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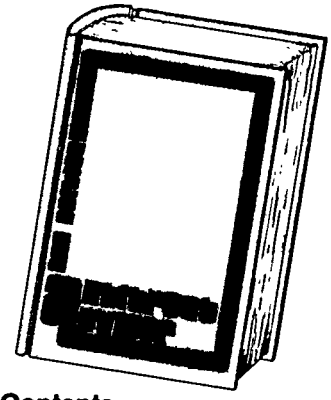

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PROPOSED AMENDMENTS TO THE FEDERAL TORT CLAIMS ACT

GRIFFIN B. BELL*

The Department of Justice has proposed a series of amendments to the Federal Tort Claims Act. Judge Bell argues here that litigation under current law of tort claims against federal employees neither serves the public interest nor provides adequate remedies for citizens whose constitutional rights have been violated. The amendments outlined here would extend the liability of the United States to include all constitutional, as well as common law, torts committed by federal employees, would grant personal immunity to federal employees, and would provide for minimum damage awards to citizens whose rights have been violated by federal officers.

Since the Supreme Court's 1971 decision in *Bivens v. Six Unknown Named Agents,*[1] which held that federal agents could be sued for violations of citizens' fourth amendment rights, several thousand lawsuits have been filed seeking money damages from federal employees for alleged constitutional abuses. Most such suits were initially brought against law enforcement and intelligence officials in the wake of congressional revelations of alleged abuses committed by the Federal Bureau of Investigation and the Central Intelligence Agency.[2] Increasingly, however, *Bivens* claims have been asserted against government officials outside the law enforcement-intelligence field whose duties make them vulnerable to tort allegations.[3]

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*Attorney General of the United States; LL.B., Mercer University Law School, 1948.

1 403 U.S. 388 (1971).

2 *E.g.,* Socialist Workers Party v. Attorney General, No. 73-CIV 3160 (S.D.N.Y.) (suit alleging unconstitutional surveillance and harassment of the Socialist Workers Party by the FBI); Driver v. Helms, No. 75-0224 (D.R.I.) (suit alleging CIA violated plaintiffs' rights by opening and reading plaintiffs' mail). A partial list of civil cases pending on January 20, 1977, against federal employees arising out of law enforcement and intelligence collection activities can be found at *Amendments to the Federal Tort Claims Act: S. 2117, Joint Hearings before the Subcomm. on Citizens and Shareholders Rights and Remedies and the Subcomm. on Admin. Prac. and Proc. of the Senate Comm. on the Judiciary,* 95th Cong., 2d Sess. 101-03 (1978) [hereinafter cited as *Senate Hearings*].

3 *E.g.,* Hohensee v. Carter, No. 78-345 (M.D. Pa., dismissed Nov. 8, 1978) (suit against President Carter, certain members of the United States Senate, and others seeking monetary damages of $20 billion for wrongful disposal of the Panama Canal); Beason v. Hudson, No. ED-76-2-C (W.D. Ark., filed Jan. 29, 1976) (suit by former assistant to Regional Director of Veterans Administration against the Regional Director,

Moreover, federal employees increasingly are being sued in their individual capacities on common law tort theories for acts performed within the scope of their duties.[4]

In my opinion, the public interest has not been well served by litigation of these actions against federal officials. Despite the widespread publicity frequently surrounding such litigation, citizens who have felt aggrieved have not been particularly successful in obtaining relief.[5] Judges and juries are understand-

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former Administrator of VA, present Administrator, and others alleging plaintiff's employment was terminated in violation of his procedural due process rights guaranteed by the fifth amendment); Weir v. Muller, No. 73E-60(R) (S.D. Miss., Nov. 29, 1978) (suit against IRS and Department of Justice officials who allegedly induced plaintiff to plead nolo contendere to an indictment for tax evasion knowing plaintiff was not guilty; damages of $25 million are sought).

4 *E.g.*, AETNA Insurance Co. v. United States, (Air traffic controllers sued for $34 million damages suffered by passengers of a commercial airliner which allegedly crashed as a result of defendants' negligence); Saraniti v. Bergland, No. 78-233 (N.D. Ohio, filed March 6, 1978) (suit against 9 employees of the Department of Agriculture who were allegedly negligent in the manner in which they seized and killed 1,500 purportedly diseased birds; damages of $1.5 million are sought); Howes v. Childers, No. 76-433 (E.D. Ky., filed Apr. 9, 1976) (wrongful death action against a mine inspector employed by the Department of Interior in his official and individual capacities alleging that plaintiff's intestate was killed in a mine accident which would not have occurred but for defendant's negligent inspection of the mine; damages of $2 million are sought).

5 Only seven money judgments have ever been entered against federal employees on *Bivens* claims; pending appeal, none has been paid. Seguin v. Hightower, No. C76-182-V, (W.D. Wash., Oct. 24, 1978) (customs agent held liable to owner of a car used in a smuggling scheme because the agent waited four and one half months before instituting a forfeiture action; court awarded plaintiff $7,300 for rental value of car plus consequential damages); Gihad v. Carlson, No. 5-71-805 (E.D. Mich., Oct. 18, 1978), *appeal docketed* No. 79-1105 (5th Cir., Feb. 16, 1979) (prison guard held liable to inmate for violating his right to religious freedom after the inmate was placed in segregation for refusing to shave his beard, which the inmate claimed was necessary to the practice of his religion); Weiss v. Lehman, No. 375-36 (D. Idaho, July 14, 1978) (Forest Service ranger ordered to pay $1,000 to plaintiff on the theory that the ranger had violated plaintiff's fifth amendment rights by destroying plaintiff's property); Askew v. Bloemker, No. S-Civ-73-79 (S.D. Ill., Sept. 29, 1978) (DEA agent held liable for violating plaintiffs' fourth amendment rights by breaking into plaintiffs' house and conducting a search without probable cause or a warrant; jury awarded $21,000 damages; prior to the verdict, plaintiffs agreed not to enforce any judgment against the agent, who was not insured, but rather to proceed against several defendant state employees who had liability insurance); Halperin v. Kissinger, 424 F. Supp. 838 (D.D.C. 1976); 434 F. Supp. 1193 (D.D.C. 1977) (held that Richard Nixon, John Ehrlichman, and John Mitchell violated plaintiffs' fourth amendment rights by authorizing an illegal wiretap on plaintiffs' telephones; each plaintiff was awarded $1.00); Dellums v. Powell, 566 F.2d 167 (D.C. Cir. 1977), *cert. denied*, 438 U.S. 916 (1978). (Chiefs of U.S. Capitol and D.C. Police held liable for unlawfully disrupting a congressman's speech at Capitol Building by wrongfully arresting and jailing the listeners); Tatum v. Morton, 562 F.2d 279 (D.C. Cir. 1977) (inspector of D.C. Police held liable for unlawfully disrupting a demonstration outside the White House).

ably reluctant to saddle employees with substantial judgments, which most federal employees do not have the resources to pay even if ordered to do so.[6] More important, current law is not favorable to those whose constitutional rights have been infringed. Unlike state government officials, who, pursuant to 42 U.S.C. § 1983, can be held liable for violating a person's constitutional rights,[7] federal officials are not subject to similar liability by statute. A federal official or employee can be held liable only if he commits a constitutional tort within the meaning of the *Bivens* decision and its progeny. Although some courts have recognized constitutional torts for violations of the first, fifth, sixth, eighth, ninth, thirteenth, and fourteenth amendments, other courts have refused to extend *Bivens* beyond its facts, limiting its scope to violations of the fourth amendment.[8] In those circuits and districts where *Bivens* has been limited, an aggrieved citizen thus is left without a remedy for deprivations of all but his fourth amendment rights.

Even if a plaintiff can establish the existence of a cognizable constitutional or common law tort, relief still may not be available. In common law tort actions, employees enjoy absolute immunity for acts taken within the outer perimeter of their line of duty.[9] In constitutional tort actions, a line of cases

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6 Many states authorize the purchase of liability insurance on behalf of their officers and employees. *E.g.*, IND. CODE ANN. § 34-4-16.5-18 (Burns, Supp. 1978); N.Y. GEN. MUN. LAW § 52 (McKinney 1978); Berman, *Integrating Governmental and Officer Tort Liability*, 77 COLUM. L. REV. 1175, 1181 (1977). The United States, however, has not authorized the purchase of such insurance, and federal employees have had difficulty obtaining liability insurance on their own. *See, e.g., Senate Hearings* at 759 (Statement of Ordway Burden, Law Enforcement Assistance Foundation).

7 42 U.S.C. § 1983 (1976) provides:

> Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

8 *See, e.g.*, Davis v. Passman, 571 F.2d 793 (5th Cir.) (en banc), *cert. granted* Oct. 30, 1978 (No. 78-5072). For a list of those cases involving extension of *Bivens* beyond the fourth amendment, *see* Lehmann, Bivens *and its Progeny: The Scope of a Constitutional Cause of Action for Torts Committed by Government Officials*, 4 HASTINGS CONST. L. Q. 531, 566 nn.226-27, 568 n.229. The scope of the *Bivens* remedy may be settled by the Supreme Court this term when it considers Davis v. Passman, *supra*.

9 Barr v. Matteo, 360 U.S. 564 (1959); Howard v. Lyons, 360 U.S. 593 (1959). Lower courts have followed these cases in a wide variety of contexts, *see* Norton v. McShane,

culminating in *Butz v. Economou,*[10] decided by the Supreme Court at the end of its last term, establishes that federal employees are entitled to qualified immunity — *i.e.,* if an employee can demonstrate he acted with a reasonable good faith belief in the lawfulness of his conduct, he cannot be held liable for money damages. Some officials, such as judges, prosecutors, and persons performing similar functions, enjoy absolute immunity from suit even in constitutional tort cases because of the special nature of their duties.[11] Although these immunity defenses often require a good deal of time-consuming discovery, employees have been very successful in establishing them.

A citizen's remedy against the United States for an alleged wrongful act of one of its employees is not much better than his or her remedy against an offending employee. As a sovereign, the United States is completely immune against suit for torts committed by its agents and employees.[12] Although enactment of the Federal Tort Claims Act in 1946 abrogated much of the government's immunity, Congress, in fact, waived sovereign immunity only for torts committed by federal employees within the scope of their employment "under circumstances where the United States, if a private person, would be liable to the claimant" under state law.[13] Since the constitutional tort is a child of federal law, the United States is not liable for such torts under the Federal Tort Claims Act and thus retains its immunity.[14] Of course, to the extent a plaintiff can base his claim on a common law tort recognized under state law the United States will be

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332 F.2d 855, 858 n.3 (5th Cir. 1964), but they have usually required that the official be exercising some sort of discretion to be entitled to absolute immunity. *See, e.g.,* Johnson v. Alldredge, 488 F.2d 820 (3rd Cir. 1973), *cert. denied sub nom.* Cronrath v. Johnson, 419 U.S. 882 (1974); David v. Cohen, 407 F.2d 1268 (D.C. Cir. 1969). The doctrine of absolute immunity for common law torts was not abrogated by Butz v. Economou, 438 U.S. 478 (1978). *See,* Granger v. Marek, 583 F.2d 781 (6th Cir. 1978); Evans v. Wright, 582 F.2d 20 (5th Cir. 1978).

10 438 U.S. 478 (1978).

11 *Id.*

12 *See, e.g.,* Feres v. United States, 340 U.S. 135 (1951).

13 28 U.S.C. § 1346(b) (1976).

14 Birnbaum v. United States, 588 F.2d 319, 322 (2d Cir. 1978); Hardy v. United States, No. 76-1423 (D.D.C.); Siebel v. United States, No. C-76-1737-S.C. (N.D. Cal. Dec. 17, 1976); *but see* Cruikshank v. United States, 431 F. Supp. 1355 (D. Hawaii 1977).

liable under the Federal Tort Claims Act. In *Birnbaum v. United States,*[15] for example, the Court of Appeals for the Second Circuit held that plaintiffs, whose mail had been covertly opened and read by CIA agents, were entitled to money damages from the United States on the theory that the agents had invaded plaintiffs' privacy and violated plaintiffs' common law copyright interests in their personal papers, even though damages could not be awarded on a constitutional tort theory.

However, many constitutional torts do not have common law analogues, such as infringement of the right to free speech or denial of a person's right to be free of unlawful discrimination as guaranteed by the fifth amendment. Further, the Federal Tort Claims Act contains exceptions and exclusions that limit those common law torts for which the government is liable.[16] Particularly important are the discretionary function exception[17] and the intentional tort exception, which precludes suit against the United States for any claim arising out of libel, slander, misrepresentation, deceit, or interference with contract rights.[18] In addition, the United States is immune against claims arising out of assault, battery, false imprisonment, false arrest, malicious prosecution, and abuse of process committed by officials other than "investigative or law enforcement officers."[19] The United States is also entitled to assert the qualified immunity of its employees as a defense in an action under the Federal Tort Claims Act.[20]

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15 588 F.2d 319 (2d Cir. 1978).

16 28 U.S.C. § 2680(a)-(n) (1976).

17 28 U.S.C. § 2680(a) (1976). *See generally* Hatahley v. United States, 351 U.S. 173 (1956); Dalehite v. United States, 346 U.S. 15 (1953).

18 28 U.S.C. § 2680(h) (1976).

19 Prior to 1974, the United States was not liable for any claims arising out of assault, battery, false imprisonment, false arrest, malicious prosecution, and abuse of process. Publicity surrounding a series of drug raids in Collinsville, Ill., in 1973, however, led Congress to amend the Federal Tort Claims Act to permit suit against the United States when such torts were committed by law enforcement officers. *See* Boger, Gitenstein & Vertvil, *The Federal Tort Claims Act Intentional Torts Amendment: An Interpretive Analysis,* 54 N.C. L.REV. 497 (1976). As Senator Sam Ervin, one of the amendment's major proponents, recognized, the legislation was but "a minimal first step in providing a remedy against the federal government for innocent victims of federal law enforcement abuses." S. REP. No. 93-588, 93d Cong., 1st Sess. 4 (1973), *reprinted in* Boger, Gitenstein & Vertvil, *supra,* at 542.

20. Norton v. United States, 581 F.2d 390 (4th Cir. 1978).

In addition to the need of establishing liability on the part of an employee or the United States, plaintiffs in constitutional cases face another requirement before they can obtain more than nominal relief — the requirement that they prove actual damages. Courts will not presume damages from the violation of a constitutional right.[21] Since the cost of bringing a suit may well exceed the damages that can be proved, a citizen may suffer a constitutional deprivation without remedy. Of course, in nonconstitutional cases, the requirement that actual damages be demonstrated presents no exceptional problems from the standpoint of a tort victim.

Despite the small odds an employee will actually be held liable in a civil suit, morale within the federal service has suffered as employees have been dragged through drawn-out lawsuits, many of which are frivolous.[22] Vigorous job performance sometimes has been impeded as otherwise responsible employees avoid difficult tasks that may expose them to the risk of a lawsuit. In the words of Judge Learned Hand:

> It does indeed go without saying that an official, who is in fact guilty of using his powers to vent his spleen upon others, or for any other personal motive not connected with the public good, should not escape liability for the injuries he may so cause; and, if it were possible in practice to confine such complaints to the guilty, it would be monstrous to deny recovery. The justification for doing so is that it is impossible to know whether the claim is well-founded until the case has been tried, and that to submit all officials, the innocent as well as the guilty, to the burden of a trial and to the inevitable danger of its outcome, would dampen the ardor of all

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21. *See, e.g.,* Carey v. Piphus, 435 U.S. 247 (1978) (high school students suspended without due process were entitled only to nominal damages in an action against the school administrator under 42 U.S.C. § 1983); Halperin v. Kissinger, 434 F. Supp. 1193 (D.D.C. 1977).

22 A significant percentage of the pending suits against federal employees are frivolous. For instance, I have been sued in my individual capacity for claims arising out of events occurring before I became Attorney General and events of which I have no knowledge or connection, such as the termination of a private school teacher by a school which indirectly receives funding from the Law Enforcement Assistance Administration, physical injuries received by inmates in federal prisons allegedly inflicted by guards and other inmates, deprivation of inmates' due process rights, and injuries to resident aliens allegedly caused by a statutory amendment to the Immigration and Nationality Act.

> but the most resolute, or the most irresponsible, in the unflinching discharge of their duties.[23]

The overwhelming majority of federal servants are honest and attempt to do their jobs in a manner furthering the interests of their nation. They are confident that if their fate is placed in the hands of a judge or jury they will prevail. The small number of judgments entered against federal employees demonstrates that their confidence is not misguided. Yet, the costs of defending a lawsuit, even a frivolous one, can be immense, and the trauma of being subjected to litigation and a potential monetary judgment, no matter how unlikely, can be severe. The fact that employees enjoy some form of immunity does not reduce the financial burden or relieve the uncertainty. Before an employee can be dismissed from a common law tort action he must show that he was acting within the scope of his employment; in a constitutional tort case, he must show he acted with a reasonable good faith belief in the lawfulness of his conduct. Extensive discovery may be required, and frequently these issues can only be resolved at trial, even though the employee is almost always vindicated. Under such circumstances, subjecting public officials to personal liability in an attempt to ensure that those few who act in bad faith be held accountable is not only bad public policy but also unfair, particularly since, unlike private citizens, they are called on to take action and make decisions that necessarily involve potential widespread injury to others.[24]

Most employees, fortunately, do not have to bear the monetary costs of their own defense. To sustain employee morale and promote vigorous job performance, the Department of Justice, from its earliest days, has recognized its obligation to represent federal employees sued for conduct performed in the lawful exercise of their duties.[25] Over a century ago, Attorney General Jeremiah Black declared:

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23 Gregoire v. Biddle, 177 F.2d 579 (2d Cir. 1949), *cert. denied,* 339 U.S. 949 (1950).

24 *See* Berman, *supra* note 4, at 1179.

25 The statutory basis for the Department's authority to represent the interests of the Government's employees, and thus those of the Government itself, derives from the Judiciary Act of 1789, which established the Office of Attorney General and provided for the creation of United States Attorneys who would be empowered to litigate "civil actions in which the United States shall be concerned," 1 Stat. 92, ch. 20, § 35 (1789). Today, this same authority is found in 28 U.S.C. § 516 (1976), which provides that the

> When an officer of the United States is sued for doing what he was required to do by law, or by the special orders of the Government, he ought to be defended by the Government. This is required by the plain principles of justice as well as by sound policy. No man of common prudence would enter the public service if he knew that the performance of his duty would render him liable to be plagued to death with lawsuits, which he must carry on at his own expense. For this reason, it has been the uniform practice of the Federal Government, ever since its foundation, to take upon itself the defense of its officers who are sued or prosecuted for executing its laws.[26]

The government's obligation to defend employees is normally met by using Justice Department attorneys. Increasingly, however, ethical considerations prevent the Department from representing an individual employee. Three situations have arisen in which the Department cannot ethically represent an employee: when full and vigorous defense of the employee requires assertion of a position in conflict with broader interests of the United States; defenses of several employees joined as defendants in the same action are inconsistent; or the employee is the subject of a criminal investigation by the Department into the conduct upon which the civil suit is based. In such situations, a Justice Department lawyer whose first and unalterable loyalty is to the interests of the United States cannot serve that loyalty, abide by the Code of Professional Responsibility, and adequately represent the interests of the employee.

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conduct of litigation in which the United States "is interested," is "reserved to officers of the Department of Justice, under the direction of the Attorney General."

Recognition of the Department's moral and statutory obligation to represent federal employees in litigation challenging the propriety of their authorized conduct has been noted by other departments and branches of the Government. Early in this century, the Assistant Comptroller to the Secretary of War stated: "That the Government should sustain its officers and employees in the discharge of their duties and defend them when attacked in the courts for alleged injuries growing out of the performance of those duties has been repeatedly affirmed." (citations omitted), 15 Comp. Dec. 621 (1909). More recently in Barr v. Matteo, 360 U.S. 564, 591 (1959), Mr. Justice Brennan, arguing in dissent for a narrowing of the immunity defense available to government employees sued for money damages, pointed out that "[p]ursuant to an Act of Congress, the inconvenience to the government officials made defendants in these suits has been alleviated through the participation of the Department of Justice."

26 9 Op. Att'y Gen. 51 (1857).

To avoid any ethical conflicts while satisfying our obligation to provide federal employees with a defense at government expense, the Department of Justice has retained approximately 75 private law firms to represent employees sued in their individual capacities when they cannot be represented by government attorneys. The private cousel program is controversial[27] and costly,[28] extends the duration of cases, makes them difficult to settle, and permits unsupervised private attorneys paid by taxpayers to raise arguments inconsistent with litigation policies of the United States. Moreover, there is no effective way to resolve these problems. The same considerations that necessitate retention of private counsel preclude the Department from imposing restraints that would restrict the independence of the private counsel.[29]

Soon after I took office in early 1977, I became aware of the trouble alleged victims of constitutional abuses had obtaining relief, the adverse impact of civil liability on employee morale, and the administrative and financial difficulties caused by the Department's private counsel program. As a result, I directed that legislation to rectify these problems be drafted and presented to Congress.[30] Later, on September 16, 1977,[31] the

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27 *See, e.g., U.S. Pays $2 Million Defending Officials of Nixon Era,* Washington Star, Feb. 6, 1978, at ____, col. ____. Moreover, there is some dispute as to whether the Justice Department has authority to retain private counsel. *See, e.g.,* JUSTICE DEPARTMENT RETENTION OF PRIVATE LEGAL COUNSEL TO REPRESENT FEDERAL EMPLOYEES IN CIVIL LAWSUITS, STAFF REPORT TO THE SUBCOMM. ON ADMIN. PRAC. AND PROC. OF THE SENATE COMM. ON THE JUDICIARY, 95TH CONG., 2ND SESS. (1978).

28 Since 1976, despite placing limits on the hourly rate and number of hours for which private counsel can be compensated, the Department has paid out over $2 million in fees to private lawyers representing government employees, a sum which was termed "unacceptably high" by the staff of the Senate Subcommittee on Administrative Practice and Procedure. STAFF REPORT, *supra* note 27, at 19. In fact, it is possible the Department will run out of money for the program during the next fiscal year.

29 Difficulties with the private counsel program led the subcommittee staff to recommend that Congress adopt amendments to the Federal Tort Claims Act similar to those proposed by the Department. *See* STAFF REPORT, *supra* note 27, at 23, 26.

30 *See Senate Hearings, supra* note 2, at 8, 9; *Hearings before the Subcomm. on Admin. Law and Gov't Relations of the House Comm. on the Judiciary,* 95th Cong., 2d Sess. 9 (1978) [hereinafter cited as *House Hearings*].

