[11]*See e.g.* City of Burbank v. Lockheed Air Terminal Inc., 411 U.S. 624 (1973); Head v. New Mexico Board of Examiners, 347 U.S. 424 (1963); Florida Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132 (1963); Colorado Anti-Discrimination Comm'n v. Continental Air Lines, 372 U.S. 714 (1963); California v. Zook, 336 U.S. 725 (1949); Rice v. Santa Fe Elevator Corp., 311 U.S. 218 (1947); Mintz v. Baldwin, 289 U.S. 346 (1933).

[12]*See e.g.* Federal Trade Commission, *Staff Report on Prescription Drug Price Disclosing,* 494-589 (Jan. 25, 1975); Verkuil, *Preemption of State Law by the Federal Trade Commission,* 1976 *Duke L.J.* 225; Note, Parker v. Brown: *A Preemptive* Analysis, 84 *Yale L.J.* 1164 (1975). *Compare* Handler, *The Current Attack on the* Parker v. Brown *State Action Doctrine,* 76 *Colum. L. Rev.* 1, 15 (1976) ("The preemption approach advocated by some of the commentators in reality calls for the repudiation of *Parker* and the shackling of the states power to regulate their own economies") with Lecture by Milton Handler on U.S. Supreme Court Decisions, During 1978, Affecting Antitrust Enforcement, *Antitrust Trade Reg. Rept.* (BNA) No. 892, F-5 (December 7, 1978) ([T]he inapplicability of the federal antitrust to acts and practices required and authorized by state law results from the operation of principles of federal preemption derived from the Supremacy Clause of the Constitution").

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