31 *See* Letter from Att'y Gen. Griffin B. Bell to the Vice President (Sept. 16, 1977), *reprinted in Senate Hearings* at 26. The Department's proposal was introduced in the

Department of Justice proposed that Congress amend the Federal Tort Claims Act. Our proposal was designed to: (1) extend the liability of the United States to include all constitutional torts committed by its employees within the scope of their employment; (2) make the United States exclusively liable for both common law and constitutional torts, thus according statutory immunity to all federal employees; and, (3) provide attorneys' fees and minimum damages of $1,000[32] to successful plaintiffs, enabling those whose constitutional rights have been violated without suffering tangible injury to obtain significant relief.[33]

When the proposed amendments were introduced during the last session of Congress, they were criticized as giving but a

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Senate by Senator Eastland as S. 2117, which is set out in *Senate Hearings* at 39, and in the House by Congressman George Danielson as H.R. 9219, *reprinted in House Hearings* at 1.

The 1977 proposal was not the first one submitted to Congress by the Department. In 1973, the Department, citing the need to replace with comprehensive legislation statutes giving some employees immunity on a piecemeal basis, proposed a bill which would have made the Government exclusively liable for the constitutional and common law torts of its employees. *See* Letter from Att'y Gen. Elliot Richardson to the Speaker of the House (Sept. 17, 1973), *reprinted in Hearings on H.R. 10439 before the Subcomm. on Claims and Governmental Rel. of the House Comm. on the Judiciary*, 93d Cong., 2d Sess. 81 (1974). Submitted to the Congress on September 17, 1973, and introduced as S.2558 and H.R. 10439, the 1973 proposal, while the subject of hearings before a House Judiciary subcommittee, was quickly overshadowed by enactment the following March of an extension of the Federal Tort Claims Act to cover "acts or omissions of investigative or law enforcement officers of the United States Government [based on claims] arising . . . out of assault, battery, false imprisonment, false arrest, abuse of process, or malicious prosecution." *See* note 19 *supra*. Although legislation similar to the Department's proposal in the Ninety-third Congress was introduced in the Ninety-fourth Congress, H.R. 387, 94th Cong., 1st Sess., no hearings were held and the Department took no formal position with respect to it.

32 The proposal also provided for minimum damages of $100 a day for each day of violation or $1,000, whichever is higher, in cases involving unlawful wiretaps. *See* 18 U.S.C. § 2520 (1976).

33 Another significant feature of the Department's original proposal was that it would have permitted the United States to be sued for constitutional torts committed by an employee acting under color of office but outside the scope of his employment. Under the existing Federal Tort Claims Act, the liability of the United States is limited to torts committed within the scope of employment. An employee, however, would have been immunized only for acts committed within the scope of his employment. In those situations where an employee committed a tort while acting outside the scope of his employment but under color of office, a plaintiff could have elected to sue either the United States or the errant employee, but not both. This election has also been incorporated in the bills pending before the current Congress. *See* text accompanying notes 55 to 56 *infra*.

phantom remedy to victims of constitutional abuses.[34] As long as the government could raise the good faith of its employees as a defense, opponents argued, plaintiffs would continue to be thwarted. In response to this criticism, the Department, on January 26, 1978, submitted an amendment to prevent the government from asserting as a defense "the absolute or qualified immunity of the employee (except members of Congress, judges or prosecutors or those performing such functions) or his good faith belief in the lawfulness of his conduct."[35] In addition, adjustments were made to allow plaintiffs to bring constitutional tort claims as class actions when appropriate.[36]

A second concern echoed by the original critics, a concern that continues to underride most criticism of the legislation, is that removing the threat of civil liability would eliminate a major deterrent to unconstitutional action.[37] The concept of immunizing federal employees from civil liability, however, is not new; it was recognized by the Supreme Court more than eighty years ago.[38] Congress itself has immunized certain specific categories of federal employees, such as motor vehicle drivers and medical personnel.[39] Absolute immunity for the Judicial Branch runs even deeper into our Anglo-American common law,[40] and, of course, immunity for members of the Legislative Branch is found in the Constitution.

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34 *See, e.g.*, Remarks of Senator Metzenbaum, *Senate Hearings, supra* note 2, at 11-25; ACLU letter to Raymond S. Calamaro, Deputy Assistant Attorney General (Oct. 3, 1977), *reprinted in Senate Hearings, supra* note 2, at 70-73; letter from Common Cause, ACLU, and others to the Attorney General (Nov. 21, 1977), *reprinted in Senate Hearings, supra* note 2, at 74-79.

35 *Senate Hearings, supra* note 2, at 48. Currently, class actions cannot be brought under the Federal Tort Claims Act. *See generally* Note, *Administrative Exhaustion under the Federal Tort Claims Act: The Impact on Class Actions*, 58 B.U.L. REV. 627 (1978).

36 *Id.*

37 *See* note 34 *supra.*

38 Spalding v. Vilas, 161 U.S. 483 (1895).

39 *E.g.*, 28 U.S.C. § 2679(b) (1976) (drivers of motor vehicles); 38 U.S.C. § 4116 (1976) (medical personnel employed by the Veterans Administration); 26 U.S.C. § 7426(d) (1976) (employees levying on property to collect federal taxes are immune from suit brought by persons claiming an interest in the property other than the taxpayers); 28 U.S.C. § 1498 (1976) (employees sued for patent infringement); 46 U.S.C. § 745 (1976) (employees sued for unlawful seizure of seagoing vessels).

40 *See* Bradley v. Fisher, 80 U.S. (13 Wall) 335 (1871).

Nevertheless, recognizing the need of a mechanism to assure that employees remain accountable for their acts, the Department met with representatives of several public interest groups particularly interested in retaining the deterrent effect of civil liability and received suggestions from many others.[41] The result of these meetings was an addition to our proposed legislative package known as the "disciplinary amendments," an innovative and revolutionary approach ensuring that employees be held accountable for their misdeeds.[42] Unlike current practice in which agency discipline is conducted behind closed doors, the amendments permitted an aggrieved party to initiate and participate in agency disciplinary proceedings against an employee who committed a constitutional tort. The disciplinary process would have been triggered when a person filed a request for an inquiry into allegedly unconstitutional conduct.[43] The agency conducting the inquiry would have been required to hold a hearing if there was a material dispute of fact that could be resolved only by the introduction of reliable evidence and the decision of the agency was likely to depend on the resolution of the dispute. If a hearing were to be held, the agency head could give to a plaintiff, an employee, or both, the opportunity to examine and cross-examine witnesses. A complaining citizen who believed the sanctions imposed on an offending employee were too lenient could appeal to an administrative review body — in most cases the Civil Service Commission — which could supplement the record by taking additional evidence. If still dissatisfied, the citizen could appeal the decision to the federal courts, which would have the power to

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41 The principal groups were the American Civil Liberties Union, Public Citizen, and the Project on National Security Studies and Civil Liberties. Other groups are listed in *Senate Hearings, supra* note 2, at 79.

42 The Department's initial proposal to strengthen existing disciplinary procedures required the Attorney General to refer to the head of the appropriate agency for investigation and possible disciplinary action any matter resulting in payment of damages by the government. Although this proposal was included in the bill, discussions with outside groups convinced the Department of the need for a stronger measure.

43 The right to participate in a disciplinary proceeding was available to a person if he had obtained a money recovery from the United States in an action under the Federal Tort Claims Act, was a plaintiff in such an action and filed a request for an inquiry not earlier than 60 nor later than 120 days after the filing of his complaint, or was invited to participate by the agency conducting the inquiry.

examine the record to determine if the administrative decision was arbitrary and capricious or unsupported by substantial evidence.

Use of strengthened disciplinary procedures rather than the threat of civil liability to deter unconstitutional action has several advantages. First, the choice of penalties an administrative agency may impose — censure, suspension, or removal — allows for more flexibility than an award of damages in a civil suit. Consequently, the sanction imposed on an errant employee would be dictated not by the amount of compensation due a victim but by more relevant factors such as his past record, the nature of his job, and deterrence.[44] Second, separating the issues of accountability and compensation would simplify tort litigation, allowing courts to concentrate on the proper amount of relief due to a victim of a constitutional abuse. Discipline then would be left to the appropriate agency, which is best able to weigh the various factors involved, subject, of course, to judicial supervision.[45] Third, the disciplinary amendments would be at least as much of a deterrent as civil liability is under current law[46] — indeed, they are opposed by many employee groups.[47]

In the House, hearings on the proposed legislation were held by the Judiciary Subcommittee on Administrative Law and Governmental Relations, chaired by Congressman George Danielson.[48] Although a bill was reported from the subcommittee, it failed to receive full committee consideration before the Ninety-fifth Congress adjourned. The bill approved by the subcommittee differed from the Department's proposal in several ways. It did not include any disciplinary amendments, provided an employee subject to administrative disciplinary action with the right to counsel, and eliminated the current exemption in the Federal Tort Claims Act for claims arising out of libel, slander, misrepresentation, deceit, or interference with con-

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44 Berman, *supra* note 6, at 1197.
45 *Id.* at 1198.
46 *Id.*
47 *See House Hearings, supra* note 30, at 27; *Senate Hearings, supra* note 2, at 400.
48 *House Hearings, supra* note 30.

tract rights.[49] The Department did not take a public position on these changes before Congress adjourned.

Senate hearings were held by two subcommittees of the Judiciary committee — the Subcommittee on Citizen and Shareholders' Rights and Remedies and the Subcommittee on Administrative Practice and Procedure.[50] Subsequently, the major features of the Department's proposals were incorporated into a bill introduced by Senator Howard Metzenbaum, chairman of the Subcommittee on Citizen and Shareholders' Rights and Remedies.[51] Although Senator Metzenbaum's bill was approved by his subcommittee, it was not taken up by the full committee before Congress adjourned. The bill contained several provisions that were unacceptable to the Department. Since similar provisions may again be the focus of debate, I will discuss them in some detail.

Because of perceived problems of disciplining employees who have left government service and the constitutional difficulty of sanctioning appointees who serve at the pleasure of the President,[52] the Department's original disciplinary amendment treated former employees and presidential appointees differently than current employees, although all were fully protected from individual liability. An administrative agency, in most cases the Civil Service Commission, would have investigated allegations of unconstitutional conduct by a former employee or Presidential appointee and, if appropriate, issued a public report censuring the offender. The Metzenbaum bill, while incorporating these special disciplinary procedures, did not fully immunize former employees or Presidential appointees. It instead provided for an "election of remedies" — plaintiffs could choose to sue the United States under the Federal Tort Claims Act, as amended, or proceed against a former employee or Presidential appointee under current law. The Department believes that offering plaintiffs an election of

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49 28 U.S.C. § 2680(h)(1976).

50 *Senate Hearings, supra* note 2.

51 Senator Metzenbaum's bill was introduced as S. 3314. It is reprinted in *Senate Hearings, supra* note 2, at 423-46.

52 Letter from John Harmon, Assistant Attorney General, to Senator Abraham Ribicoff at 8; *see* Myers v. United States, 272 U.S. 52 (1926).

remedies would frustrate some of the major purposes of the legislation. Although presumably most plaintiffs would sue the United States if the Federal Tort Claims Act were amended to make relief easier to obtain, many plaintiffs, particularly those who bring suits simply for harassment, would continue to sue individuals. Further, the election provision can be easily circumvented when there are multiple plaintiffs. As long as employees remain individually liable, their morale and job performance will be impaired, suits in which they are joined as defendants will still be difficult to settle, and the Department will be forced to continue its private counsel program. Moreover, granting immunity to current but not former employees might induce employees who have committed constitutional violations to remain with the government to avoid liability.

A second feature of the Metzenbaum bill to which the Department objected involved the scope of conduct for which an employee would be immunized. The Department's proposal immunized an employee for all acts committed within the "scope of his employment." To retain civil liability in egregious cases, such as those in which an employee acts in bad faith, the Metzenbaum bill only immunized an employee acting "within the scope of his authority or with a reasonable good faith belief in the lawfulness of his conduct." The scope of employment standard in the Department bill is the same as the one in the Tort Claims Act, and it has been defined in numerous judicial decisions.[53] The Metzenbaum standard, on the other hand, is new and would require much litigation before employees would know the extent of their liability. Use of the Department's standard also would avoid endless and expensive discovery into the state of mind of an employee and the actual authority delegated to him by his agency. Under the Department's proposal, to gain relief a plaintiff need only have established that a constitutional tort had been committed by a federal employee acting within the scope of his employment, a relatively easy task.

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53 *E.g.*, Avery v. United States, 434 F. Supp. 937 (D. Conn. 1977).

Debate about these proposals undoubtedly will continue in the current Congress.[54] On March 5, 1979, Congressmen Rodino and Danielson introduced H.R. 2659;[55] ten days later, Senator Kennedy introduced S. 695.[56] Both bills, based on drafts supplied by the Department, are substantively indistinguishable and similar to the bills supported by the Department in the last session of Congress. Like their predecessors, H.R. 2659 and S. 695 would make the United States the exclusive defendant in suits based on common law and constitutional torts committed by a government employee within the scope of his employment. Class action procedures, minimum damages of $1,000,[57] reasonable attorneys' fees, and litigation costs would be available to constitutional tort plaintiffs. In addition, the United States could not assert the good faith of its employee as a defense. Both bills also include provisions for citizen initiated disciplinary proceedings. Although the disciplinary amendments are almost identical to those originally proposed during the last Congress, the Department has made some revisions. The most significant changes concern former employees and Presidential appointees. The Department has attempted to treat these categories the same as current employees. Under the new amendments, to gain immunity, a former employee must agree to submit to discipline by his former agency, which could censure him or impose a fine up to one-twelfth of his average annual salary at the time the constitutional violation was committed. If a former employee declined to submit to possible disciplinary action, he would remain individually liable. Complaints of unconstitutional conduct by Presidential appointees would be referred to the Merit Systems Protection Board, which would conduct an inquiry and recommend appropriate disciplinary action, if any, to the President.

The Department of Justice has gone a long way to satisfy the

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54 125 CONG. REC. S2919 (daily ed. March 15, 1979) (Statement of Sen. Kennedy).

55 125 CONG. REC. H1107 (daily ed. March 6, 1979).

56 *See* note 54 *supra.*

57 In the case of constitutional torts based on a continuous course of conduct, such as a wiretap or mail cover extending for several months, the bills provide for liquidated damages of $100 a day, not to be less than a total of $1,000 or to exceed a total of $15,000. No award of liquidated damages for any one class in a class action may exceed $1 million.

concerns of the original critics of our legislative package. Many of those critics, including the American Bar Association, now support the legislation, and the differences between the Department and remaining opponents are relatively slight. I am optimistic that this Congress will agree that amendments to the Federal Tort Claims Act are in the public interest and will act favorably on our proposals.

MENTAL HEALTH LEGISLATION AND ITS RELATIONSHIP TO PROGRAM DEVELOPMENT: AN INTERNATIONAL REVIEW

TIMOTHY W. HARDING*
WILLIAM J. CURRAN**

In its effort to improve the delivery of mental health services around the world, the World Health Organization recently conducted an extensive survey of the laws affecting mental health in WHO countries. Drs. Harding and Curran, the principal coordinators of the survey, provide a summary of the survey's findings, outlining the salient conclusions of the WHO report. They conclude by offering recommendations for establishing a comprehensive legal framework for mental health programs in both developing and developed countries.

Introduction

In 1954 the World Health Organization (WHO) completed the first international comparative review of mental health legislation.[1] In that same year, its Expert Committee on Mental Health published a series of recommendations for the improvement of mental health laws.[2] By the mid-1970s, these two documents, important international reference points for over two decades, no longer reflected the current state of knowledge due to developments in the intervening years both in legislation and in the organization of national mental health programs.[3]

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1 *Hospitalization of Mental Patients,* 6 INT'L DIG. OF HEALTH LEGIS. 3 (1955).

2 WORLD HEALTH ORGANIZATION EXPERT COMM. ON MENTAL HEALTH, TECHNICAL REP. SERIES NO. 98, LEGISLATION AFFECTING PSYCHIATRIC TREATMENT: FOURTH REPORT (1955).

3 Curran & Harding, *The Law and Mental Health: Harmonizing Objectives,* 28 INT'L DIG. OF HEALTH LEGIS. 725, 730, 738-42 (1977) [hereinafter cited as *Law and Mental Health*].

We determined at WHO that a newer and more comprehensive survey of mental health laws should be prepared in order to provide an up-to-date review of the prevailing legislation in a large group of countries throughout the world and to supply legislators, mental health administrators, professionals in the field, lawyers, and interested other voluntary groups and individuals with criteria for evaluating the mental health legislation in their own countries.[4] To this end, we were concerned with the relationship between mental health legislation and the current and projected development of mental health services in the respective countries. We believed that mental health legislation, if it were to be effective, should reflect accurately the current status of the mental health programs of the country and should not be an obstacle to further development and improvement of mental health services. The Secretariat of WHO in Geneva, therefore, drafted a detailed questionnaire regarding mental health legislation and programs and distributed it to member countries and to the Regional Offices.[5] The responses to the questionnaire were collected in Geneva during 1976 and 1977; WHO received completed questionnaires from 66 respondents in 48 countries.[6]

The respondents were highly knowledgeable and experienced in the mental health field in their home countries and included the following persons: members of the Expert Advisory Panel on Mental Health of WHO (which included approximately 100 government officials, senior psychiatrists, and other mental health professionals in over 50 countries); resident WHO representatives for mental health programs in member nations all over the world; representatives of national (voluntary) mental health associations; and important individuals and groups selected by the Regional Offices.[7]

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4 *Id.* at 731.

5 *Id.* at 742-43. The questionnaire elicited information on existing legislation with specific reference to voluntary and involuntary treatment, appeal procedures, patient review boards, differentiation between different categories of mental disorder, treatment restrictions, and qualifications of mental health personnel. The questionnaire sought information regarding legislative reform movements and the interaction between mental health laws and programs.

6 *Id.* at 743.

7 *Id.*

The total number of countries included in this comparative analysis was 43.[8] Among this group, 31 nations were operating under formally adopted statutes and administrative regulations while 12 nations were classified as functioning under an informal system with no specific laws covering mental health treatment and hospitalization.[9] In order to provide broad coverage, at least two countries were included from each of the six regions of WHO throughout the world. The selection included nations of widely varying size and populations, level of socioeconomic development, political structure and history, and pattern of mental health programs.[10] In countries with a federal government structure, an examination was conducted of the laws in two subfederal states or provinces in the country.[11]

The project's legal research staff conducted the comparative analysis of the mental health legislation in the countries selected for review. We relied upon statutory and regulatory materials contained in the law libraries of the United Nations and the International Labor Office in Geneva and supplied by the respondents. We also drew from literature and reports on file at WHO which provided information about the actual operation of mental health programs in the countries under examination.[12]

This article summarizes the salient findings, conclusions, and

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8 *Id.* at 744. The countries surveyed were Australia (South Australia, Victoria), Bahrain*, Benin*, Brazil, Canada (Alberta, British Columbia), Costa Rica, Cyprus, Democratic Yemen, Denmark, Egypt, Ethiopia* (Draft Law), France, Fiji, Ghana, India (Punjab and Uttar Pradesh), Iran*, Iraq* (Draft Law), Japan, Jordan*, Kuwait*, Lesotho, Malaysia, Nigeria, Norway, Pakistan, Poland, Peru, Qatar*, Romania, Rwanda*, Saudi Arabia* (Draft Law), Senegal, Sudan, Switzerland (Basel-Stadt and Geneva), Syria, Thailand*, Tanzania, Trinidad and Tobago, U.S.S.R., United Kingdom (England, Wales), United States (Indiana, Massachusetts), Uruguay, Yemen Arab Republic*.

The countries identified by asterisks were classified as those operating under informal systems, that is, those operating without any specific legislation covering treatment or hospitalization for the mentally disordered. The subfederal states or provinces included in the study are indicated in parentheses after the name of the country.

9 *Id.* Those countries operating under an informal system have been signified by asterisks in note 8 *supra.*

10 *Law and Mental Health, supra* note 3, at 744.

11 *Id.* at 745.

12 *Id.* at 744.

TABLE 1

YEARS OF MAJOR ENACTMENT

1970-1976	Canada (Alberta), Costa Rica, Saudi Arabia (Draft law, 1976), Senegal, Sudan, Trinidad and Tobago, United States of America (Indiana, Massachusetts).
1965-1969	Romania, Switzerland (Geneva), Syrian Arab Republic.
1960-1964	Canada (British Columbia), Lesotho, Norway, Switzerland (Basel-Stadt).
1955-1959	Australia (Victoria), United Kingdom (England and Wales).
1950-1954	Japan, Malaysia, Peru, Poland.
1930-1949	Australia (South Australia), Brazil, Cyprus, Democratic Yemen, Denmark,[a] Egypt, Fiji, Tanzania, Uruguay.
1900-1929	India,[b] Nigeria, Pakistan.[b]
Pre-1900	Ghana,[c] France.[d]

a Amended by Order of 1957 and 1959.
b The basic Indian law is the Colonial Law of 1912. The same law is currently operational in Pakistan and Burma.
c Operating under law of 1888, amended 1957; new law 1972 not in operation.
d Frequently amended, notably in 1960 and 1962.
SOURCE: Curran & Harding, *The Law and Mental Health: Harmonizing Objectives*, 28 INT'L DIG. OF HEALTH LEGIS. 725, 746 (1977).

recommendations contained in WHO's final report on this project.[13] The first part of this article reviews the current state of mental health legislation, examining from a comparative perspective the relationship between existing law and the development of mental health services. The second part outlines a series of recommendations for establishing a comprehensive legal framework for mental health programs.

13 A full report of the study including a review of the statutory provisions of the countries surveyed is contained in *Law and Mental Health, supra* note 3, at 725.

TABLE 2

REPORTED RATES OF VOLUNTARY ADMISSIONS

Percentage	*Country*
0-10	Fiji,[a] India (Punjab),[a] Malaysia,[a] Pakistan,[a] Syrian Arab Republic, Uruguay.
11-40	Bahrain, India (Uttar Pradesh),[a] Japan, Tanzania, United States of America (Indiana).
41-60	Australia (Victoria), Benin, Democratic Yemen,[a] Jordan, Norway, Switzerland (Geneva), United States of America (national).[b]
61-80	Australia (South Australia), France,[a] Trinidad and Tobago, United States of America (Massachusetts).
81-90	Ghana, Iran,[a] Lesotho,[a] Poland, Rwanda,[a] Switzerland (Basel-Stadt),[a] United Kingdom (England and Wales).
91-100	Cyprus, Denmark, Egypt,[a] Iraq, Kuwait, Senegal,[a] Sudan, Union of Soviet Socialist Republics.[c]

a Estimate.
b Latest national figures for 1972 give an estimate of 48.6% voluntary patients in the 50 States.
c Between 96 and 99% in 1975, according to a number of indices.
SOURCE: Curran & Harding, *The Law and Mental Health: Harmonizing Objectives*, 28 INT'L DIG. OF HEALTH LEGIS. 725, 751 (1977).

I. REVIEW OF CURRENT MENTAL HEALTH LEGISLATION

A. *The Adequacy of Present Legislation*

Although it is difficult to develop comparative standards for measuring the efficacy of current national mental health laws, the WHO project selected three general criteria. The two most useful quantitative standards proved to be the number of years which have passed since the enactment of the last major revision of the mental health laws and the current rate of voluntary

admission of patients to the mental health facilities of the country. Tables 1[14] and 2[15] respectively provide information on these criteria in each of the surveyed countries and subfederal jurisdictions.

We caution that recent enactment is not always a guarantee that the legislation of a particular nation is functioning adequately in relation to the nation's needs, nor is the fact that the law is many decades old an irrefutable indication that the law is hopelessly out of date. Some laws were virtually obsolete at the time of their enactment while others, like the French law of 1838, seem to be adaptable to changing conditions, at least as long as they allow for the adoption of new and revised administrative regulations and ministry directives.[16] Nevertheless, the date of enactment is a useful guide to determining the major legal, political, and psychiatric influences which may have had a role in determining the substance and thrust of the legislation. For example, codes stressing judicial involvement and institutional visiting committees, and vesting authority in powerful asylum superintendents were enacted in the middle to the late nineteenth century. In these same years, the mentally ill and retarded were segregated or alienated from the general population. They were generally deprived of legal capacity and civil rights.[17] On the other hand, the earlier decades of this century, from 1900 to 1940, were marked by legislative optimism about psychiatric care and treatment, and the mental health laws began to display a greater tendency toward simplified admission procedures, but with management emphasis still upon large, multipurpose mental institutions. The later decades of this century have seen a movement toward community-based mental health services and greater protection for the human rights of patients.[18]

The historical pattern sketched above relates essentially to the industrial countries. Developing countries generally proceeded according to a different pattern. Many are functioning

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14 *Id.* at 746.
15 *Id.* at 751.
16 *Id.* at 746.
17 *Id.* at 740, 745.
18 *Id.* at 745.

currently without a formal legislative structure for their mental health services. A substantial number of countries still operate under provisions enacted by colonial powers many decades ago.[19] Only a few newly independent nations in our survey had adopted entirely new mental health legislation especially applicable to current conditions in their countries.[20]

With respect to voluntary admission, the second factor used by WHO in determining the adequacy of present legislation, commentators agree generally that a movement toward voluntary status for as many mental patients as practicable is highly desirable, both in clinical terms and for the sake of the patients' social and legal well-being. This viewpoint was expressed in 1966 by the Canadian Royal Commission on Health Services: "The number and proportion of all voluntary admissions is alleged to be, to some extent, an index of acceptance of and attitudes toward psychiatric treatment by the community."[21] The figures provided in Table 2 concerning voluntary admission should, however, be interpreted with some caution. Only a few countries compile comprehensive nationwide statistics on annual admissions and patient census. Some countries gather statistics only on admissions to public mental health facilities. In addition, countries apply varying admission categories.[22] Developing nations with informal systems tended to report the highest rates of voluntary admission because of less cumbersome procedures, less reliance on the courts, and greater stress on family responsibility for patients.[23]

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19 *Id.* For example, the law and practice in Benin, Nigeria, and Rwanda still reflect their colonial origins. *Id.* at 747.

20 Only Senegal, for example, among the new nations in the African region, had adopted new legislation specifically attempting to reconcile modern psychiatric knowledge with local conditions.

21 ROYAL COMM. ON HEALTH SERVICES, PSYCHIATRIC CARE IN CANADA: EXTENT AND RESULTS 70 (Canada, 1966).

22 In many countries an admission is considered voluntary if the patient is brought to the hospital by his family: Benin, Democratic Yemen, Iran, Jordan, Kuwait, Lesotho, Qatar, Romania, Saudi Arabia, Thailand, and the Yemen Arab Republic. In virtually all the surveyed countries a parent's commitment of his minor child was deemed a voluntary admission; only Brazil, Costa Rica, Denmark, France, Ghana, India, Malaysia, Norway, Pakistan, Poland, Peru, Senegal, and Switzerland (Basel-Stadt and Geneva) apparently provided otherwise. *Law and Mental Health, supra* note 3, at 767, 826-38.

23 *Id.* at 749, 752.

A third standard used by WHO in determining the relevancy of present mental health laws was the existence and strength of legislative reform movements in the respective countries. Although this criterion is less quantifiable than the first two, WHO deemed it to be equally useful. Nearly all regions of the world reported an interest in up-dating and reforming mental health legal codes. Activity was widespread among the countries of the Eastern Mediterranean Region where a Group Meeting on Mental Health and Mental Health Legislation was held in Cairo in June of 1976.[24] In Asia, the Indian government has been examining since 1971 draft proposals for reform of its outmoded Lunacy Act of 1912.[25] Action is expected soon by the central and state governments. In the African Region, respondents called attention to the work of a special psychiatric committee in Nigeria cooperating with the federal government in drafting a modern mental health code.[26]

In Europe, the national mental health laws were found to be from ten to forty years old. At present, legislative reform interest appears to be strongest in the United Kingdom and in Poland.[27] In England and Wales, for example, the central government released in 1977 a so-called consultative document suggesting changes in the Mental Health Act of 1959.[28] In Poland, a draft act for a completely new mental health code has been proposed to the government.[29] In both countries, the suggested reforms emphasized the rights of mental patients.

In North America, legislative activity has been quite extensive in the 1970s with the enactment of new laws in a large number of American states and Canadian provinces.[30] Here again the emphasis has been on human rights. We received no

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24 WORLD HEALTH ORGANIZATION (REG'L OFFICE FOR THE E. MEDITERRANEAN), GROUP MEETING ON MENTAL HEALTH AND MENTAL LEGISLATION: CAIRO, EGYPT, 12-17 JUNE 1976 (Sept. 1976).

25 *Law and Mental Health, supra* note 3, at 747-48.

26 *Id.* at 756.

27 *Id.* at 747.

28 DEP'T OF HEALTH AND SOCIAL SECURITY, REVIEW OF THE MENTAL HEALTH ACT 1959 (Great Britain, 1976).

29 Daszkiewicz, Dabrowski & Kubicki, *Mental Health Code,* THE NATION AND THE LAW, BULL. 8-9 (Poland, 1974).

30 *Law and Mental Health, supra* note 3, at 748. In both of the American states surveyed by this study, new legislation had been recently adopted. In Massachusetts,

reports of recent changes or reform efforts in Central or South America in recent years. However, efforts to reform general public health codes, such as the one in Costa Rica, have resulted in some changes in mental health legal procedures.[31] Furthermore, in the Caribbean area, Trinidad and Tobago enacted new mental health laws in 1975 which contain a number of innovative features.[32]

Legal efforts in the Western Pacific Region have not been widespread except in Australia.[33] Two of the Australian states, South Wales[34] and Victoria,[35] were examining important study reports which recommend substantial changes in the state law in the mental health field.

Respondents from 28 of the 43 countries surveyed expressed dissatisfaction with the current law of their respective countries.[36] The most frequent objection was that the law was too

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this revision took place in 1970 by the simultaneous repeal and enactment of a whole chapter of the Massachusetts Code, MASS. GEN. LAWS ANN. ch. 123 (West Supp. 1979). In Indiana, legislative reform has been a continuing process, although the legislative reforms of 1975 should be particularly noted. IND. CODE ANN. § 16-14-9.1-1 to -18 (Burns Supp. 1978).

Massachusetts, Washington, West Virginia, and Michigan have revised their legislation so as to restrict the duration, procedural laxity, and grounds for involuntary civil commitment. MASS. GEN. LAWS ANN. ch. 123 § 12 (West Supp. 1979); WASH. REV. CODE ANN. § 71.05 (Supp. 1978); W. VA. CODE §§ 27-5-1 to -6 (Supp. 1978); MICH. COMP. LAWS ANN. §§ 330.1423-.1497 (1975 & Supp. 1978). Washington, Colorado, and Massachusetts provide further that commitment alone does not operate to deprive a person of his civil rights. WASH. REV. CODE ANN. § 71.05.060 (1975); MASS. GEN. LAWS ANN. ch. 123 § 25 (West Supp. 1979); COLO. REV. STAT. § 27-10-104 (1973). Concern with emergency detention is reflected in a Michigan provision which limits the use of chemotherapy prior to judicial hearings. MICH. COMP. LAWS ANN. § 330.1718 (1975). Connecticut and Florida have recently enacted psychiatrist-patient privilege statutes, CONN. GEN. STAT. § 52-146d (1979); FLA. STAT. ANN. § 90.242 (West Supp. 1978), while Minnesota has now limited a guardian's heretofore unnecessarily broad authority over his ward. MINN. STAT. ANN. § 252A.11 (West Supp. 1978). Thus, developments in mental disability legislation in the United States have been extensive and numerous. For a review of the present state of the law and suggestions for further change, *see Legal Issues in State Mental Health Care: Proposals for Change*, 2 MENTAL DISABILITY L. REP. 57 (1977) (article continued in subsequent volumes of the REPORTER).

31 *Law and Mental Health, supra* note 3, at 748, 767.

32 *Id.* at 748.

33 *Id.* at 747.

34 MENTAL HEALTH ACT REVIEW COMM., REPORT TO THE NEW SOUTH WALES HEALTH COMMISSION (Australia, Dec. 1974).

35 COMMITTEE OF INQUIRY INTO HOSPITAL AND HEALTH SERVICES IN VICTORIA, REPORT TO THE MINISTER OF HEALTH (Australia, 1975).

36 *Law and Mental Health, supra* note 3, at 748.

simple rather than too complex. The majority of dissatisfied respondents asserted that their mental health codes were obsolete and unresponsive to their country's current needs.[37] Among specific professional groups, psychiatrists in clinical practice were reported to be the most unsatisfied with the law, followed by mental health professionals and social workers.[38] In a few countries lawyers and civil rights activists were reported to be the most active advocates of change in the law.[39]

B. *Specific Comparative Review of Legislation*

Our analysis primarily emphasized the relationship between the existing law and the development of mental health services. We selected a variety of substantive criteria based upon their acceptance in the legal and psychiatric literature. We also considered whether these criteria could be tested by examining the laws themselves and by evaluating the responses to our questionnaire.

1. Hospitalization Versus Community Services

We considered as our first criterion whether the legislative code concentrated exclusively upon hospitalization procedures to the exclusion of any reference to the development and support of community-based mental health services. In a study conducted in the early 1960s, Krapf and Moser found the movement to comprehensive mental health services for a broader segment of the population to be one of the most important indicia of progressive change.[40] The laws of only a few of the nations surveyed, however, contained provisions regarding the organization of community mental health sources.[41] Instead, most countries were concerned almost exclusively with

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37 *Id.*
38 *Id.* at 749.
39 *Id.*
40 Krapf & Moser, *Changes of Emphasis and Accomplishments in Mental Health Work, 1948-1960,* 46 MENTAL HYGIENE 163 (1962).
41 Such laws were found in France, Norway, Senegal, Sudan, and the United States. *Law and Mental Health, supra* note 3, at 750, 762-63.

hospitalization procedures.[42] Some laws contained provisions for guardianship of mental patients and retarded residents, but often the sole purpose of these provisions was to channel payments to the hospital to care for the patient, or to manage the patient's property while he was hospitalized. With few exceptions, these laws considered treatment of mental illness the exclusive province of large multipurpose institutions. A substantial majority of our respondents reported that their mental health laws neither encouraged nor discouraged the development of community-based mental health services.[43] They also reported that the national legislatures in these countries were very reluctant to provide funds to establish such services.[44]

The laws in some nations providing for foster care and community guardianship centers proved to be an important index of community-based facilities for the mentally ill. The law of the Soviet Union contained detailed procedures for foster care under professional supervision in the collective farms.[45] The new mental health legislation enacted by Senegal in 1975 required psychiatric villages comprised of mentally ill persons and their families to be established in each region of the country.[46] As early as 1944, the French promulgated a special order setting up a plan for organizing community centers to place former mental patients in foster homes in their own communities.[47]

The movement toward community-based services need not be viewed only as an alternative to well-staffed mental hospitals. Both options are necessary. Efforts in a few countries to close mental hospitals and thrust large numbers of mental patients upon communities which do not have adequate services and facilities have failed badly.[48] Nevertheless, most industrial

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42 *Id.* at 749-50.
43 *Id.* at 732.
44 *Id.* at 732, 748.
45 *Id.* at 750, 762, 836-37.
46 *Id.* at 750, 762-63.
47 *Id.* at 762.
48 "The most difficult issues arise when discharged patients commit violent acts which result in outcries in the press and other mass media against the improper discharge of 'dangerous maniacs' into the community. As a result there is currently

nations have begun to shift to comprehensive services which include a variety of community-based alternatives. Developing nations have been moving toward integrating mental health services with general medical services operated in local communities. This movement has been prompted by an interest in effectively and efficiently using scarce health manpower and facilities.[49]

a. Hospitalization

Hospitalization procedures in the countries which were surveyed continued to be varied and complex. The trend toward voluntary procedures noted in the 1955 WHO report[50] also continued. Three different patterns were operating: (1) legal systems with clear provisions specifically authorizing voluntary or informal admission; (2) legal systems with no provision for voluntary admission although such admissions routinely took place; and (3) informal legal systems with voluntary admissions being the predominant mode of civil commitment. Most of the countries surveyed fell in the first category.[51] Countries with large and complex systems such as France and Japan were among those in the second category.[52] Developing countries in the Eastern Mediterranean formed a significant portion of nations in the last category.[53]

The most dramatic change in the hospitalization laws over the past twenty years came in involuntary commitment. Laws authorizing commitment on medical certification alone — without prior approval of a court even though no emergency existed — have become more widespread. In 1955 there were non-judicial procedures in 19 of the 37 countries surveyed. By 1976, this procedure had been adopted by 34 jurisdictions in the 43 nations

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something of a 'backlash' against over-enthusiastic policies of discharge." *Id.* at 809.

49 WORLD HEALTH ORGANIZATION EXPERT COMM. ON MENTAL HEALTH, TECHNICAL REP. SERIES No. 564, ORGANIZATION OF MENTAL HEALTH SERVICES IN DEVELOPING COUNTRIES: SIXTEENTH REPORT 18 (1975).

50 *Hospitalization of Mental Patients,* 6 INT'L DIG. OF HEALTH LEGIS. 15 (1955).

51 Twenty-four countries fell into this category. *Law and Mental Health, supra* note 3, at 765.

52 Four countries fell into this category. *Id.*

53 Twelve countries lacked any legislation covering voluntary admissions to mental hospitals. *Id.*

under review.[54] In most countries, the patient or his family could appeal to a court after the commitment, but the appeal was often limited, such as being allowed only after three months of hospitalization, or only once annually or semi-annually.[55] In 11 of the jurisdictions, non-judicial commitment represented the only compulsory method for long-term hospitalization. In the jurisdictions where there existed an alternative to a procedure requiring prior judicial approval, the respondents indicated that the non-judicial procedure was heavily favored. Hospital authorities, committing groups such as social workers and police, and patients and their families were reported to favor this method. They believe that the non-judicial procedure reduces the social stigma associated with court commitment.[56]

Preference for non-judicial commitments was not universal. In 12 countries, judicially ordered commitments were the exclusive method of involuntary long-term hospitalizations. This group of countries included Cyprus, Democratic Yemen, Ghana, India, Iran, Iraq, Nigeria, Pakistan, Romania, Senegal, Tanzania and the United States.[57] The United States was the only nation whose constitution required prior judicial review of non-emergency involuntary commitment.[58]

The predominant legal ground for involuntary hospitalization in the countries surveyed was the patient's potential for endangering himself or members of the community at large. More than three-quarters of the laws examined contained standards of dangerous behavior which a patient must violate in order to be committed.[59] In about half of this group these standards collectively constituted the only criterion for commitment. In the

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54 *Id.* at 768. Among those countries permitting involuntary hospitalization without prior court approval were Brazil, Canada (Alberta, British Columbia), Costa Rica, Denmark, Egypt, France, Japan, Jordan, Kuwait, Lesotho, Norway, Peru, Poland, Qatar, Saudi Arabia, Sudan, Switzerland (Basel-Stadt, Geneva), Syria, Thailand, Trinidad and Tobago, U.S.S.R., United Kingdom (England, Wales), and Uruguay. *Id.* at 838-68.

55 These restrictions on access to review tribunals, contained in the Mental Health Act of 1959 in England and Wales, have spread to many other countries as a result of conscious imitation. *Id.* at 776.

56 1 L. GOSTIN, A HUMAN CONDITION 28-33 (1975).

57 *Law and Mental Health, supra* note 3, at 838-68.

58 Simon v. Craft, 182 U.S. 427 (1901).

59 A dangerous behavior test was required in Australia (South Australia, Victoria),

remaining half, they were used as one of several grounds for involuntary hospitalization.[60] The other criteria stated in the statutes related to the person's need for treatment, his refusal to accept it, or his inability to appreciate or perceive his need for treatment. The statutes rarely made any attempt at defining dangerousness. In Brazil commitment was authorized for patients with suicidal tendencies, for those exhibiting serious aggression toward others, and for persons troubled in their social life or tending toward immoral actions.[61] In Romania a patient could be committed for endangering the life, health, or bodily integrity of himself or members of the community. A patient also could be hospitalized involuntarily for committing other serious acts covered by the penal law.[62] The Indiana law contained two classifications. The first one, called "dangerousness," was defined as the "substantial risk that [the patient] will harm himself or others." The other was termed "gravely disordered" and included patients who were in danger of being harmed because of their inability to provide themselves with food, clothing, shelter, or other essentials.[63]

Our survey also revealed a clear trend away from the adoption of temporary observational hospitalization procedures. Only a small minority of the jurisdictions continued to have such laws on the books.[64] The greater availability of diagnostic facilities in the community and the increasing involvement of family medical practitioners in treating mental illness cases

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Benin, Brazil, Canada (Alberta, British Columbia), Democratic Yemen, Denmark, Egypt, France, Fiji, India, Iran, Iraq, Japan, Kuwait, Lesotho, Norway, Pakistan, Peru, Poland, Romania, Rwanda, Saudia Arabia, Senegal, Sudan, Switzerland (Basel-Stadt, Geneva), Syria, Tanzania, U.S.S.R., United Kingdom (England, Wales), United States (Indiana, Massachusetts), and Uruguay. *Law and Mental Health, supra* note 3, at 838-68.

60 In 17 countries, compulsory hospitalization could only be ordered upon a finding of dangerousness. *Id.* at 768.

61 *Id.* at 769, 841.

62 *Id.* at 856.

63 IND. CODE ANN. §§ 16-14-9.1-1, 16-14-9.1-3 (Burns Supp. 1978).

64 Only 13 jurisdictions provide specifically for observational hospitalization: Australia (South Australia, Victoria), Egypt, Iraq, Japan, Lesotho, Malaysia, Peru, Saudi Arabia, Syria, Trinidad and Tobago, and United Kingdom (England, Wales). *Law and Mental Health, supra* note 3, at 875-78.

65 *Id.* at 770.

have contributed to the decline of these laws.[65] The observational procedures, however, have been continued extensively in criminal court matters which require psychiatric evaluations.[66] The public mental hospitals in many jurisdictions were reported to be involved heavily in this activity, with a large percentage of their beds occupied by observational cases from the local courts.[67]

Emergency commitment procedures continued to be an important part of the mental health legislative systems in nearly all countries and jurisdictions.[68] The only recently enacted code without an emergency commitment law was the one adopted in Alberta, Canada in 1972.[69] No particular trends were discernible, except that some of the newer laws adopted shorter periods of hospitalization. The most common period throughout the world was seventy-two hours, though some of the statutes allowed periods of up to two and three weeks.[70] The newer statutes often reduced hospitalization to no more than twenty-four hours before the patient would have to be released or committed under regular procedures.[71] The objective of the new laws apparently was to reduce the stigma and the trauma of commitment by shortening the allowable period of detention. It has been observed, however, that the reduction in time can be counterproductive. The very short periods of evaluation tend to force the hospitals to seek an automatic extension since the period is too short to conduct an adequate clinical observation.[72]

The new systems of periodic evaluation used two approaches to achieve their goals. The first one required reporting by the hospital at stated intervals while the patient is hospitalized. The second approach shortened the commitment periods and permitted renewal of the commitment order only subsequent to a full reevaluation of the patient's condition in light of the

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66 *Id.* at 772-73.
67 *Id.* at 772.
68 *Id.* at 770.
69 ALTA. REV. STAT. ch. 231 (1970).
70 *Law and Mental Health, supra* note 3, at 771.
71 The U.S.S.R., for example, requires a special panel of three psychiatrists to make a report within 24 hours of an emergency admission. *Id.*
72 *Id.* at 808.

grounds which originally were asserted as a basis for committing him.[73] The most recent reform legislation reflected a preference for the latter method. The evaluation usually is conducted by the medical staff of the hospital, not by outside consultants, and it is limited to the clinical progress of the patient. In some jurisdictions, however, the evaluation also considers the availability of treatment in the community, family support, living conditions for the patient, and the patient's legal competency to handle his own affairs. Legislation recently enacted in Massachusetts, for example, provided for a comprehensive evaluation of this nature and included separate staffs for the clinical, social, and legal components of the review.[74]

The new law in Alberta, Canada, also offers a new approach to periodic evaluation.[75] The unusually short initial commitment period of thirty days may be extended for two months upon reevaluation. Upon further reevaluations, the period may be extended at six month intervals without limitation. The law requires reevaluations to be conducted with the same formalities as the initial commitment. Thus, two "therapists" must examine the patient and certify the examination. Although one of the therapists must be a physician, the other one may be a psychologist, a social worker, or a nurse who is licensed under the law for this purpose.

b. Community Mental Health Care

Central governments employed two primary methods to stimulate development of community mental health care services. One technique made government funds or health insurance benefits available to finance such services. The other approach decentralized authority for operating and funding the community services. The former method often did not require legislative action, except for budgets and appropriations. The latter method, however, usually entailed formal delegation of powers by law.

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73 Examples of the former are found in Australia (South Australia, Victoria), Romania, and Sudan, and of the latter in Lesotho and United States (Indiana). *Id.* at 838-69.

74 *Id.* at 869.

75 *Id.* at 780, 841.

France was among the first countries to implement a system using both financial incentives and formal decentralization.[76] In 1944, the French enacted a plan creating special centers to facilitate placing former patients in foster homes. In 1955, they established supporting community mental hygiene centers with central government support for up to 80 percent of costs. In the 1960s, a master plan was adopted to reorganize and modernize the public mental hospitals. Patients were assigned to hospitals according to the sectors and departments where they resided. This "sectorization" of the mental health services and facilities was designed to provide effective coordination and continuity of care between hospitals and community follow-up with discharged patients. Regulations adopted in the national social security system set standards for mental health treatment in the community centers.

Sudan's new Mental Health Law enacted in 1975 established a Mental Health Board in each province and delegated to these boards the power to set up local mental health boards in their provinces as they are needed.[77] Senegal's law, also adopted in 1975, authorized the organization of psychiatric villages in each region.[78] Such programs exist in other African countries but may not be mentioned in their mental health codes.

The program in the United States is funded heavily by the federal government, but it functions under state law. Community mental health centers are operated either by local, county or municipal governments, or by voluntary corporations governed, in part, by local citizens. State laws enacted in the 1950s greatly stimulated the growth of community-based services. In 1959, the Council of State Governments produced a model state law for community mental health services patterned closely after the Minnesota Community Mental Health Act of 1957.[79] Congress enacted in 1963 the Community Mental Health Centers Act. Although Congress substantially amended the Act in 1975, the basic legislative purpose of the Act remained unchanged: to

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76 *Id.* at 762.
77 *Id.* at 762-63.
78 *Id.* at 750, 763.
79 *Id.* at 763.

TABLE 3

SCOPE OF MENTAL HEALTH LEGISLATION

BASIC SYSTEM

1. General scope: Benin, Canada (British Columbia), Cyprus, Democratic Yemen, Fiji, Ghana, India, Iran, Kuwait, Lesotho, Nigeria, Pakistan, Romania, Sudan, Syrian Arab Republic, Tanzania, Trinidad and Tobago, United Kingdom, United States of America (Indiana).

2. Combines mentally ill and retarded, but separate legislation for some other special categories: Australia (South Australia and Victoria), Brazil, Canada (Alberta), Egypt, Japan, Malaysia, Peru, Poland, Senegal, Switzerland (Basel-Stadt and Geneva), Union of Soviet Socialist Republics.

3. Separate legislation for all, or nearly all, categories: Costa Rica, Denmark, France, Norway, United States of America (Massachusetts), Uruguay.

SPECIAL CATEGORIES

1. Alcoholism and drug dependence: Australia (South Australia and Victoria), Brazil, Norway, Union of Soviet Socialist Republics.

2. Alcoholism and alcohol abuse: Costa Rica, Denmark, Egypt, France, Poland, Switzerland (Basel-Stadt and Geneva), United States of America (Massachusetts).

3. Drug dependence and drug abuse: Australia (South Australia), Costa Rica, Egypt, France, Japan, Malaysia, Peru, Senegal, Switzerland (Basel-Stadt and Geneva), United States of America (Massachusetts), Uruguay.

4. Sexual deviancy: Australia (South Australia), Denmark, Egypt, Norway, Switzerland (Basel-Stadt), United States of America (Massachusetts).

SOURCE: Curran & Harding, *The Law and Mental Health: Harmonizing Objectives*, 28 INT'L DIG. OF HEALTH LEGIS. 725, 759 (1977).

provide grant-in-aid for constructing and operating community health services throughout the country.[80]

2. Recognition of Categories of Mental Disorder

The second evaluation criterion was the degree to which legislation in the surveyed countries recognized different categories of mental disorder in defining mental illness and in operating treatment programs. Table 3[81] classifies legislation

80 42 U.S.C. § 2689 (1976).

81 *Law and Mental Health, supra* note 3, at 759.

according to this standard. It is evident from Table 3 that the majority of the countries still functioned under legislation which made no distinctions in mental disorder. Some countries combined mental illness and retardation but separated out such categories as alcoholism and drug addiction.[82] Only a few nations maintained several categories and classified mental retardation independently from mental illness.[83]

3. Recognition of the Rights of the Mentally Disabled

WHO considered the extent to which laws recognized the need to protect the rights of mental patients as a third criterion of modern, effective mental health legislation. At the international level, the United Nations demonstrated a concern for human rights by adopting the Declaration of the Rights of the Child in 1959,[84] the Declaration of the Rights of the Mentally Retarded in 1971,[85] and most recently the Declaration of the Rights of Disabled Persons in 1976.[86] The Disabled Persons Declaration includes the mentally ill in the definition of the disabled. It reaffirms the principle that disabled individuals should have the same fundamental rights as other persons. It also underscores the need to provide proper legal safeguards and due process of law whenever there is any limitation of rights or deprivation of liberty of disabled persons. Most of the newer mental health reform legislation enacted in the 1970s in the countries we surveyed contained important provisions protecting patients' rights. The provisions varied considerably and dealt with such diverse subjects as voting rights, the right to appeal commitment orders, the right to communicate with legal counsel, and the right of patients to wear their own clothes rather than hospital gowns.[87]

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82 *Id.* at 760.

83 The jurisdictions making such a differentiation were Costa Rica, Denmark, France, Norway, United States (Massachusetts), and Uruguay. *Id.* at 758-59.

84 G.A. Res. 1386, 14 U.N. GAOR, Annex (Agenda Item 64) 1, at 16-17, U.N. Doc. A/4185 (1959).

85 G.A. Res. 2856, 26 U.N. GAOR, Supp. (No. 29) 93-94, U.N. Doc. A/8429 (1971).

86 G.A. Res. 3447, 30 U.N. GAOR, Supp. (No. 34) 88-89, U.N. Doc. A/10,034 (1976).

87 *Law and Mental Health, supra* note 3, at 754.

In our questionnaire, many of the respondents expressed concern about the failure of current laws in their countries to protect patients' rights. It is interesting to note, however, that the area of greatest concern was the exploitation of patient labor.[88] This may be due to the fact that the majority of our respondents were psychiatrists and other professionals associated with treatment programs. The responses suggest the need to give more attention to this area in formulating amendments to current mental health laws. Our survey revealed that only Indiana has enacted legislation designed to protect patients from labor exploitation.[89]

In a number of countries legislation provided some formal mechanism for protecting the welfare and rights of patients. In the older and more traditional systems, these functions were performed by visiting committees to the individual institutions or by more centralized visiting committees or boards.[90] One of the most respected centralized bodies of this type is the Scottish Welfare Board. It acts as the national overseer of the mental health system, conducts vigorous investigations of patient complaints, and makes recommendations for correcting problems in providing mental health services. Some countries have abolished the visiting committee system and have replaced it with quasi-judicial bodies like the mental health review tribunals of England and Wales.[91] Frequently found in British Commonwealth nations, the most recent tribunal was formed in 1975, under the Mental Health Act of Trinidad and Tobago.[92]

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88 *Id.* at 781.

89 IND. CODE ANN. §§ 16-13-12.8-1 to -12.8-8 (Burns Supp. 1978). The Indiana law defines an employment relationship as generally existing "whenever a patient is assigned, asked, or permitted to work. . . . A major factor in determining whether or not an employment relationship exists is whether the work performed is of any consequential economic benefit to the institution. Generally, work shall be considered to be of consequential economic benefit if it is of the type that employees normally perform, in whole or in part, in the institution or elsewhere. . . . [D]etermination of an employment relationship does not depend on the level of the performance of the patient or whether the work is of therapeutic value to the patient." *Id.* at § 16-13-12.8-1(h). If an employment relationship exists, then the Indiana law requires that the patient be afforded reasonable compensation.

90 Thirteen of the surveyed countries provided for visiting committees: Australia (South Australia, Victoria), Democratic Yemen, Egypt, Fiji, Ghana, India, Malaysia, Nigeria, Norway, Peru, Sudan, Switzerland (Geneva), and Uruguay. *Law and Mental Health, supra* note 3, at 777.

91 *Id.*

92 *Id.* at 861-62.

These tribunals usually are comprised of a lawyer, a physician, and a community representative. They hear appeals from patients concerning involuntary hospitalization and changes in status. The change of status cases generally involve instances where patients contest decisions to restrict their rights within an institution.

The basic objective of all of the tribunals and other types of review panels is to provide accountability in the system, *i.e.*, to require administrators and clinicians to justify their decisions about patients. The periodic evaluation process noted earlier and the various reviews of the "necessity" for continued hospitalization and treatment are designed for a similar purpose. These mechanisms are gaining support as important management techniques in the mental health field.

With respect to the right to receive treatment and the right to refuse treatment,[93] the earlier mental health codes rarely dealt directly with treatment methods or clinical practices. Such matters were left to the discretion of medical staffs of the institutions. Controls generally were placed only on the use of mechanical restraints.[94] Laws in many countries still provide for these controls, but more attention is being directed now toward specific clinical practices such as convulsive shock, psychosurgery, and behavior modification.[95] Consent of the patient or the patient's family is required in many countries

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93 *Id.* at 813-15. There is an extensive amount of literature in America regarding the right to treatment. *See generally* Birnbaum, *The Right to Treatment,* 46 A.B.A.J. 499 (1960); Chambers, *Alternatives to Civil Commitment of the Mentally Ill: Practical Guides and Constitutional Imperatives,* 70 MICH. L. REV. 1108 (1970); Kittrie, *Compulsory Mental Treatment and the Requirements of "Due Process,"* 21 OHIO ST. L. J. 28 (1960); *Developments in the Law — Civil Commitment of the Mentally Ill,* 87 HARV. L. REV. 1190 (1974); Note, *Nascent Right to Treatment,* 53 VA. L. REV. 1134 (1967); Note, *Mental Illness: A Suspect Classification?,* 83 YALE L. J. 1237 (1974).

94 In Massachusetts, for example, the law formerly provided merely that "[n]o restraint in the form of muffs or mitts with lock buckles or waist straps, wristlets, anklets or camisoles, [or] head straps . . . shall be imposed upon any patient in any institution except . . . in cases of extreme violence, infliction of self injury, active homicidal or suicidal condition or physical exhaustion." MASS. GEN. LAWS ANN. ch. 123, § 35 (West 1969) (repealed 1970).

95 The revised Massachusetts law provides, for example, that any committed mentally disordered person has the right "to refuse shock treatment [and] to refuse lobotomy . . . provided, however, that any of these rights may be denied for good cause . . . and provided, further, that shock treatment or lobotomy shall not be performed on any such person without the written consent of said person's legal guardian or his nearest living relative." MASS. GEN. LAWS ANN. ch. 123 § 23 (West Supp. 1979).

before any shock treatment can be used.[96] The Butler Committee in the United Kingdom has recommended that no hazardous or irreversible treatment procedure be used even with patient consent unless a psychiatrist independent of the institution approves.[97] Our questionnaire survey indicated considerable interest in these issues and a substantial movement toward requiring patient consent for many treatment procedures.[98]

Some countries expressed an interest in establishing a right to treatment for mental patients and a right to habilitation for the retarded. The earliest efforts in this direction were made in the United States during the 1960s.[99] These efforts were

96 *Law and Mental Health, supra* note 3, at 781. The Butler Committee noted that "[t]o what extent compulsory treatment is authorized by the Mental Health Act 1959 [7 & 8 Eliz. 2., c. 72] is not entirely clear.... We have sought the comments of the Department of Health and Social Security, and the Department's legal advisers take the view that... such treatment as is considered necessary may be administered irrespective of the patient's wishes or those of his relatives.... The Department readily acknowledged that the point was a difficult one, however, and for this reason they invariably advised that in the case of a specific form of treatment involving any risk, the patient (if he is capable of understanding) or the nearest relative should be told what was proposed and the consent of both should, if possible, be obtained as a matter of policy." COMMITTEE ON MENTALLY ABNORMAL OFFENDERS, REPORT, CMND. NO. 6244, at 50-51 (Great Britain, 1975).

97 COMMITTEE ON MENTALLY ABNORMAL OFFENDERS, REPORT, CMND. No. 6244, at 277 (Great Britain, 1975).

98 *Law and Mental Health, supra* note 3, at 780-81.

99 *Id.* at 778-79. In the seminal case of Rouse v. Cameron, 373 F.2d 451, 453 (D.C. Cir. 1967), the court suggested that there might exist a constitutional right to treatment in that "[i]ndefinite confinement without treatment of one who has been found not criminally responsible may be so inhumane as to be 'cruel and unusual punishment.' " In the 1970's many courts followed this suggestion. For example, in Welsch v. Likins, 373 F. Supp. 487 (D. Minn. 1974) (alternative holding) the court held that involuntarily committed mentally retarded persons were not criminals but victims of "status" and that therefore commitment without treatment was unconstitutional and in violation of the eighth amendment. Another example is to be found in Renelli v. Department of Mental Hygiene, 73 Misc.2d 261, 340 N.Y.S.2d 498 (Sup. Ct. 1973). Other courts have grounded the right to treatment not on the eighth amendment, but rather on procedural due process grounds; treatment, it is argued, provides the only justification for the lax procedural safeguards so prevalent in commitment statutes. Wyatt v. Stickney, 325 F. Supp. 781, 784 (M.D. Ala. 1971), *enforced,* 344 F. Supp. 387 (M.D. Ala. 1972), *aff'd sub nom.* Wyatt v. Aderholt, 503 F.2d 1305 (5th Cir. 1974). *Accord,* Davis v. Watkins, 384 F. Supp. 1196 (N.D. Ohio 1974). Still other courts have argued that a strict scrutiny standard applies in commitment cases, either because of the abridgement of fundamental interests entailed by commitment or because of the existence of "suspect" characteristics in mentally disabled persons. An equal protection or substantive due process argument, then, is used to arrive at a right to treatment. Stachulak v. Coughlin, 364 F. Supp. 686 (N.D. Ill. 1973) (dicta); Wyatt v. Stickney, 325 F. Supp. 781 (M.D. Ala. 1971), *enforced,* 344 F. Supp. 387 (M.D. Ala. 1972), *aff'd sub nom.* Wyatt v. Aderholt, 503 F.2d 1305 (5th Cir. 1974); Donaldson v. O'Connor, 493 F.2d 517 (5th Cir. 1974), *vacated and remanded,* 422 U.S. 563 (1975).

limited to committed patients as a condition of their involuntary restraint. American court cases have subsequently extended the right to all categories of patients. The Supreme Court has examined the issue, and at best it has demonstrated only partial support for the concept.[100] Except for a few jurisdictions in the United States, none of the countries surveyed has as yet adopted a statutory right to treatment.[101] The English Interdepartmental Committee examined the Mental Health Act of 1959 and recommended establishing multidisciplinary panels to oversee a variety of treatment issues in the mental institutions, including complaints from patients that they are not receiving adequate treatment.[102] The Committee concluded that such a system would be a practical answer to the proposal for a statutory right to treatment. The panels have not as yet been established, however.

Many respondents asserted that patients should have the right to refuse psychiatric treatment.[103] The issue arises mainly with respect to criminal offenders and their claimed right to refuse drug treatment and behavior modification programs. The United Kingdom's Butler Committee dealt with these issues and fundamentally agreed with the notion that these programs should be used with mentally disordered prisoners only on a voluntary basis, barring exceptional circumstances.[104]

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100 O'Connor v. Donaldson, 422 U.S. 563, 576 (1975). Characterizing the case as one involving the right to liberty and not the right to treatment, the Court held that "a State cannot constitutionally confine without more a nondangerous individual who is capable of surviving safely in freedom by himself or with the help of willing and responsible family members or friends." The import of this holding is far from clear. Does "without more" mean "without treatment" and if so, why this judicial obtuseness? Moreover, does this decision mean that had Donaldson been receiving treatment, he could have been involuntarily confined notwithstanding his nondangerousness? Similarly, does it mean that had Donaldson been dangerous, he could have been confined without treatment? In sum, the court avoided the right to treatment issue and in the process raised more questions than it answered. *See* Note, *The Supreme Court Sidesteps the Right to Treatment Question*, 47 U. COLO. L. REV. 299 (1976).

101 "A patient shall be entitled to reasonable living conditions, humane care and treatment, medical and psychiatric care and treatment in accordance with the standards accepted in medical practice." IND. CODE ANN. § 16-14-1.5-2 (Burns 1973).

102 DEP'T OF HEALTH AND SOCIAL SECURITY, REVIEW OF THE MENTAL HEALTH ACT 1959, at 35-40 (Great Britain, 1976).

103 *Law and Mental Health, supra* note 3, at 781. *See* sources cited in note 93 *supra*.

104 COMMITTEE ON MENTALLY ABNORMAL OFFENDERS, REPORT, CMND. NO. 6244, at 277 (1975).

Laws in most countries proved to be inadequate in providing guidance to mental hospitals and clinicians about the patient's right to refuse treatment, or the authority of the institutions to impose treatment. Legislation in most countries generally did not address these issues. In some countries, the court commitment orders contained authorization to impose treatment on committed patients.[105] It seemed to be assumed in most countries that treatment could not be imposed upon voluntary or informal patients.[106]

II. Recommendations and Guidelines

A. *General Observations Applicable to Both Developed and Developing Countries*

The WHO study did not develop a set of legislative provisions which could be recommended to all nations of the world. Conditions in the countries and the availability of resources in manpower and facilities were too diverse to allow for such a uniform approach. Instead, the study stressed self-evaluation and specific, individualized legislative enactments addressed to the country's own needs. To aid in this approach, the study provided recommendations in the form of fundamental principles and alternative structures to achieve particular objectives.

After examining the laws and the relevant literature, we formulated a set of basic principles for developing a complete legal structure to delineate mental health programs. A multidisciplinary working group comprised of persons drawn from the fields of psychiatry, psychology, sociology, public health administration, and the judiciary, reviewed and revised the principles.[107] The basic statutory structure should be concerned with the following areas:[108] (1) formulating the objectives of the mental health program within a broad public health policy; (2) defining the proper authority for administering, planning, and implementing the program; (3) developing a

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105 *Law and Mental Health, supra* note 3, at 781.
106 *Id.* at 781, 815.
107 *Id.* at 781-82.
108 *Id.* at 782-83.

budgetary policy which outlines techniques for continuing fiscal support of publicly conducted mental health services; (4) detailing a structure for operating and evaluating mental health programs, requiring accountability of the persons who run the programs; (5) establishing programs for basic and applied research and for the education of mental health personnel; (6) insuring equitable, non-discriminatory access to mental health services, including consideration of hospitalization and discharge provisions for mental health facilities; (7) protecting the welfare, dignity, property, and other rights and privileges of mentally disordered and retarded persons and their families; (8) establishing minimum standards for the control of manpower resources and for the construction and operation of mental hospitals, clinics, community centers, and similar facilities; (9) regulating the quality, supply, and distribution of therapeutic drugs in the mental health services throughout the jurisdiction and regulating the use of drugs and other treatment methods.[109]

In addition to these broader goals of policy formulation and implementation, the statutory system should provide for necessary delegation of authority to appropriate government agencies, such as a department of health. Under this delegation the agency would be able to adopt administrative orders, decrees, or regulations to implement further the legislative policy and to supply technical detail to the program. Such detail may involve control of manpower and facilities or regulation of therapeutic methods.

A thorough review and evaluation process should be devised as a part of the national mental health policy.[110] Procedures for periodic review would allow the consideration of changes in societal practices and attitudes toward mental health and of innovations in the field.

Based on information collected in the survey, we can suggest

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109 Policy concerns would include proper control in the following areas: shock treatment and other harsh therapeutic methods, punishments, and compulsory drug-treatment regimes in behavior modification programs in prisons and other controlled settings.

110 *Id.* at 789.

a number of alternative procedures which could be implemented to achieve the stated goals.

A useful formal mechanism which can be created by the legislatures themselves is the statutory commission;[111] it can be either an ad hoc or a permanent body. Among the best known ad hoc statutory commissions are the Royal Commissions which existed in the United Kingdom from 1924 to 1926[112] and from 1954 to 1957.[113] Many countries have established standing Law Reform Commissions or Law Revision Commissions. The Canadian Law Reform Commission, for example, has done work recently in the mental health field.[114] These statutory bodies have the advantage of having unquestioned prestige and are thus able to attract considerable public attention to their efforts. Their recommendations generally carry great weight with legislatures. Such commissions, however, may be relatively expensive and cumbersome, while their procedures could prove to be rigid. Public hearings conducted by such commissions often develop into quasi-judicial hearings which focus on complaints about wrongful detention and mistreatment lodged by patients.[115] This tendency reveals the central weakness of the government investigative commission as a review mechanism: it lacks control over the information it must receive and evaluate. It probably is unrealistic to expect such commissions to carry out detailed, ongoing monitoring of complex fields such as mental health.

As an alternative, the legislature could make periodic review of mental health law the responsibility of the government department which has primary authority in implementing the law.[116] This agency (usually the department of health, or an analogous cabinet office) should be united with the unit charged

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111 *Id.* at 789-90.

112 ROYAL COMMISSION ON LUNACY AND MENTAL DISORDER, REPORT, CMND. NO. 2700 (Great Britain, 1926).

113 ROYAL COMMISSION ON THE LAW RELATING TO MENTAL ILLNESS AND MENTAL DEFICIENCY, REPORT, CMND. NO. 169 (Great Britain, 1957).

114 LAW REFORM COMM. OF CANADA, A REPORT TO PARLIAMENT ON MENTAL DISORDER IN THE CRIMINAL PROCESS (Canada, 1976).

115 The public hearings of the Royal Commission in the United Kingdom, convened in 1924-1926, developed into court-like proceedings, with patients making detailed accusations of wrong treatment. *Law and Mental Health, supra* note 3, at 790.

116 *Id.* at 790-91.

with mental health planning and evaluation if one exists and if not, with a generalized planning unit that possesses some mental health expertise. Placing responsibility for reviewing the laws at the cabinet level should guarantee the best possible access to necessary information concerning the operation of services. On the other hand, there are disadvantages to this system of review. The focus of inquiry will be narrower than it would be if a government-wide mechanism such as a special legislative commission were employed. The health department also may be quite conservative in its views of needed legislative change. There is a natural tendency in such departments to prefer manipulating existing law rather than engaging in the time-consuming process of seeking new mandates and laws from the legislature.

A third alternative would be to use professional associations.[117] In our survey we found that professional groups, societies, and associations sponsored legislative and programmatic changes in several countries. These groups have first-hand knowledge of conditions and can speak with authority about the need for improvement. Many psychiatric and other professional associations have standing committees on legislation. They devote much of their energy, however, to appearing before legislative committees to articulate their position on pending legislation. Their evaluation of the legislation tends to focus upon its impact on their own group's professional interests. Although professional associations can make valuable contributions, the general public probably would wish to have the views of the mental health system's professional infrastructure presented in a more balanced fashion.

A fourth alternative would be to form voluntary associations comprised of citizens interested in working for improvement in mental health services. These groups would be responsible for overseeing current mental health legislation.[118] Such associations have been growing in strength and influence since early in this century. The story of Clifford Beers and the founding of the

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117 *Id.* at 791.
118 *Id.* at 791-92.

National Council for Mental Hygiene is well known.[119] The movement is now active in many parts of the world. Most national groups are affiliated with the World Federation of Mental Health, or, in the field of retardation, the International League of Societies for the Mentally Retarded.[120]

These associations are often important and influential in legislative efforts.[121] They have become increasingly independent of earlier professional influences and now are dominated by citizens rather than professionals. Yet, they can call upon professional advice and support from both psychiatrists and lawyers in reviewing needed improvements in mental health programs and legal codes. These certainly are important strengths, but there are several possible drawbacks to the associations. First, association members may not be involved in actual operations and program planning. As a consequence, they will be unable to appreciate constraints on resources. Second, associations may lack comprehensive information. Instead of concentrating on broader policy matters, members may tend to focus on difficult cases involving the cure of individual patients. Finally, associations may appear to the public as special pleaders for ex-patient causes.

As a final alternative, we suggest drawing upon the resources of academic institutions.[122] Academic groups have qualities which make them quite valuable for reviewing laws and mental health programs. Their staffs have library resources and technical research skills. They are apt to have some historical perspective and thus are not as prone as others to accept too readily the latest fads in reform movements. They may have international ties which enable them to make transnational comparisons. Academicians, however, tend to approach problems in a theoretical fashion which often ignores the realities of operational constraints. Thus, academic institutions perhaps should not be relied upon exclusively. Moreover, institutes of legal

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119 C. BEERS, A MIND THAT FOUND ITSELF (4th ed. 1917).

120 *Law and Mental Health, supra* note 3, at 792.

121 For example, the National Association of Mental Health, a British lay organization, recently published an influential and comprehensive review of mental health legislation. *See* L. GOSTIN, A HUMAN CONDITION (1975).

122 *Id.* at 792-93.

medicine are relatively few, and they generally have interests wider and often more demanding than legislative review. But there are trends toward more closely linking governmental mental health services with academic departments in sociology, criminology, law, psychiatry, and certain allied health professional programs. Partnerships between academic institutions and the government in legislative review and drafting can produce fruitful results.

In nations or communities where the government and professional and lay organizations actively participate in the mental health movement, a combination of review procedures could be used to forge an optimal program of periodic review. This approach has been germinating in Canadian provinces, American states, and some European nations. Developing countries, however, are unlikely to use this approach in the near future because they lack the necessary resources. In countries with centrally planned economies, such heterogeneous activities may be unacceptable in view of the usual practice. It may be useful, therefore, to propose a single model which could be more universally workable.[123]

A standing interdepartmental advisory committee might provide such a model. The members could be drawn from the departments concerned with health care, social and welfare services, the penal system, law-enforcement agencies, and the judiciary. The secretariat's responsibilities could be performed by the mental health unit of the health department. In addition to representatives of the key governmental departments, the committee should include a mix of legislators, judges, attorneys, representatives of lay mental health-retardation associations, academicians from different disciplines, and other appropriate representatives for the particular country. The advisory committee would need to be informed thoroughly about the national mental health policy and programs and would require access to the national health information system. It also would need the authority to request additional data and to collect its own supplemental information.

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123 *Id.* at 793-94.

The proposed mechanism is admittedly a hybrid; it would require modification to fit specific national situations. The elements suggested above are designed to provide the committee with prestige, a balanced representation of interests, relevant information input, and an efficient and adequate administration.

The first step in the committee's investigative efforts should be a thorough review of the jurisdiction's existing legislation in each of the areas outlined in the legal framework described earlier.[124] In countries with no formal legal provisions in areas considered fundamental to programs operation, the committee would be responsible for drafting and proposing such legislation.

In developing an ongoing review process, clear objectives with timetables and quantifiable goals must be established. For example, an advisory committee could set as a goal to be achieved in two years an increase in the proportion of voluntary admissions from 40 percent to 60 percent. The following list presents examples of the type of programmatic and legislative objectives which could be developed: (a) promoting community-based care for selected priority conditions; (b) improving access to treatment for patients living in remote rural areas; (c) reducing the numbers of chronically hospitalized patients; (d) assuring earlier and more effective treatment for acutely disturbed patients; (e) protecting the general public from potentially dangerous, psychotic persons; (f) redefining the responsibility for development of mental health care; and (g) stimulating local communities to participate in mental health programs.

The committee should review a wide spectrum of factors which can require alteration of the national mental health program and its legal structure. These factors should include operational issues such as the adequacy of regulations and decrees designed to implement the mental health code. The committee should investigate whether new methods of treatment or patient management necessitate the setting of newer, more ambitious goals. Advances in drug therapy, for example,

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124 *Id.* at 794-98.

actually may call for more legal controls on use and distribution rather than fewer.

The committee should seek information concerning the welfare and rights of patients. This is not a simple area in which to apply objective evaluation. But quantitative data should be developed. The following list suggests the type of data which could be gathered: the number and type of complaint letters from patients over a particular period; the rate of utilization of different commitment procedures (which may indicate overuse of emergency procedures or restraint-oriented procedures in some facilities or communities); and the number and outcome of formal appeals of hospitalization, release, and special treatment orders before the courts or mental health review tribunals.

Lastly, the review committee should assess public attitudes toward mental health and mental illness. One goal of assessing these attitudes would be to determine whether the law played a role in changing the public's perception of different kinds of patients. A second goal would be to evaluate the public's opinion about the effectiveness of current laws and the need for new ones. It certainly is important for the public to support efforts in the mental health area. Public support is particularly important for laws and programs which encourage or require patients to be placed in community-based facilities.

The World Health Organization could work with countries in developing such a continuing legislative review process.[125] WHO has a number of resources which would be useful in working with different countries. A key resource is its health legislation service. In connection with that service, WHO publishes a periodical on health law entitled, *International Digest of Health Legislation.* The publication provides a highly visible forum for presenting innovative changes in mental health programs.[126] In addition, WHO can provide countries with information concerning methods of implementing review processes, development of relevant data, and data analysis. Finally, WHO could collaborate with individual countries to shape systems of review

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125 *Id.* at 798-99.
126 *Id.* at 798.

which meet their individual needs and to develop an international data bank on mental health laws and programs.

B. *Special Approaches for Developing Countries*

The professional literature on legislative reform in mental health codes has focused almost exclusively on industrial countries. Little attention has been given to the needs of the developing countries. Mental disorders are a serious problem in the developing countries, but nutrition, infectious disease, and sanitation are also urgent health problems. Few of the developing countries have been able to give highest priority to mental health improvement; this condition is reflected in the outdated, generally inadequate and unresponsive mental health laws in these nations.

A 1975 survey concluded that in most developing countries there existed but one psychiatrist and two psychiatric nurses per 100,000 population, while in many such countries the ratio was as low as one psychiatrist and one psychiatric nurse per 1,000,000 population.[127] Mental health services in these countries historically have been conducted in large centralized mental hospitals which have provided an institutional response totally inappropriate for the rural, agrarian communities in which most of the populations reside. The "asylum concept" grew up in Northern Europe and America as a response largely to the ills of urban poor. Colonial administrations transferred this concept intact to the African colonies.[128] The system was imposed and cemented into the fabric of the colonial society by the adoption of mental health codes suitable to the asylum era. Thus, for example, the 1890 Lunacy Act of England and Wales was used as the model for legislation in many parts of the British Empire and the basic law survives today in parts of Africa, the Eastern Mediterranean, and Southeast Asia.[129]

A specific example may serve to illustrate these points.[130] In

127 WORLD HEALTH ORGANIZATION EXPERT COMM. ON MENTAL HEALTH, TECHNICAL REP. SERIES NO. 564, ORGANIZATION OF MENTAL HEALTH SERVICES IN DEVELOPING COUNTRIES: SIXTEENTH REPORT 14 (1975).

128 *Law and Mental Health, supra* note 3, at 819.

129 *Id.*

130 *Id.* at 819-20.

Tanzania efforts to improve health care for all of the people, 90 percent of whom live in rural settings, have been linked closely with a national policy which urges rural development and local contribution as instruments of liberation and socioeconomic improvement. The 1969-1975 Health Plan was directed at developing preventive and rural health services. In order to increase coverage of primary health care, medical assistants and aides provided most of these services. At the time of independence, acutely mentally disturbed persons could be handled only in local prisons where they were detained for up to two months. There was one centralized mental hospital for the country. Chronic patients were transferred to this institution where the number constantly grew over the years. The increase confirmed the public's impression that once patients were committed, they rarely returned home. Dating from 1937, the existing mental health code dealt mainly with "custody" in the central hospital under court-ordered commitment. There were also detailed provisions for managing and administering the estates, however meager, of committed patients and criminal lunatics.

Despite this restricted legal framework, decentralization efforts advanced in recent years.[131] Regional psychiatric centers have been established in five of the country's twenty regions. Future plans include further regional development with mental illness care at the local health centers and more support for community and family care. Currently only 20 to 30 percent of the admissions to local centers are voluntary. It is recognized generally that substantial revision of the law is necessary. The new law in Tanzania will be tailored to specific needs and will be integrated with the development of regional and local public health programs.

Throughout the developing countries, the incidence of mental disorders secondary to infectious disease is high. There is an urgent need for rapid diagnosis and available treatment for mental symptoms such as confusion and excitement. Existing mental health codes in these countries do not recognize this need. Moreover, lack of appropriate services at the local level

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131 *Id.*

has meant that patients with neurological disturbances have been forced into the antiquated institutional system for mental illness, despite the fact that these patients could be treated adequately in community clinical facilities. In the rural areas, the lack of treatment facilities leads to the appearance of particularly florid forms of mental illness and numbers of untreated, itinerant, "vagrant" psychotics.[132] Breaking out of this morass of abject conditions requires first a strategy and second a mechanism to implement new mental health programs. New legislative initiatives can play an important role in leading these efforts.

1. Methods for Improving Mental Health Services

The recent report[133] of the WHO Expert Committee on Organization of Mental Health Services in Developing Countries has suggested several steps for improving services in these nations. These steps are summarized below with a commentary on methods of legal implementation.

a. Decentralization of Facilities and Services[134]

The reliance on large, central mental hospitals would be decreased by increasing the scope and availability of outpatient services and alternative methods of inpatient care in other facilities. Current populations in the larger hospitals would be reduced by vigorous rehabilitation efforts. The legal implications of the change should be clear from earlier discussions in this article. The law should be revised to remove barriers to community care for patients, especially in general hospitals and public facilities. Early discharge and rehabilitation should be encouraged by simplifying legal provisions for discharge and foster care and by supporting and supervising discharged patients by health and welfare personnel.

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132 *Id.* at 820.

133 WORLD HEALTH ORGANIZATION EXPERT COMM. ON MENTAL HEALTH, TECHNICAL REP. SERIES NO. 564, ORGANIZATION OF MENTAL HEALTH SERVICES IN DEVELOPING COUNTRIES: SIXTEENTH REPORT (1975).

134 *Law and Mental Health, supra* note 3, at 821.

b. Integration of Mental Health with General Health Services[135]

A major goal of the developing countries should be to integrate mental health services with general public health clinical and preventive services. This objective has received strong endorsement from WHO throughout the world and WHO is currently devoting resources to aid developing countries in achieving it. Integration should occur at the admininstrative and policy-making levels, as well as at the delivery points. Planning and development of needed health manpower should be conducted on an integrated, cooperative basis without competitive activity for scarce personnel and training resources. Rigid legal distinctions between mentally ill and other patients should be avoided. Treatment for all classes of patients should be the same and should be essentially voluntary. General hospitals should be authorized to treat all types of patients, including those with functional psychiatric symptoms, as well as those with acute psychiatric symptoms which are organically based. The law should encourage linkages between specialized mental health facilities and other services by exchanging staff and other resources.

c. Extension of Mental Health Care[136]

The decentralization and integration suggested above can have little impact unless actual services are extended into geographic areas which are not being served now. This means shifting and expanding mental health services to rural communities and to other neglected areas such as slums located on the fringes of urban areas. Here the law could be a rallying point. National and local governments can promote this extension of services by drafting laws clearly stating the type of care which shall be made available to the neglected communities, and by charging someone to provide such care. Specific programs given priority could be those concerned with handling acutely

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135 *Id.* at 821-22.
136 *Id.* at 822.

disturbed patients or providing follow-up services for discharged mental patients. It may be helpful also to delineate in the statute the role of community welfare workers, the police, and village chiefs in dealing with acute emergencies involving disturbed or confused persons and dangerous psychotics. These provisions should encourage these community personnel to use their own health services rather than resort to restraint, arrest, and imprisonment.

In many developing countries, it is not uncommon for disturbed persons to rely upon traditional healers instead of upon medical-psychiatric services, or in addition to such services. These healers often serve socially useful functions. In some situations, however, they may use harmful methods and may deliberately deceive patients and their relatives. As a consequence, patients will be diverted from needed care and treatment. Generalizations about how to deal with these healers are of little value. Health planners are, however, becoming more aware of their potential in a complete health environment. Legislation must be sensitively framed in this area. Laws forbidding practice by traditional or faith healers can be impossible to enforce. The aim of the law should be to control dangerous practices and the improper use of drugs by unscrupulous healers. Efforts at collaboration between traditional healers and the mental health system could be encouraged in some areas.

d. Planning and Policy Formulation[137]

Developing countries should enact legislation which adopts a national mental health policy within the national health plan. This legislation should be complemented with legal mechanisms to facilitate necessary interdepartmental cooperation in operating mental health services.

2. Guides to Formulating Mental Health Legislation

With respect to implementing these objectives, the general statutory suggestions previously made are still applicable. However, it may be helpful to provide some criteria to assess

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137 *Id.* at 823.

legal provisions with developing nations in mind. We shall suggest, therefore, some mistakes to avoid in formulating legal blueprints for mental health systems in developing countries.[138]

In general, laws which impede desired changes in the delivery of mental health care should not be adopted. For example, provisions which impair the ability of existing community resources such as traditional healers to assist the institutional health system should not be incorporated into the mental health code. Community resources are particularly crucial when an overburdened health system cannot cope with all of the problems presented. Laws establishing or reinforcing a completely separate mental health service also are undesirable. Provisions restricting treatment, for example, only in psychiatric hospitals operated by the government present a strong barrier to the process of integrating all available resources with the general health services. Similarly, narrowly drawn legal requirements pertaining to the allocation of staff or other medical resources can impede the flexibility of mental health services and unnecessarily tax the administrative process.

Developing countries also should pay particular attention to language used in their mental health codes. Statutes should not contain language which creates or reinforces negative attitudes toward the mentally ill. However, cosmetic changes such as replacing the word "lunacy" with the term "mentally ill" are of little value unless the quality of patient care is improved as well; the new terms soon become as stigmatizing as the old ones. Indeed, what actually happens to patients is more important than what they are called. The effort should be to avoid handling mental patients in the same way as criminals or dangerously ill persons who must be removed from the community. If these objectives are followed, new terms with genuinely new meanings can be adopted into the law.

Realizing that it is more difficult to improve mental health programs than merely to caution against pitfalls, we also can suggest some more positive approaches in formulating legislation.[139] All of these suggestions should be considered in the context of a major theme which this article has stressed: namely,

138 *Id.* at 823-24.
139 *Id.* at 824-25.

that laws should reflect closely the overall direction and approach of a country's mental health policy.

First, laws should be enacted and amended with a view toward protecting human and civil rights. Since many people in developing nations are illiterate, it is important that legal protections through appellate review procedures are fully explained to patients, responsible family members, and agencies working with the patients. Similarly, people living in remote areas should be able to raise legal issues in local courts concerning mentally ill relatives.

Second, it is important that statutes require treatment services to be established according to priority conditions throughout the country. Each nation would select its own priorities. Particular attention should be given to ensuring that nonurban areas receive an equitable distribution of services.

In drafting legislation, lawmakers should take into account the availability of health personnel. Unrealistic constraints operating against the available pool of health personnel should be removed, but realistic training criteria for various tasks should be spelled out in regulations. Generic terms such as "mental health officers" can cover several categories of functions in nursing, counseling, and social services.

Finally, the legal system should be flexible and should encourage mental health goals to be achieved efficiently. A factor often overlooked by those not directly involved in changing legal standards is the complexity of the process and the time involved. This process can be difficult and frustrating: Changes in regulations and so-called statutory instruments, for example, may require review and approval of more than one cabinet department and the legislature. Care should be taken, therefore, to build flexibility into the mental health system and the law so that improvements and adjustments can be made internally. In many developing countries, checks and balances among various departments often delay fundamental change for years. One possible approach to overcome delays is to incorporate mental health procedures into the general public health law, allowing alternative approaches to accomplishing broadly stated general health policies (as, for example, in the new public health codes of Costa Rica, Sudan, and Jamaica).

Taken together, these suggestions, based upon our extensive survey, should go far toward promoting more effective and more humane responses to mental disorders in developing countries. When these special approaches are incorporated into the broader scheme of assessing the status and function of mental health laws, both developed and developing countries should be able to institute legislative changes which will contribute to improved mental health in the years to come.

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NOTE

ADMINISTRATIVE ACTION TO END DISCRIMINATION BASED ON HANDICAP: HEW'S SECTION 504 REGULATION

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Confronted by broad delegations of authority, government administrators must frequently draft comprehensive implementing regulations against a limited background of legislative intent. In this Note, Mr. Engebretson examines the drafting of regulations under section 504 of the Rehabilitation Act of 1973, which prohibits discrimination against handicapped persons by recipients of federal funds.

In the absence of an explicit statement of legislative purpose, he observes, HEW drafters chose by analogy to employ principles of equal treatment first articulated under statutes barring race and sex discrimination. Mr. Engebretson explores this process of drafting by analogy and analyzes the effect the drafters' choice of this procedure had on the substantive rules intended to prevent discrimination against handicapped persons.

Introduction

When a crowd of handicapped people camped in the reception area of Health, Education, and Welfare Secretary Joseph Califano's office in early April, 1977, they suddenly brought a little-noticed legislative and executive lawmaking process into the public consciousness. That process involved a full congressional delegation of authority: administrators were to translate an innocuous section of a statute into detailed regulations which sweepingly assert the right of handicapped people to participate equally in American society. The handicapped demonstrators were attempting to force Secretary Califano to sign the regulation after what they viewed as an excessively long drafting period. He signed the regulation three weeks after the occupation began.[1]

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*B.A., Dartmouth, 1975; J.D., Harvard, 1978.

1 *See* Isbell, *How the Handicapped Won Their Rights*, CIV. LIB. REV., Nov./Dec. 1977, at 61, for one account of these events.

The statutory provision which placed the rights of the handicapped under federal protection and triggered the rulemaking process within HEW was section 504 of the Rehabilitation Act of 1973,[2] which simply states: "No otherwise qualified handicapped person in the United States . . . shall, solely by reason of his handicap, be excluded from the participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving Federal financial assistance." Section 504 as enacted by the Congress contained no indication of how its provisions were to be implemented. Would regulations have to be promulgated to put this law into force? If so, who would write and enforce such rules?

Eventually, the responsibility for implementing section 504 was delegated by default to the Office for Civil Rights (OCR) of HEW. That office transformed a one-sentence command from Congress into the rules signed by HEW Secretary Califano. This Note will describe the development and content of the regulations implementing section 504. Part I will discuss the extensive delegation of rulemaking authority under the Rehabilitation Act of 1973 and the 1974 amendments to the Act and the relationship of section 504 to statutes forbidding racial and sexual discrimination by recipients of federal funds. Part II presents the administrative response to handicapped rights legislation by considering briefly why HEW's Office for Civil Rights was given rulemaking responsibility under section 504 and by summarizing the form and content of the regulations that office promulgated. Part III will examine the regulations in greater detail, concentrating on how OCR resolved four major issues left open by the Rehabilitation Act. It will analyze the regulations enacted under section 504 in light of the myriad of policy choices OCR faced during the drafting process.

I. The Congressional Delegation of Authority

Congress delegated the task of formulating regulations to end discrimination against the handicapped to HEW in two stages. First, section 504 of the Rehabilitation Act of 1973 implied that

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2 29 U.S.C. § 794 (1976).

regulations similar to those promulgated by HEW under statutes forbidding racial or sexual discrimination were to be drafted. Second, the process by which the Rehabilitation Act was amended in 1974 indicated in a peculiar, yet explicit way that HEW would bear the burden of implementing section 504 through rulemaking.

A. *The Rehabilitation Act of 1973*

Congress enacted the Rehabilitation Act of 1973[3] primarily to improve the states' delivery of vocational rehabilitation services to handicapped individuals. The Act created the statutory basis for the Rehabilitation Services Administration within HEW and was intended to provide federal guidance and funding for the continued development of state rehabilitation services.

Section 504[4] appears as the last provision of the Act. Tacked on to the end of the "Miscellaneous Provisions" title of the Act, section 504 was joined to three unrelated sections dealing with problems facing handicapped people outside the specific context of rehabilitation programs.[5]

The language of section 504 parallels that of the anti-discrimination provision of Title VI of the Civil Rights Act of 1964, which states that "No person in the United States shall, on the ground of race, color, or national origin, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving Federal financial assistance."[6] Section 504 also tracks the anti-discrimination provision of Title IX of the Education Amendments of 1972, which states: "No person in the United States

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3 Rehabilitation Act of 1973, Pub. L. No. 93-112, 87 Stat. 355 (codified, *as amended by* Rehabilitation Act Amendments of 1974, Pub. L. No. 93-516, 88 Stat. 1617, at 29 U.S.C. §§ 701-974 (1976)).

4 29 U.S.C. § 794 (1976).

5 Section 501 of the Rehabilitation Act of 1973, *supra* note 3, deals with employment of handicapped persons by the federal government. 29 U.S.C. § 791. Section 502 establishes an Architectural and Transportation Barriers Compliance Board to study and promote the elimination of architectural barriers confronting the handicapped in public buildings, transportation, parks, and housing. *Id.* § 792. Section 503 forbids discrimination on the basis of handicap by government contractors. *Id.* § 793.

6 42 U.S.C. § 2000d (1976). Section 504 could have been enacted as an amendment to Title VI. The amendment could have been made by deleting the word "or" after "color"

shall, on the basis of sex, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any education program or activity receiving Federal financial assistance . . . ."[7]

The similarity between section 504 and these other statutes, however, is limited to the language prohibiting discrimination. In Title VI, Congress followed the simple prohibition of racial discrimination with a detailed section directing all federal agencies and departments which disburse federal money to promulgate regulations implementing the anti-discrimination provisions.[8] Title VI provides for presidential review of the regulations and mandates the termination of federal funds, after a hearing, to grant recipients not in compliance with the regulations.[9] In addition to termination procedures, the statute allows judicial review of agency action against recipients in order to prevent arbitrary and capricious decisions.[10] Four other sections of Title VI further clarify Congress' position on specific issues which would arise in the writing and enforcement of regulations.[11]

Likewise, in Title IX of the Education Amendments of 1972, Congress followed the prohibition of sex discrimination contained in section 901 with provisions outlining exceptions to that prohibition,[12] with implementation and review sections

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and adding "or handicap" after "national origin." Many attempts to amend Title VI in this manner have failed. *See* Wright, *Equal Treatment of the Handicapped*, 26 EMORY L.J. 65, 65-66 n.2 (1977). This may be due to the unwillingness of Congress to reopen Title VI and subject it to the possibility of potentially weakening amendments. Interview with John Wodatch, Acting Branch Chief, Handicapped Discrimination Branch, Office for Civil Rights, Department of Health, Education, and Welfare, in Washington, D.C. (Feb. 15, 1978) (on file with the author) [hereinafter cited as Wodatch Interview].

7 20 U.S.C. § 1681 (1976).

8 42 U.S.C. § 2000d-1 (1976).

9 *Id.*

10 *Id.* § 2000d-2.

11 *See id.* § 2000d-3 (Title VI does not govern employment practices of recipients); *id.* § 2000d-4 (a contract for insurance or loan guaranty does not subject the insured to Title VI); *id.* § 2000d-5 (action on an application by a local school district for federal education funds may not be deferred because of alleged noncompliance with Title VI unless the district is given opportunity for a hearing); *id.* § 2000d-6 (Title VI should be applied uniformly across the country).

12 *See* 20 U.S.C. § 1681 (1976). Under this section admissions practices of institutions below the undergraduate level are exempted from Title IX. *Id.* § 1681(a)(1). Religious, military, and other traditionally single-sex institutions are also exempted. *Id.* § 1681(a)(5). An exemption for fraternities and sororities has also been inserted in Title

identical to those enacted as part of Title VI,[13] and with provisions intended to guide HEW in the implementation of Title IX in certain areas of sex discrimination in education.[14]

Section 504, however, stands naked within the Rehabilitation Act. It is unaccompanied by any implementation provisions. Nothing within the Rehabilitation Act indicates whether section 504 is merely a grand statement of national policy or a specific mandate for the creation of an extensive body of civil rights regulations. No authority is delegated to any agency to promulgate or enforce regulations under the Act. This silence must be contrasted with the language of section 503 of the Rehabilitation Act, which, in forbidding discrimination against the handicapped by government contractors, contains a detailed explanation of the implementing regulations to be drafted.[15] That section mandates the promulgation of implementing regulations by the Department of Labor ninety days after enactment, establishes a complaint procedure within the Labor Department, and authorizes waiver of the section's requirements in the "national interest."[16]

The complete absence of *any* legislative history for section 504 compounds the uncertainty created by the lack of statutory elaboration.[17] The anti-discrimination provision passed without generating a written comment. Other issues dominated the hearings, reports, and floor discussion of the Rehabilitation Act.[18] Congressional concern focused on the Act's reorganiza-

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IX. *Id.* § 1681(a)(6). Boys and Girls State and National Conferences, father-son and mother-daughter activities, and pageant awards are also exempt. *Id.* § 1681(a)(7)-(9).

13 *Id.* §§ 1682-1682.

14 *Id.* § 1685 (a contract for insurance or guaranty does not subject the insured to the requirement of Title IX); *id.* § 1686 (separate living facilities exception).

15 29 U.S.C. § 793 (1976).

16 *See id.* § 793(c).

17 The only mention of any proposal related to § 504 appears in the 1972 Senate hearings. The testimony of James Stearns, a Dartmouth College student with cerebral palsy, incorporated a copy of his senior thesis in which he discussed the possibility of amending Title VI to prohibit discrimination based on handicap. *Rehabilitation Act of 1972: Hearings on H.R. 8395 Before the Subcom. on the Handicapped of the Senate Comm. on Labor and Public Welfare,* 92d Cong., 2d Sess. 423, 494-98 (1972).

18 The principle sources of legislative history for the Rehabilitation Act of 1973 are the House and Senate reports. *See* H.R. REP. No. 93-244, 93d Cong., 1st Sess. (1973); H.R. REP. No. 93-500, 93d Cong., 1st Sess. (1973), *reprinted in* [1973] U.S. CODE CONG. & AD. NEWS 2143; S. REP. No. 93-318, 93d Cong., 1st Sess. (1973), *reprinted in* [1973] U.S. CODE CONG. & AD. NEWS 2076; S. REP. No. 93-391, 93d Cong., 1st Sess. (1973). *See*

tion of HEW and the extent of funding of rehabilitation services which would be authorized by the Act.[19] President Nixon's veto of two earlier versions of the Act in 1972 and 1973[20] further obscured discussion of the implications of section 504. Therefore, when Nixon signed the third version of the Act on September 26, 1973,[21] section 504's broad ban on discrimination against the handicapped became law without any congressional indication of its intended purpose or impact.

B. *The 1974 Amendments*

Congress attempted to remedy the lack of both explicit language in and a legislative history for section 504 in an unusual fashion during the passage of the Rehabilitation Act Amendments of 1974.[22] The Amendments revised the definition of handicapped individual for the purposes of the anti-discrimination provisions of section 504. Under the 1973 Act, only those individuals who could benefit from rehabilitation services in obtaining employment were defined as "handicapped." Under the Amendments, the definition was altered, so that those individuals who had been, but were no longer, handicapped (*e.g.*, those who had recovered from disabling mental illness or heart disease) or had been incorrectly diagnosed as handicapped (*e.g.*, persons erroneously believed to be mentally

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also the reported House and Senate hearings, *Vocational Rehabilitation Services to the Handicapped: Hearings on H.R. 8395 and Related Bills Before the Select Subcomm. on Education of the House Comm. on Education and Labor*, 92d Cong., 2d Sess. (1972); *Rehabilitation Act of 1972: Hearings on H.R. 8395 Before the Subcomm. on the Handicapped of the Senate Comm. on Labor and Public Welfare*, 92d Cong., 2d Sess. (1972); *Rehabilitation Act, 1973: Hearings on S.7 Before the Subcomm. on the Handicapped of the Senate Comm. on Labor and Public Welfare*, 93d Cong., 1st Sess. (1973); and the debates in the House and Senate, 119 CONG. REC. 18,116-34 (1973); (House); *id.* at 24,551-90 (Senate); *id.* at 29,615-34 (Senate approval of conference report); *id.* at 30,148-50 (House approval of conference report).

19 *See, e.g.*, 119 CONG. REC. 24,567 (remarks of Sen. Alan Cranston); *id.* at 24,587-88 (remarks of Sen. Harrison Williams).

20 8 WEEKLY COMP. OF PRES. DOC. 1579 (Oct. 27, 1972); 9 WEEKLY COMP. OF PRES. DOC. 302 (Mar. 27, 1973).

21 Rehabilitation Act of 1973, *supra* note 3.

22 Rehabilitation Act Amendments of 1974, Pub. L. No. 93-516, 88 Stat. 1617 (codified at 29 U.S.C. §§ 701-794 (1976)).

retarded) would be protected by section 504.[23] Because the language of the anti-discrimination provisions of the Rehabilitation Act of 1973 was designed to be all-inclusive, revision of the definition of "handicapped person" was necessary to make those provisions applicable to the formerly handicapped and those presumed to be handicapped, not merely to those who could benefit from rehabilitation services in obtaining employment.[24]

The Senate Report accompanying the final version of the Amendments supplied a legislative history for section 504.[25] This peculiar after-the-fact legislative history (dubbed "legislative future" at HEW[26]), declared that Congress had intended section 504 to be an aggressive piece of civil rights legislation. The report explained:

> Section 504 was patterned after, and is almost identical to, the anti-discrimination language of [Titles VI and IX]. The section therefore constitutes the establishment of a broad government policy that programs receiving federal financial assistance shall be operated without discrimination on the basis of handicap. It does not specifically require the issuance of regulations or expressly provide for enforcement procedures, but it is clearly mandatory in form, and such

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23 The definition of handicapped individual in the 1973 Act stated: "The term 'handicapped individual' means any individual who (A) has a physical or mental disability which for such individual constitutes or results in substantial handicap to employment and (B) can reasonably be expected to benefit in terms of employability from vocational rehabilitation services . . . ." 29 U.S.C. § 706(6) (Supp. III 1973) (amended 1974). The Amendments added a sentence to the definition: "For the purposes of [Titles IV and V], such term means any person who (A) has a physical or mental impairment which substantially limits one or more of such person's major life activities, (B) has a record of such an impairment, or (C) is regarded as having such an impairment." 29 U.S.C. § 706(6) (1976).

The open-ended language of clause (A) of the amended definition leaves open many controversial questions. Several of these problems were resolved during the regulation drafting process. Most significantly, alcoholics and drug addicts were determined to be within the definition of "handicapped person" for purposes of section 504. 42 Fed. Reg. 22,686 (1977). A problem currently faced by HEW is whether the obese are also to be included under the definition of "handicapped person." Wodatch Interview, *supra* note 6.

24 The underinclusive definition of "handicapped individual" in the 1973 Act is evidence of the lack of consideration Congress gave to § 504 during the enactment process.

25 S. REP. No. 93-1297, 93d Cong., 2d Sess. (1974), *reprinted in* [1974] U.S. CODE CONG. & AD. NEWS 6373.

26 Wodatch Interview, *supra* note 6.

regulations and enforcement are intended.[27]

The Report also revealed that Congress had intended section 504 to be enforced in the same manner as the proscriptions against racial discrimination contained in Title VI and the ban on sex discrimination in Title IX.[28] HEW, "because of that Department's experience in dealing with handicapped persons and with the elimination of discrimination in other areas," was given responsibility for enforcing section 504 and was "authorized" to terminate federal aid as a means of compelling compliance.[29]

II. HEW'S RESPONSE TO SECTION 504: THE REGULATION-DRAFTING PROCESS

HEW responded to the broad delegation of authority implied by the Senate Report by initiating a lengthy regulation-development process that spanned the tenure of three secretaries of the department and ended with Secretary Califano's approval of the final section 504 regulations in April 1977.[30] This Part will describe the drafting of regulations protecting the handicapped against discrimination and the structure of the regulations that were eventually promulgated.

A. *Designated Drafters: The Office for Civil Rights*

The Office for Civil Rights (OCR) of HEW received the responsibility for drafting and enforcing the regulations that were to be issued under section 504. OCR, a subunit of the Office of the Secretary of HEW, had previously monitored com-

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27 S. REP. No. 93-1297, *supra* note 25, at 39-40, *reprinted in* [1974] U.S. CODE CONG. & AD. NEWS 6373, 6390-91.

28 A possible explanation for the use of after-the-fact legislative history rather than the insertion of implementing provisions in the statute through amendment may lie in a strategic choice by groups representing the handicapped and by some congressional staff members to avoid the risk of a full debate on the issue of discrimination against the handicapped.

29 S. REP. No. 93-1297, *supra* note 25, at 40, *reprinted in* [1974] U.S. CODE CONG. & AD. NEWS 6373, 6391.

30 *See* 45 C.F.R. pt. 84 (1977). The drafting process spanned the tenures of HEW Secretaries Caspar Weinberger, Donald Mathews, and Joseph Califano.

pliance with the anti-racial discrimination provisions of Title VI.[31] This enforcement effort took two forms. A national network of OCR field offices investigated and reviewed federal fund recipients' compliance with the requirements of Title VI. Within the field offices, a complaint processing system had also been established to investigate and, if necessary, adjudicate charges of racial discrimination by fund recipients.[32] In addition, OCR had assumed broad policy formulation and enforcement responsibilities in the area of sex discrimination in education under Title IX parallel to those it possessed in the area of racial discrimination.

After the enactment of section 504, then-HEW Secretary Caspar Weinberger tentatively assigned responsibility for the new legislation to OCR.[33] He apparently believed that the language of section 504 indicated the statute was a civil rights law for the handicapped, and OCR, the office most familiar with civil rights enforcement, therefore should administer the provision.[34] Weinberger chose this alternative rather than assigning implementation responsibility to HEW program offices directly responsible for the administration of programs and the granting of federal funds. Compliance with section 504 could have become a condition of continued receipt of grants administered by individual offices, but the vast field investigation network and complaint resolution structure of OCR would not then have been available for the enforcement of section 504.

This decision, approved in the legislative history of the 1974 Amendments,[35] gave OCR the responsibility for drafting and enforcing handicapped discrimination regulations under section 504. This choice was to have a great effect on the substantive content of the final HEW regulations.

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31 COMMISSION ON CIVIL RIGHTS, CIVIL RIGHTS ENFORCEMENT EFFORT - 1974, at 123-30 (1974).

32 Interview with James Hinchman, Associate General Counsel, Office of General Counsel, HEW, in Cambridge, Mass. (October 28, 1977) (on file with the author) [hereinafter cited as Hinchman Interview].

33 Wodatch Interview, *supra* note 6.

34 *Id.* Secretary Weinberger was also under some pressure from the Senate authors of the Rehabilitation Act, who informed him in a letter that § 504 was intended to be a civil rights statute. *Id.*

35 *See* text accompanying notes 25 to 29 *supra.*

B. *OCR's Work Product: The Final Regulations Under Section 504*

The final regulations promulgated under section 504 by HEW consist of seven subparts.[36] Two subparts, A and G, are essentially procedural. Subpart A defines terms used in the rest of the regulation, elaborates section 504's broad prohibition of discrimination against the handicapped, and provides for voluntary compliance with the statute.[37] Subpart G asserts that enforcement and complaint procedures used under title VI's prohibition of racial discrimination are to be used under section 504.[38]

The remaining five subparts contain the substance of the regulation. Subparts B and C apply to all recipients of HEW funding. Subpart B governs the employment practices of recipients, prohibiting discrimination against handicapped applicants and employees, and requiring that a recipient make "reasonable accommodation" to the limitations of handicapped applicants or employees, unless such accommodation "would impose an undue hardship on the operation of its program."[39] Subpart C requires that all programs receiving funds from HEW be accessible to handicapped persons.[40] It has become the most controversial provision of the regulation because of the financial burden critics believe it will impose on recipients. Under this regulation, all facilities of HEW recipients whose construction began after the Act became effective June 3, 1977, must be designed and built so as to be "readily accessible to and usable by" handicapped persons.[41] HEW-assisted programs

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36 45 C.F.R. pt. 84 (1977). HEW was given the lead responsibility for the implementation of § 504 by Executive Order No. 11,914, 41 Fed. Reg. 17,871 (1976).

The regulations issued by HEW, however, apply only to recipients of HEW grants. Other federal agencies are to draft regulations covering their own constituencies, presumably using the HEW regulations as a model. On January 3, 1978, HEW promulgated regulations setting forth procedures for the promulgation and enforcement of § 504 regulations by other federal agencies. 43 Fed. Reg. 2136 (1978) (to be codified in 45 C.F.R. pt. 85).

37 45 C.F.R. §§ 84.1-.10 (1977).

38 *Id.* § 84.61.

39 *Id.* §§ 84.11-.14, 84.22(a).

40 *Id.* §§ 84.21-.23.

41 *Id.* § 84.23(a).

employing existing facilities must also be "readily accessible, when viewed in their entirety."[42] This requirement may be met through a combination of the careful scheduling of the use of facilities currently accessible to the handicapped, the use of different delivery methods for services, and, in some cases, by structural alterations.[43]

Three other subparts apply to specific classes of HEW recipients. Subpart D governs pre-school, elementary, and secondary education providers.[44] It requires that a "free appropriate public education [be provided] to each qualified handicapped person who is in the recipient's jurisdiction."[45] The subpart also requires jurisdictions which accept federal funds to "mainstream" handicapped children. "Mainstreaming" describes the educating of handicapped children in the same setting as that of nonhandicapped children "to the maximum extent appropriate to the needs of the handicapped person."[46] Subpart E governs recipients that offer post-secondary education, prohibiting discrimination on the basis of handicap in the recruitment and admission of students and in treatment of admitted and enrolled students.[47] Specific sections apply to admissions tests, course requirements, and the provision of auxiliary services such as readers, housing, financial aid, and athletics. Subpart F governs providers of health, welfare, and social services (*e.g.*, hospitals and nursing homes) and mandates equal treatment of handicapped patients with other persons.[49]

III. The Administrative Resolution of Substantive Issues of Handicap Discrimination

In translating the broad statement of section 504 into a final regulation, OCR staff members resolved many issues left open by the text of the Rehabilitation Act of 1973. This Part will ex-

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42 *Id.* § 84.22(a).
43 *Id.* § 84.22(b).
44 *Id.* §§ 84.31-.39.
45 *Id.* § 84.33(a).
46 *Id.* § 84.34(a).
47 *Id.* §§ 84.41-.49.
48 *Id.* §§ 84.42-.47.
49 *Id.* §§ 84.51-.54.

amine the treatment of four of those issues: 1) defining discrimination on the basis of handicap; 2) deciding whether mainstreaming of handicapped persons should be required in order to prevent discrimination by pre-school, elementary, and secondary educational institutions; 3) establishing standards by which to measure compliance with section 504 in situations where a handicap renders equal treatment impossible; and 4) determining how the regulations were to be enforced.

These issues have been selected for discussion not because they were difficult to resolve (indeed, problems of enforcement responsibility were settled by the legislative history of the 1974 Amendments[50]), nor because they all engendered controversy. They were chosen because they reveal the myriad ways administrators respond to broad delegations of authority and because the resolution of these issues significantly affects both federal funds recipients and the handicapped.

A. *Defining Discrimination on the Basis of Handicap*

1. The Initial Stage: Searching for Parallels

When section 504 was enacted, the staff of OCR was thoroughly familiar with problems of discrimination based on race, color, or national origin and on sex. It had had no experience with discrimination based on handicap. OCR staffers given responsibility for drafting regulations had no sense of what the concept meant.[51]

The drafting team first considered preparing regulations whose language would mirror that of rules issued by HEW under Title VI, barring racial discrimination, and Title IX's proscription of sex discrimination.[52] OCR's study of the problem,

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50 *See* text accompanying notes 25 to 29 *supra*.

51 Wodatch Interview, *supra* note 6. Much of Part III is based on a separate interview with the drafters of the regulation: John Wodatch, Acting Branch Chief, Handicapped Discrimination Branch, Office for Civil Rights (OCR); Anne Beckman, attorney-advisor, Office of General Counsel, HEW, assigned to Handicapped Discrimination Branch, OCR; and Alexandra Buek, Branch Chief, Civil Rights Division, Office of General Counsel, HEW, in Washington, D.C. (Feb. 15, 1978) [hereinafter cited as Drafters' Interview].

52 *See* 45 C.F.R. §§ 80.1-.13 (1977) (Title VI); *id.* §§ 85.1-86.71 (Title IX).

however, revealed that discrimination on the basis of handicap differed from other forms of discrimination. Title VI's mandate could easily be reduced to a workable rule for the formulation of a regulation: equal treatment will end racial discrimination.[53]

Likewise, the general prohibition against sex discrimination could be implemented with only slightly more difficulty. Equal treatment can usually eliminate such discrimination, but situations exist where different treatment may be necessary. To avoid discriminatory treatment, a college or university may be obliged to provide separate living facilities for men and women, or to take sex into account in its athletic program. Congress explicitly identified many of the situations where different treatment of the sexes could be required in Title IX and amendments to it, thus relieving the drafters of regulations under the statute of that responsibility.

Reducing the broad mandate of section 504 to a workable set of regulations presented a different challenge. As a general guide, equal treatment of the handicapped seemed inappropriate to the drafters because it would exclude the handicapped from many programs, creating the sort of discrimination that section 504 was intended to eliminate. Departing from the equal treatment standard, however, would leave the drafters to search for solid standards upon which to base antidiscrimination rules. They were obliged to face the tough questions of when different treatment of the handicapped would be needed and what sort of different treatment could end discrimination, given the many kinds and degrees of physical and psychological handicaps. In this most difficult area of discrimination, Congress had abandoned the helpful role it played in eliminating racial and sexual discrimination by failing to insert guidelines on different treatment into the statute.[54]

To discover what fundamental principles should underlie the section 504 regulations, the OCR staff attempted to remedy the

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53 The HEW Title VI regulation uses just one of its 16 pages to state and elaborate the rule. *Id.* §§ 80.1.-.13. The rest of the regulation establishes procedures and defines beneficiaries. Those cases in which equal treatment will not result in an end to discrimination based on race have created great problems which are still unresolved. *See* text accompanying notes 59 to 63 *infra.*

54 *See* note 12 *supra.*

lack of congressional guidance by studying the problem itself. The agency went directly to handicapped people to discover what constitutes discrimination. Through meetings with, and comments from, handicapped groups and individuals, OCR learned of the problems which the regulation would have to address.[55]

2. The Preliminary Section 504 Regulation

The initial phase of regulatory development ended when OCR published a preliminary regulation under section 504, a draft premised on the assumption that discrimination on the basis of handicap was different from race or sex discrimination.[56] Under Title VI, blacks are to be accorded equal treatment with whites. Under Title IX, women are to receive equal treatment with men. Under both statutes, different treatment is an indicator of discrimination. In preparing the draft section 504 regulation, OCR perceived that there was a real difference between handicapped and nonhandicapped people. This perception complicated OCR's conception of discrimination on the basis of handicap, as HEW's preamble to the draft regulation made clear:

> Section 504, however, differs conceptually from both Titles VI and IX. The premise of both Title VI and Title IX is that there are no inherent differences or inequalities between the general public and the persons protected by those statutes, and, therefore, there should be no different treatment in the administration of federal programs. The concept of section 504, on the other hand, is far more complex. Handicapped persons may require different treatment in order to be afforded equal access to federally assisted programs and activities, and identical treatment may, in fact, constitute discrimination. . . .[57]

Thus, while the Title VI and Title IX regulations are based on the principle that equal treatment would ensure equal participation in HEW programs, the preliminary section 504 regulation

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55 Drafters' Interview, *supra* note 51.

56 Nondiscrimination on the Basis of Handicap, 41 Fed. Reg. 20,296,-20,304-11 (1976). *See also id.* 20,297-304 app. A (commentary on preliminary regulation by OCR).

57 41 Fed. Reg. 20,296 (1976).

rested on the premise that different treatment would be required to obtain equal participation. The draft, then, became a description of the different treatment which would be appropriate in a wide variety of contexts.[58]

The preliminary regulation could be seen as a grand application of the doctrine of facial neutrality endorsed by the Supreme Court in *Lau v. Nichols*.[59] In *Lau*, a class of non-English speaking Chinese students sued officials of the San Francisco Unified School District, alleging that the failure of the school system to remedy those students' language disadvantage violated the equal protection clause of the fourteenth amendment[60] and Title VI.[61] The Ninth Circuit Court of Appeals had found no violation, relying on the rule that equal treatment is sufficient under Title VI and held that "However commendable and socially desirable it might be for the school district to provide special remedial education programs to disadvantaged students, . . . we find no constitutional or statutory basis upon which we can mandate that these things be done."[62]

Relying on Title VI and the regulations promulgated under it by HEW, the Supreme Court reversed. It held that equal treatment of the Chinese students, ignoring the fact that they did not understand English, had the effect of discriminating against them on the basis of national origin and therefore was forbidden under Title VI regulations.[63] The application of facially neutral rules and practices which, in effect, discriminate would be prohibited. In special cases, different treatment to prevent racial discrimination would be required under Title VI.

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58 The decision of the drafters of the preliminary regulation to treat discrimination against the handicapped differently from race and sex discrimination may have resulted from the insertion of § 504 into the Rehabilitation Act, rather than into Title VI or Title IX. *Cf.* note 6 *supra* (reasons for not amending Title VI to include handicapped persons). The difference in the anti-discrimination regulations may also have followed from OCR's reliance on handicapped individuals during the drafting process for information on the nature and extent of discrimination. This may have led OCR to the conclusion that different treatment was the best means of achieving equal participation.

59 414 U.S. 563 (1974).

60 U.S. CONST. amend. XIV.

61 42 U.S.C. § 2000d (1976); *see* text accompanying note 6 *supra*.

62 483 F.2d 791, 798 (9th Cir. 1973), *rev'd*, 414 U.S. 563 (1974).

63 414 U.S. at 568.

The facial neutrality doctrine of *Lau* provided the foundation for the preliminary section 504 regulation. The general rule of the draft regulation was that special treatment would be required to meet special needs unless equal treatment could meet the goal of the Rehabilitation Act. This inversion of Title VI analysis, in which the equal treatment rule of Title VI becomes the exception to section 504, however, was unacceptable as a basis for the section 504 regulation. The problem with such an inversion lies in the difficulty of determining the kind and magnitude of differential treatment which may ultimately lead to a non-discriminatory result. "Equal treatment means no discrimination" provides a solid foundation on which to construct regulations; once this principle is left behind, no easily ascertainable guideposts for drafting concrete rules remain. Thus, the attempt to end discrimination by differential treatment may actually exacerbate, rather than alleviate, existing discrimination.[64]

The draft regulations contained many examples of the dangers of adopting differential treatment as the rule rather than the exception. One provision of the higher education subpart of the draft provided:

> *Different Admissions Criteria.* A recipient may . . . apply criteria for the admission of handicapped persons which differ from the criteria applied to nonhandicapped persons, where such criteria are useful as predictors of completion of the education program or activity in question or of success in the occupation or profession for which the education program is designed to educate students.[65]

In effect, this section, by authorizing different treatment of the handicapped, sanctioned the kind of discrimination section 504 was intended to eliminate. Nonhandicapped applicants to law school, for example, do not have to establish that they will become successful attorneys, much less practice law at all.[66] It

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64 Interview with James Gashel, Chief of Washington Office, National Federation of the Blind, in Washington, D.C. (Feb. 16, 1978) (on file with the author) [hereinafter cited as Gashel Interview]. *See* Gashel, *Civil Rights for the Handicapped: Potentials and Perils for the Blind,* BRAILLE MONITOR, July 1977, at 220.

65 *See* 41 Fed. Reg. 20,310 (1976) (proposed 45 C.F.R. § 84.42(c)).

66 Gashel Interview, *supra* note 64.

is unlikely that this section would have been proposed if the basic assumption of the drafters had been that discrimination against the handicapped is similar to race or sex discrimination, and that equal treatment of the handicapped, in general, will lead to equal participation.

3. The Final Regulation: Establishing a Norm of Equal Treatment of the Handicapped

The final regulations HEW issued under section 504 abandoned the problematic view of discrimination on the basis of handicap contained in the preliminary draft. Instead, OCR drafters adopted the equal treatment rule employed in regulations aimed at racial and sex discrimination.[67] The structure and basic content of the final regulations closely parallel that of the preliminary regulation, as the basic principle of equal treatment must be tempered by exceptions requiring different treatment. Thus, much of the section 504 regulations' content consists of exceptions to a basic rule. Nevertheless, the emphasis of the final regulation is on equal treatment of the handicapped, an emphasis evident in the preamble to the regulation:

> There is overwhelming evidence that in the past many handicapped persons have been excluded from programs entirely or denied equal treatment, simply because they are handicapped. But eliminating such gross exclusions and

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67 *See, e.g.*, 45 C.F.R. pt. 84 app. A, at 374,383 (1977) (Comment on 45 C.F.R. § 84.4(c)(2)(iv)). The decision to abandon the emphasis of the preliminary regulations on different treatment of the handicapped resulted in part from pressure by organizations of the handicapped such as the National Federation of the Blind. Gashel Interview, *supra* note 64. Martin Gerry, Director of OCR during the drafting process, acknowledged the role the Federation played in the regulation development process in an address before its 1976 convention:

> In many cases the impact of . . . disabilities would not in any way require anything other than a fair equal opportunity to be presented in terms of identical treatment or identical services by a provider. I think the comments in the June 14 letter very appropriately made this point and I think the emphasis in the draft was ill-placed. That emphasis will be changed [and] will reflect much more the operating assumption that there should be substantial evidence presented if [it is claimed that] a particular physical characteristic prevents the achievement of equality through identical treatment — this assumption being the reverse of the current draft.

Gashel, *Civil Rights for the Handicapped: Potentials and Perils for the Blind*, BRAILLE MONITOR, July, 1977, at 221.

> denials of equal treatment is not sufficient to assure genuine equal opportunity. In drafting a regulation to prohibit exclusion and discrimination, it became clear that different or special treatment of handicapped persons . . . may be necessary in a number of contexts in order to assure equal opportunity.[68]

This statement contrasts sharply with the statement in the preamble of the preliminary regulation.[69] Equal treatment, although "not sufficient to ensure genuine equal opportunity," is the governing principle of the final regulations.

This shift in emphasis becomes even more evident when the general anti-discrimination section of the preliminary regulation is contrasted with the corresponding section of the final regulation. The preliminary regulation stated: "A recipient shall provide aid, benefits, and services to handicapped persons in a manner different from that in which they are provided to others, when such action is necessary to provide qualified handicapped persons with aid, benefits, or services which are comparable to these provided to others . . . ."[70] In contrast, the final regulation states: "A recipient . . . may not . . . [p]rovide different or separate, aid, benefits, or services to handicapped persons . . . unless such action is necessary to provide qualified handicapped persons with aid, benefits, or services that are as effective as those provided to others."[71] The first version affirmatively authorized different treatment. The final section 504 regulation authorizes different treatment as an exception which is permitted only after equal treatment has proved to be inappropriate. The controversial section on different admissions requirements was dropped.

The final section 504 regulation aligns the concept of discrimination on the basis of handicap with the concept of discrimination on the basis of race and sex. This alignment produced regulations which, by authorizing different treatment within the context of an equal treatment rule, limits unnecessary and discriminatory differential treatment by HEW

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68 42 Fed. Reg. 22,676 (1976).
69 *See* text accompanying note 57 *supra*.
70 41 Fed. Reg. 20,305 (1976) (proposed 45 C.F.R. § 84.4(b)(2)).
71 45 C.F.R. § 84.4(b)(1)(iv) (1977).

grant recipients and better assures equal participation of handicapped people in HEW programs. Moreover, it embraces a healthy perception of handicapped people as being essentially no different from the nonhandicapped.

Of course, the possibility always exists that recipients of HEW grants will misinterpret the authorizations of different treatment contained within the section 504 regulations.[72] Those charged with enforcing the new rules will have to maintain a constant guard against unnecessary different treatment which leads to discrimination against the handicapped. But the equal treatment principle of the final regulation provides a clear standard against which the appropriateness of unequal treatment can be measured. It should play an important role in the implementation of section 504.

B. *The Mainstreaming Problem*

1. Mainstreaming in the Context of Pre-school, Elementary, and Secondary Education

When Congress enacted section 504 and delegated the responsibility for implementing its provisions to HEW, the potentially explosive question of whether to "mainstream" handicapped children into educational programs lay buried within that statute's prohibition of discrimination. "Mainstreaming" requires the establishment of programs for educating handicapped children, to the maximum extent possible, with nonhandicapped children in a regular school setting designed to eliminate discrimination against handicapped children. Both the handicapped and educators are deeply di-

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72 A section of the final regulation in the higher education subpart, for example, allows recipients, in order to avoid discriminating on the basis of handicap, to modify academic requirements by changing "the length of time permitted for the completion of degree requirements," by substituting "specific courses required for the completion of degree requirements," and by adapting "the manner in which specific courses are conducted." *Id.* 45 C.F.R. § 84.44(a)(1977). Under these provisions, a college, in rescheduling classes to take into account the relative accessibility of certain rooms to handicapped individuals, might consider the ability of particular professors to teach handicapped students or the effectiveness of certain teaching methods in teaching handicapped students. Handicapped students who, as a result, face a reduced choice of professors and methods are discriminated against. Gashel Interview, *supra* note 64.

vided over the question of whether the educational benefits, if any, mainstreaming confers on handicapped and non-handicapped students outweigh the financial and personnel burdens mainstreaming imposes on local schools.[73] Underlying this policy debate is the legal question of whether any "separate but equal" education program for the handicapped can survive legal attacks based on *Brown v. Board of Education*[74] and the principles underlying legislation barring discrimination based on either race or sex. It has been argued that cases forbidding racially separate but equal educational facilities also apply to similar situations involving men and women.[75] Whether this argument can be carried over to discrimination on the basis of handicap poses more difficult problems.

Congress relieved OCR of the obligation of resolving these questions by the enactment of the Education of All Handicapped Children Act on November 29, 1975.[76] Through the Act, Congress imposed its own solution of the mainstreaming issue. Under the Act states are required to develop plans which provide for the identification of all handicapped children within their borders and which assure that "a free appropriate public education will be available for all handicapped children . . . not later than September 1, 1978," in order to continue to qualify for federal education aid.[77] The Act also mandates the establishment of "procedures to assure that, to the maximum extent appropriate, handicapped children . . . are educated with children who are not handicapped. . . ."[78] Safeguards were established to

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73 *See* Greenberg & Doolittle, *Can Schools Speak the Language of the Deaf?*, N.Y. Times, Dec. 11, 1977, § 6 (Magazine) at 50; *Mainstreaming*, TODAY'S EDUC., Mar./April 1976, at 19; NATIONAL ADVISORY COUNCIL ON EDUCATION PROFESSIONS DEVELOPMENT, MAINSTREAMING: HELPING TEACHERS MEET THE CHALLENGE (1976); MAINSTREAMING: CONTROVERSY AND CONSENUS, (P. O'Donnell & R. Bradfield eds. 1976).

74 347 U.S. 483 (1954).

75 *See* Buek & Orleans, *Sex Discrimination — A Bar to Democratic Education: Overview of Title IX of the Education Amendments of 1972*, 6 CONN. L. REV. 1, 19 (1973); Comment, *Implementing Title IX: The HEW Regulations*, 124 U. PA. L. REV. 806, 815-18 (1976).

76 Pub. L. No. 94-142, 89 Stat. 773 (1975), (*codified at* 20 U.S.C. §§ 1401-1461 (1976).

77 20 U.S.C. § 1412(2)(B), (C) (1976). The Act codifies the holding of Mills v. Board of Education, 348 F. Supp. 866 (D.D.C. 1972).

78 20 U.S.C. § 1412(5)(B) (1976).

ensure that state agencies comply with the mandate of Congress.[79]

OCR drafters followed Congress' mandate by imposing on state education agencies an obligation to mainstream. The section 504 regulation requires state agencies to "identify and locate every qualified handicapped person residing in the recipient's jurisdiction who is not receiving a public education," to "provide a free appropriate public education to each qualified handicapped person," to educate each qualified handicapped person "with persons who are not handicapped to the maximum extent appropriate," and to establish procedural safeguards.[80] The drafters inserted a hint that "[c]ompliance with the procedural safeguards of . . . the [Education of All Handicapped Children Act] is one means of meeting this requirement."[81]

It is fortunate that the mainstreaming issue was resolved by Congress' enactment of the Education of All Handicapped Children Act. OCR and HEW thus can hide behind Congress and evade responsibility for imposing on localities the financial obligations of mainstreaming. The opposition to mainstreaming has been heavy. State education agencies have complained about the huge financial and administrative burden imposed by mainstreaming and about inadequate federal funding to cover the increased costs from the federally imposed requirement.[82] New Mexico has asserted it will forego federal support and educate handicapped children without federal funds and control.[83] Had OCR been unable to rely on a congressional policy decision, its attempted imposition of mainstreaming — without providing federal aid to implement such a program — would have placed it at the center of the debate.

Financially strapped school districts could have focused their opposition to mainstreaming on the broad delegation of authority from Congress to HEW in section 504 and on the question of whether a civil rights office in HEW should be allowed to make

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79 *Id.* § 1415.
80 45 C.F.R. §§ 84.32(a), .33(a), .34(a), .36 (1977).
81 45 C.F.R. § 84.36 (1977).
82 N.Y. Times, Jan. 30, 1978, at 1, col. 2.
83 *Id.*

a legislative decision on the crucial educational issue of mainstreaming. By challenging the legitimacy of the section 504 development process, opponents of mainstreaming could have weakened the force of the entire regulation.[84]

More general requirements of program accessibility also inspired a considerable opposition among aid recipients.[85]Yet opponents of that requirement did not fundamentally challenge the legitimacy of the regulation as a whole. Recipients agree that some program accessibility requirement is necessary and that it should be set by HEW regulations. Controversy centers on the asserted vagueness and inflexibility of specific provisions. Mainstreaming, on the other hand, was an issue on which little prior agreement had existed. By relying on Congress' resolution of the issue, OCR shielded itself and its regulations from serious attack and allowed the delegation of authority under section 504 to go unchallenged.

2. Mainstreaming in Other Contexts

The use of the mainstreaming concept within the section 504 regulation is not limited to the context of pre-school, elementary, and secondary education. Institutions of higher education are required to mainstream by requirements that recipients of aid "shall operate [their] programs and activities in the most integrated setting appropriate."[86] More importantly, a provision of subpart A, applicable to all HEW aid recipients, states: "Despite the existence of separate or different programs or activities provided in accordance with this part, a recipient may not deny a qualified handicapped person the opportunity to participate in such programs or activities that are not separate or different."[87]

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84 A legal challenge to the § 504 regulation could have asserted that § 504 represented an unconstitutional delegation of authority from the legislative to the executive branch. For a discusson of the non-delegation doctrine, *see generally* Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1667, 1672-73, 1693-97 (1975).

85 *See* Stanfield, *Bringing the World to the Disabled — The Feds Start to Get Tough*, NAT'L J., Feb. 18, 1978, at 273-76.

86 45 C.F.R. § 84.43(d) (1977).

87 *Id.* § 84.4(b)(3).

The extension of the mainstreaming principle beyond the context of "lower" education in the section 504 regulation is a refinement of the rule of equal treatment that underlies the entire final regulation. Under this rule handicapped people cannot be channeled into separate programs unless a separate program must be employed to avoid discrimination. "Mainstreaming" may be defined in similar terms. It is significant that mainstreaming provisions did *not* appear in the preliminary regulation, which was bottomed on a principle of "separate but equal" treatment rejected in other contexts.[88]

C. *Establishing Standards of Compliance*

The drafters of the section 504 regulation based the final draft of the rules on the principle that equal treatment of the handicapped should be required in most circumstances and chose mainstreaming as one method to achieve the goal of ending discrimination on the basis of handicap. After these foundations of the regulation had been developed, the drafters then faced a new set of difficult problems as they struggled with the actual language of the regulations. In this phase of regulatory development, standards for the behavior of HEW grant recipients had to be developed and articulated. The content of these standards would be crucial for two reasons. First, the standards would set forth HEW's initial position on when different treatment of the handicapped would be necessary to ensure equal participation. The standards would also warn HEW grant recipients of what the cost of compliance would be.

In the preamble to the final regulation, HEW acknowledged that the interests of both the handicapped and cost-conscious state agencies had to be considered in the drafting of standards:

> Ending discriminatory practices and providing equal access to programs may involve major burdens on some recipients. Those burdens and costs, to be sure, provide no basis for exemption from section 504 or this regulation. . . . But . . . factors of burden and cost had to be taken into account in the

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88 *See* text accompanying notes 74 to 75 *supra*. *See also* Brown, Emerson, Falk & Freedman, *The Equal Rights Amendment: A Constitutional Basis for Equal Rights for Women*, 80 YALE L.J. 871, 902 (1971).

> regulation in prescribing the actions necessary to end discrimination. . . .[89]

The OCR staff members who drafted the section 504 regulation confronted the problem of balancing the practical limits on aid recipients' ability to finance equal participation for the handicapped with the clear language of a statute mandating such participation.

This question became intermingled with another issue before the drafters: whether to draft a short, broadly phrased regulation or one that was long and highly detailed.[90] The problem of what the substance of compliance standards under section 504 would be could not be separated from that of whether such standards would be in broad or highly specific language.

The consequences of choosing either a broad or a specific approach to draftsmanship are significant. A detailed regulation, designed to give recipients a clear indication of HEW's position on all issues, may in practice be inflexible and unwieldy, affecting recipients differently through strict application. Moreover, situations neither anticipated nor addressed may slip through the regulation, leading to a need for continual amendment. A broadly phrased regulation avoids these administrative difficulties, but it frequently leads to litigation on questions of substantive compliance. In effect, under broad regulations, the courts may actually be forced to draft specific rules of conduct.

The final section 504 regulation employs elements of both approaches to drafting. The regulation is short,[91] considering the many classes of recipients and great number of issues it must address. Its requirements are stated briefly and in broad terms. On the other hand, a detailed analysis of each provision of the regulation is attached as an appendix to the whole.[92] The appendix offers specific examples of how the regulation is to be applied, discusses the drafting history and sources of each provi-

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89 42 Fed. Reg. 22,676 (1976).

90 This issue was one of 15 on which HEW requested specific comments when the draft regulations were published. *See* 41 Fed. Reg. 20,296 (1976).

91 The text of the § 504 regulation covers only 16 pages in the 1977 edition of the Code of Federal Regulations. *See* 45 C.F.R. pt. 84 (1977).

92 45 C.F.R. pt. 84 app. A, at 374-91 (1977).

sion, and generally indicates to recipients what OCR intended each broadly termed section to mean.

The combination of a broadly worded regulation with a detailed appendix is a particularly appropriate technique for bringing aid recipients into compliance with section 504. The elimination of discrimination against the handicapped poses new and bewildering problems. OCR must provide HEW grant recipients with effective guidance on how they can be solved. Yet the delegation of responsibility under section 504 is so broad that OCR may be foreclosed from placing a detailed, strict, and costly set of demands onto aid recipients during the initial implementation of the statute.

This combination of general regulations with elaborate, detailed appendices is illustrated by subpart B of the section 504 regulation, which prohibits discrimination against the handicapped in employment. Under the section 504 regulation, grant recipients' employment practices must meet a standard of "reasonable accommodation to the known physical and mental limitations" of a handicapped current or prospective employee, unless the employer can demonstrate such accommodation "would impose an undue hardship in the operation of [his] programs."[93] Although the text of the regulation contains some general definitions of reasonable accommodation and undue hardship, more detailed information is contained in the appendix, which delineates examples of reasonable accommodation and provides guidance for determining undue hardship. The appendix reveals that OCR drafters copied standards used in the employment regulation from regulations issued by the Department of Labor under section 503 of the Rehabilitation Act of 1973,[94] a general prohibition of discrimination on the basis of handicap by government contractors. The experience of the Labor Department in applying its standards, the appendix ex-

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93 *Id.* § 84.12(a).

94 29 U.S.C. § 793 (1976). The Labor Department's regulation states: "A contractor must make a reasonable accommodation to the physical and mental limitations of an employee or applicant unless the contractor can demonstrate that such an accommodation would impose an undue hardship on the conduct of the contractor's business." 41 C.F.R. § 60-741.7(d) (1977).

plains, will be relevant in the enforcement of the HEW employment regulation.[95] The appendix also makes clear that OCR elected to use a standard of "reasonable accommodation," over substantial objections from recipients who asserted the proposed standard was vague, because "the Department of Labor reports that it has experienced little difficulty in administering" its requirements.[96]

Other standards of compliance, however, were formulated from scratch by OCR. "Program accessibility" standards were developed entirely by OCR.[97] Subpart F, covering health, welfare, and social service agencies, also contains an "original" standard which requires grant recipients with more than fifteen employees to provide auxiliary aids to handicapped patients and other clients when making such aids available "would not significantly impair the ability of the recipient to provide its benefits or services." The appendix elaborates upon this tiny standard by offering "adversely effect" as an alternative formulation of "significantly impair," and by giving an example of compliance involving a small neighborhood clinic.[99]

The compromise adopted by OCR in the regulation drafting process — formulating broad standards for the differential treatment of handicapped people only when necessary and compensating for vagueness in the text of the rules in the appendix — should enable the 504 regulation to become an effective, comprehensible tool without turning the broad statutory mandate into a strict, inflexible regulatory regime imposed on local social service providers.

D. *Establishing Enforcement Mechanisms*

The efforts that led to the formulation of the principles and language of the section 504 regulation will all be wasted unless the rules drafted to end discrimination against the handicapped are effectively enforced. Admittedly, the principle that

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95 45 C.F.R. pt. 84, app. A at 374, 380-81 (1977).
96 *Id.* at 380.
97 *See id.* at 382-84; Drafters Interview, *supra* note 51.
98 45 C.F.R. § 84.52(d)(2) (1977).
99 *Id.*, 45 C.F.R. pt. 84 app. A, at 391.

discrimination against handicapped people is improper is widely accepted. Yet it is certain HEW, through OCR, will be required to enforce section 504 affirmatively, in the light of such factors as budget constraints faced by HEW aid recipients, administrative inertia, and misunderstanding or ignorance by the handicapped of their rights.

Through omission in the Rehabilitation Act of the implementing provisions found in legislation barring race and sex discrimination, Congress did not instruct HEW whether the provisions of section 504 were to be enforced as a condition to grants made by HEW or by enforcement efforts similar to those employed under Title VI's ban on race discrimination.[100] The text of the statute did not state whether termination of grants would be permitted as a sanction for noncompliance with section 504. The legislative history of the 1974 Amendments to the Rehabilitation Act of 1973[101] helped to fill the omission. The Senate Report on the Amendments asserted that it was the intent of Congress in 1973 that section 504 be enforced through the enactment of regulations and the use of complaint and investigation procedures employed under Title VI by OCR,[102] and not through the placing of conditions on HEW grants.[103] An executive order issued April 28, 1976, confirmed that HEW was to have the power to cut off federal funds for noncompliance with the section 504 regulations.[103]

At first glance, it appears that OCR will be unable to enforce vigorously regulations promulgated under section 504. OCR has been unable to run its complaint and investigation machinery efficiently under the rapidly growing burden of its responsibilities to end race and sex discrimination by HEW grant recipients.[104]

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100 *See* text accompanying, notes 7 to 16 *supra.*

101 Rehabilitation Act Amendments of 1974, *supra* note 3.

102 *See* text accompanying notes 26 to 28 *supra.* The final regulation acknowledges this congressional decision to give OCR the § 504 enforcement responsibility through its incorporation by reference of the Title VI complaint procedures. 45 C.F.R. § 84.61 (1977).

103 Exec. Order No. 11,914, 41 Fed. Reg. 17,871 (1976).

104 *See, e.g.,* Note, *Sex Discrimination — The Enforcement Provisions for Title IX of the Education Amendments of 1972 Can Be Strengthened to Make the Title IX Regulations More Effective,* 49 TEMPLE L.Q. 207, 216-19 (1975) [hereinafter cited as *Sex Discrimination*]; *see generally* COMMISSION ON CIVIL RIGHTS, FEDERAL CIVIL RIGHTS ENFORCEMENT EFFORT — 1974, at 131-209 (1975).

The protection of the rights of the handicapped may be frustrated by the breakdown of OCR's enforcement effort in other areas.

A notice of proposed rulemaking issued by HEW in 1975 contains some staggering statistics about enforcement responsibilities.[105] OCR's present complaint and investigation procedures were established when the Office held responsibility only for Title VI, which barred racial discrimination by 16,000 school districts, 2,874 institutions of higher education, and 30,000 other recipients, and for Executive Order 11246, which placed similar restrictions on approximately 4300 contractors.[106] Since then, OCR has taken responsibility for the enforcement of Title IX, whose prohibition against sex discrimination affects most of the educational institutions covered under Title VI, and the enforcement of the anti-sex discrimination provision of the Public Health Service Act,[107] involving 1500 more recipients of federal funds.[108]

The task of enforcement has proved to be far beyond the capacity of OCR's staff of 800.[109] The addition of enforcement responsibility for the section 504 regulation which affects nearly 49,000 recipients of aid from HEW[110] and millions of handicapped persons represented by groups which will not hesitate to file complaints with HEW[111] may lead to increasingly poor performance by OCR.

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105 40 Fed. Reg. 24,148 (1975). The proposed rule streamlined the Title VI complaint process and represented an attempt by HEW to change OCR's procedures to meet its increased workload. The proposed rule never became final; HEW withdrew it in the face of opponents' claims that it would force more people into the courts and that HEW had not exerted itself fully under the existing compliance system. *Sex Discrimination, supra* note 104, at 212-14 (1975).

106 40 Fed. Reg. 24,148-49 (1975).

107 42 U.S.C. §§ 200-300 (1976).

108 40 Fed. Reg. 24,149 (1975).

109 *Id.*

110 *Id.*

111 The National Federation of the Blind, for example, began filing complaints alleging § 504 violations well before the promulgation of the final regulation. Gashel Interview, *supra* note 64. OCR handled these pre-regulation complaints by judging the alleged discriminatory action against general standards which were not in all cases reflected in the provisions of the final regulation. Drafters Interview, *supra* note 51.

The National Federation of the Blind also brought suit under § 504 before the regulation was issued, asserting that the section created a private right of action and suc-

Recent developments, however, indicate that bleak forecasts of the prospects for enforcement of section 504 may be exaggerated. OCR's ability to carry out its enforcement responsibility has been materially improved as the result of litigation undertaken against HEW. In one case, *Adams v. Richardson*,[112] black students and taxpayers sued the Secretary of HEW and the Director of OCR, alleging "defaults on the part of defendants in the administration of their responsibilities under title VI . . . ."[113] Plaintiffs alleged that OCR had defaulted by failing to go beyond informal negotiations with recipients found to be in violation of Title VI by OCR or the federal courts. The district court found for plaintiffs on all counts and ordered OCR in 1973 to enforce Title VI against the named recipients through administrative hearings and terminations of grants.[114] Upon plaintiffs' motion for further relief, the District Court ordered OCR to take action against six southern states whose higher education systems were still not in compliance with Title VI.[115]

While the result of *Adams* could have channeled OCR resources into Title VI enforcement from other OCR responsibilities, including putting section 504 into force, the final settlement of the case made in December, 1977, may in fact aid the enforcement of section 504. Responding to pressure from the National Federation of the Blind, which intervened in *Adams* on behalf of the beneficiaries of section 504, HEW agreed to add

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cessfully alleging that a recipient of federal funds had violated its general prohibition. Gurmankin v. Constanzo, 411 F. Supp. 982 (E.D. Pa. 1976), *aff'd*, 556 F.2d 184 (3d Cir. 1977). One reason for bringing suit before the regulation had been issued was to create judicial precedents that could influence the substance of the regulation. Gashel Interview, *supra* note 64.

Whether handicapped persons will be allowed to bring private causes of action under § 504 may be decided by the Supreme Court in Southeastern Community College v. Davis, 574 F.2d 1158 (4th Cir. 1978), *cert. granted*, 47 U.S.L.W. 3463 (U.S. Jan. 9, 1979) (No. 78-711). Other federal courts have held that a private right of action was created by § 504. *See, e.g.*, Leary v. Crapsey, 566 F.2d 863, 865 (2d Cir. 1977) (per curiam) (existence of cause of action conceded by defendants); Lloyd v. Regional Transp. Auth., 548 F.2d 1277, 1284-88 (7th Cir. 1977).

112 351 F. Supp. 636 (D.D.C. 1972), *order issued*, 356 F. Supp. 92 (D.D.C.), *aff'd and modified in part*, 480 F.2d 1159 (D.C. Cir. 1973).

113 351 F. Supp. at 637.

114 356 F. Supp. 92 (D.D.C. 1973).

115 Adams v. Califano, 430 F. Supp. 118 (D.D.C. 1977).

898 people to the OCR staff in an effort to clear the backlog of discrimination complaints within two years and to "spot-check" 30 HEW grant recipients for compliance with the section 504 regulation.[116] Although no results of the settlement have been reported, the settlement has improved the potential for vigorous enforcement of section 504 by HEW.

Furthermore, it seems clear that OCR, not the HEW program offices responsible for administering grant programs, was the appropriate subunit of HEW to have been assigned the job of enforcing section 504. OCR concentrates its efforts on problems of discrimination. It is willing to read the prohibitions of discrimination against the handicapped contained in section 504 expansively and considers itself to be responsible to a constituency composed of the handicapped.[117] The complaint and investigation procedures already in place for enforcement of other anti-discrimination programs could serve as a highly visible means of ensuring compliance and educating the handicapped about their rights.[118] Placing enforcement responsibility for section 504 in the program offices never previously assigned to enforce civil rights statutes might have led to a far less sweeping enforcement effort, in part due to the identification of program staff offices with aid recipients who were also potential discriminators.

Conclusion

Section 504 of the Rehabilitation Act of 1973 was a vague, one-sentence statement of a policy opposing discrimination on the basis of handicap. It baldly asserted the right of the handicapped to participate equally in the programs of federal fund recipients without any indication of how its provisions were to be implemented. The administrative process by which HEW, through its Office for Civil Rights, prepared the regulations that would put section 504 into force may be as worthy of study

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116 Adams v. Califano, No. 3085-70 (D.D.C. Dec. 29, 1977). Congress funded 898 new enforcement positions in OCR for fiscal 1979. *See* Departments of Labor and Health, Education, and Welfare Appropriation Act, 1979, Pub. L. No. 95-480, 92 Stat. 1567 (1978); S. REP. No. 95-1119, 95th Cong., 2d Sess. 129-30 (1978).

117 Drafters Interview, *supra* note 51.

118 Hinchman Interview, *supra* note 32.

as the content of the regulations that were the end product of that process.

Given the opportunity to write on a clean slate in the area of discrimination against the handicapped, OCR elected to rely on its experience in enforcing statutes barring discrimination on the basis of race and sex, eventually drafting regulations paralleling earlier enactments with the principle that equal treatment of a group (in this case, the handicapped) would generally lead to equal participation in society by that group. It also balanced the need for occasional differing treatment of the handicapped to assure equal treatment against the heavy burden that the costs of such differing treatment would impose on HEW grant recipients by drafting broadly worded regulations that would allow for some flexibility in the implementation of section 504.

HEW was not the only arm of government to play a role in the emergence of the section 504 regulation. Congress resolved some of the initial ambiguity of the Rehabilitation Act by mandating mainstreaming by elementary and secondary schools and, through after-the-fact legislative history, assigning the responsibility for enforcing section 504 to OCR. Finally, the courts, in *Adams*, forced HEW to recognize the inadequacy of its enforcement staff, leading to an increase in personnel that may provide effective implementation of the goal of section 504 — the end of the exclusion of handicapped persons from full participation in American life.

NOTE

INCOME TAX DEDUCTIONS AND CREDITS FOR NONPUBLIC EDUCATION: TOWARD A FAIR DEFINITION OF NET INCOME

GLEN A. YALE*

Courts have recently held unconstitutional legislative attempts to provide financial aid to nonpublic schools. Citing the impermissible effect of aiding religiously affiliated institutions, these decisions have prompted strong criticism of congressional proposals to provide tax credits for nonpublic education expenses.

In this Note Mr. Yale argues that the income tax system can take account of tuition payments made by parents to nonpublic elementary and secondary schools without running afoul of constitutional prohibitions. He points out that parents who fulfill their legal obligation to their children through use of the public schools receive benefits which should be accounted for in the income tax. Creating a tax formula which can recognize the difference between parents who use public schools and those who do not, Mr. Yale concludes that measures designed to place all parents on an equal footing for tax purposes would survive attacks based on the first amendment.

Introduction

In the early 1970s, the Supreme Court, relying on the first amendment's ban on laws "respecting the establishment of religion or prohibiting the free exercise thereof," decided a series of cases invalidating state statutes which provided government aid to nonpublic education.[1] In light of these decisions, several commentators suggested it was unlikely any such

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1 Committee for Pub. Educ. & Religious Liberty v. Nyquist, 413 U.S. 756 (1973) (program of direct grants to nonpublic schools and tuition reimbursements and tax benefits for parents of children in nonpublic elementary and secondary schools held invalid) [hereinafter cited as *Nyquist*]; Levitt v. Committee for Pub. Educ. & Religious Liberty, 413 U.S. 472 (1973) (reimbursement of nonpublic schools for administering examinations required by state law, including those prepared by nonpublic school employees, and for maintaining certain records held unconstitutional); Lemon v. Kurtzman, 403 U.S. 602 (1971) (Ohio system of reimbursement for certain secular education expenses incurred by nonpublic schools and Rhode Island program of salary supplementation for teachers of secular courses in nonpublic schools held unconstitutional).

aid programs, aside from those providing services such as transportation[2] or textbook loans to individual students,[3] would ever obtain judicial approval.[4] As a basis for questioning the validity of government aid plans, the courts and the commentators have relied on *Committee for Public Education and Religious Liberty v. Nyquist,*[5] a Supreme Court decision holding that a New York program which provided tax benefits to the parents of children enrolled in nonpublic elementary and secondary schools was unconstitutional.[6] Yet, accepting the propriety of the analysis set forth in *Nyquist* for determining whether a program aiding nonpublic schools constitutes an unconstitutional establishment of religion,[7] *Nyquist* ought not to be cited for the general proposition that every program of tax adjustments for elementary and secondary education expenses must be struck down.

The *Nyquist* opinion may be understood as examining the following syllogism:

(Major Premise) Aid to parochial shools is invalid under the Establishment Clause.

(Minor Premise) Tax credits to nonpublic school parents provide aid to parochial schools.

(Conclusion) Therefore, tax credits to nonpublic school parents are invalid.

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2 Everson v. Board of Educ., 330 U.S. 1 (1947).

3 Board of Educ. v. Allen, 392 U.S. 236 (1963).

4 Pfeffer, *Aid to Parochial Schools: The Verge and Beyond,* 3 J. L. & EDUC. 115, 121 (1974); Wilson, *The School Aid Decisions: A Chronicle of Dashed Expectations,* 3 J. L. & EDUC. 101, 105 (1974); Morgan, *The Establishment Clause and Sectarian Schools: A Final Installment?,* 1973 SUP. CT. REV. 57, 58, 93.

5 413 U.S. 756 (1973), discussed at text accompanying notes 78 to 106 *infra.*

6 Public Funds for Pub. Schools of N.J. v. Byrne, 444 F. Supp. 1228 (D.N.J. 1978) (deduction from gross income of $1000 for each child in a nonpublic school held unconstitutional); United Ams. for Pub. Schools v. Franchise Tax Bd. of Cal., No. 73-0090 (N.D. Cal. Feb. 1, 1974), *aff'd mem.,* 419 U.S. 890 (1974) (tax plan similar to that in *Nyquist* held unconstitutional); Minnesota Civil Liberties Union v. State, 302 Minn. 216, 224 N.W.2d 344 (1974), *cert. denied,* 421 U.S. 988 (1975). *See also* Kosydar v. Wolman, 353 F. Supp. 744 (S.D. Ohio 1972) (per curiam) (three-judge court), *aff'd sub nom.* Grit v. Wolman, 413 U.S. 901 (1973) (decision holding Ohio's $90 tax credit to parents of children in nonpublic schools to be unconstitutional, affirmed by the Supreme Court the day *Nyquist* was decided); Wolman v. Essex, 342 F. Supp. 399 (S.D. Ohio) (three-judge court), *aff'd mem.,* 409 U.S. 808 (1972) (tuition reimbursement plan invalid).

7 The *Nyquist* majority used a three-pronged test for determining whether a state aid program was unconstitutional under the Establishment Clause. To be constitutional,

The bulk of the *Nyquist* opinion explores the contours of and exceptions to the major premise. The Court gave only limited consideration to the minor premise. This failure to develop fully the minor premise constitutes the greatest weakness in the Court's opinion. This Note will argue that tax credits and deductions which take account of expenditures by parents for nonpublic education do not constitute "aid" to nonpublic schools or to parents. It will conclude that such tax credits and deductions, designed to improve fairness and equity within an income tax scheme, are compatible with *Nyquist.* The Supreme Court's weak analysis of the tax problems contained within *Nyquist* ought not to be equated with its holding on constitutional issues.[8] Certain systems of tax adjustments for educational expenditures may be constitutional means of improving the equity of the income tax system.[9]

I. Education Expenses in an Income Tax

A. *Tax Deductions and Tax Credits Generally*

Almost every income tax system makes provision for deductions and credits. These measures may serve either or both of two purposes. First, deductions may be employed to define the net income which is to be taxed. Thus, a legislature may allow a

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such a plan must have a secular legislative purpose; its primary effect must be one that neither advances nor inhibits religion; and the plan must not lead to excessive governmental entanglement with religion. 413 U.S. at 773; *see* text accompanying note 79 *infra.*

8 *See generally* Morgan, *supra* note 4, for a critique of the reasoning employed in the 1973 cases on aid to nonpublic schools.

9 This Note will not set forth the details of every conceivable plan of tax credits or deductions for nonpublic educational expenses that could be held constitutional under *Nyquist.* Rather, it outlines the means by which such a plan may be structured consistently with recent Supreme Court decisions.

This Note neither supports nor opposes the adoption of tax credit or deduction plans for nonpublic elementary and secondary education as a general matter. While the achievement of tax equity is an important goal, adoption of the tax credit or deduction plans discussed in this Note may conflict with valid concerns of economic, educational, or social policy.

This Note also will not consider problems associated with providing tax adjustments to parents of children enrolled in nonpublic schools which engage in racially discriminatory practices. *See* McGlotten v. Connaly, 338 F. Supp. 448 (D.D.C. 1972) (charitable contribution deduction unavailable for gift to fraternal group barring nonwhites from membership).

deduction for expenses incurred in pursuing gross income.[10] Second, there are those deductions and credits which are designed to encourage certain economic or social conduct and are thus extraneous to the purposes for imposing a tax on net income.[11]

The underlying purpose of a particular deduction or credit is not merely of academic interest. Generally the proper legislative treatment of an item in a tax system should follow its underlying purpose. A deduction reduces the income to be used in the computation of taxes. A credit, which is provided without regard to the payor's income, reduces the tax due.

If a given expense is incurred in pursuit of income, a rational tax system would allow a deduction for the expenditure. It thus becomes appropriate to allow a deduction for trade and business expenses incurred in the pursuit of gross income.[12] Such expenses might include, for example, rental of a place of business.[13] If certain conduct is to be encouraged independent of the income of the taxpayer, a credit would be a more appropriate means of providing an incentive, in order to prevent the differential treatment of taxpayers in a system employing "progressive" rates.[14] The federal Internal Revenue Code currently uses credits to provide incentives. For instance, a credit

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10 *See* I.R.C. § 162: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in any trade or business. . . ." Any other result would lead, in effect, to the imposition of a gross receipts tax.

11 *See* C. KAHN, PERSONAL DEDUCTIONS IN THE PERSONAL INCOME TAX 1 (1960).

12 I.R.C. § 162(a).

13 *See* I.R.C. § 162(a)(3).

14 *See* C. KAHN, *supra* note 11, at 15. The tax treatment of charitable contributions illustrates the problems implicit in defining the purpose of a provision of tax law. If the deduction for charitable contributions, I.R.C. § 170, is intended to encourage such gifts, a tax system employing progressive rates provides a greater incentive to high-income taxpayers to make such gifts through the use of a deduction rather than a credit. For example, if the tax rate for the highest income bracket is 70%, the deduction of a $1000 charitable contribution can be seen as a gift of $300 by a taxpayer matched by $700 from the government. By contrast, a $1000 gift of a person whose marginal tax rate is 14% would be the equivalent of a $860 gift by the taxpayer and a $140 government matching grant. By comparison, if a fixed tax credit, calculated as a percentage of the gift, were provided for charitable contributions, taxpayers at all income levels would receive equal tax benefits for equal donations. *See generally* Taussig, *Economic Aspects of the Personal Income Tax Treatment of Charitable Contributions,* 20 NAT'L TAX J. 1 (1967). Thus, some authorities have proposed replacing the charitable contributions deduction with a tax credit or a system of matching government grants.

Such a system of matching grants has been advocated by many commentators. *See,*

for small contributions to candidates for public office is designed to encourage all taxpayers to participate in the political process.[15]

Occasionally, however, Congress has chosen to employ credits rather than deductions to define net income for the purposes of the Internal Revenue Code. The recent change in the tax treatment of child care expenses provides an example of the way credits and deductions may be used interchangeably. Prior to 1976, some outlays for child care were deductible from gross income, ostensibly because they freed parents to obtain gainful employment.[16] Yet the Tax Reform Act of 1976 eliminated the deduction for child care expenses, replacing it with a credit.[17] The rationale for a tax adjustment had not changed. Rather, by enacting a credit, Congress had sought to make the tax benefit available to those who do not itemize deductions.[18] The existence of the "zero bracket amount," which has replaced the standard deduction,[19] may create pressure, as the child care

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e.g., Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970); Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expend-itures With Direct Governmental Assistance*, 84 HARV. L. REV. 352, 381-94 (1970); McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 TAX L. REV. 377 (1972). *But see* Bittker, *Charitable Contributions: Tax Deductions or Matching Grants?*, 28 TAX L. REV. 37 (1972).

Not all commentators agree that the deduction for charitable contributions is simply an incentive for gifts; however, the legislative history, though meager, indicates that Congress had an incentive in mind. *See* C. KAHN, *supra* note 11, at 6-7, 46-47. A few writers have argued that the deduction serves to refine the definition of net income, because there is no correspondence between what one contributes as a gift and the benefits received from the gift. *See* Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 314, 344-75 (1972).

15 I.R.C. § 41.

16 *See* I.R.C. § 214 (repealed by Tax Reform Act of 1976, Pub. L. No. 94-455, § 504(b), 90 Stat. 1520 (1976)).

Administrative and judicial resistance to the argument that child care expenses were incurred for the generation of income rather than for personal consumption forced the enactment of legislation authorizing a child care deduction. *See, e.g.*, Henry C. Smith, 40 B.T.A. 1038 (1939), *aff'd mem.*, 113 F.2d 114 (2d Cir. 1940).

17 Tax Reform Act of 1976, Pub. L. No. 94-455, § 504(a), 90 Stat. 1520 (1976) (replacing I.R.C. § 214 with I.R.C. § 44A).

18 H.R. REP. No. 94-658, 94th Cong., 2d Sess. 13 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 2897, 2907-08. The use of the child care credit as a means of refining the definition of net income was criticized in Goode, *Economic Definition of Income*, in COMPREHENSIVE INCOME TAXATION 1, 25 n.47 (J. Pechman ed. 1977).

19 *See* Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, § 102(a), 91

deduction episode indicates, to employ credits for certain income-related expenditures although pure tax theory indicates that the use of a deduction would be more appropriate.

Thus, deductions and credits may have the purpose of either defining net income or providing an incentive which is extraneous to the imposition of an income tax. Although a deduction is the best way to refine the concept of net income and a credit the best way to offer an incentive, the form by which a legislature chooses to provide a tax adjustment is not necessarily indicative of the underlying purpose for the exclusion. Competing pressures may cause deviations from the optimal formula.

B. *Education Expenditures and the Current Federal Income Tax*

Since most states which have an income tax use the federal Internal Revenue Code as a model, a study of how education expenditures are treated within that statute can provide insight into their treatment on all levels of government.

In general, deductions for education expenditures are not allowed under the federal Internal Revenue Code. No provision of the statute specifically allows the deduction of such expenses, and regulations promulgated under sections 162 and 212 of the Code, which generally provide for the deduction of expenses incurred in a taxpayer's trade or business, specifically refuse to allow such deductions in most cases.[20] Deductions for education expenses, however, are available to those who have met the minimum educational requirements for practicing a given trade or profession. Essentially, deductions are permitted for expenses incurred in continuing education programs which "[maintain or improve] skills required by the individual in his

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Stat. 126 (1977) (codified at I.R.C. § 63(b)-(g)) (defining zero bracket amount); *id.* § 101(d), (repealing I.R.C. § 141 (standard deduction)). *See also* S. REP. No. 95-66, 95th Cong., 1st Sess. 15-17 (1977), *reprinted in* [1977] U.S. CODE CONG. & AD. NEWS 185, 195-96.

20 Educational expenses incurred to meet the minimum educational requirements of a taxpayer's trade or profession, *e.g.*, costs incurred for law school, are not deductible. Treas. Reg. § 1.162(b) (1958). *See also* Treas. Reg. § 1.212-1(f) (1957).

employment or other trade or business,"[21] or for education expenses specifically required either by law or by a taxpayer's employer if they are "imposed as a condition to the retention by the individual of an established employment relation, status, or rate of compensation."[22]

Although the federal Code does not permit parents to take deductions for their children's elementary and secondary education expenses, parents, as such, do receive some tax benefits. Individual taxpayers may take a personal exemption deduction of $1000 for each dependent who is a child of the taxpayer and is either under 19 years of age or is a student.[23] Scholarships and fellowship grants are generally excluded from gross income.[24] A charitable contribution deduction may be claimed for gifts to educational institutions.[25] Public educational institutions receive additional support through the exclusion from taxable income of interest on state and municipal bonds[26] and the deduction allowed for state and local taxes paid.[27]

There have been numerous attempts to enact federal tax credits or deductions for primary, secondary, and higher education expenditures. In 1969, a measure introduced by Senator Abraham Ribicoff (D-Conn.) authorizing tax credits for tuition paid to institutions of higher education was passed by the Senate.[28] In 1972 several House bills would have enacted forms

21 Treas. Reg. § 1.162-5(a)(1) (1958).

22 Treas. Reg. § 1.162-5(a)(2) (1958).

23 I.R.C. § 151.

24 I.R.C. § 117. Support received by a student in the form of a gift is excluded from income. *See* I.R.C. § 102.

25 I.R.C. § 170. However, no deduction is available for contributions to organizations, including churches, that operate schools which refuse to enroll children from certain social and ethnic groups. Rev. Rul. 75-231, 1975-1 C.B. 158. *See also* Rev. Rul. 71-447, 1971-2 C.B. 230.

Deductions are unavailable for educational expenditures clothed as charitable contributions. *See, e.g.,* Chester D. Tripp, 22 T.C.M. (CCH) 1225 (1963) (scholarship intended by donor to benefit only one named student not deductible as charitable contribution); Rev. Rul. 71-112, 1971-1 C.B. 93 ("donation" required by educational institution not a charitable contribution); Rev. Rul. 54-580, 1954-2 C.B. 97 (interpreting § 23 of Internal Revenue Code of 1939) (parochial school tuition not a deductible contribution to organization sponsoring school).

26 I.R.C. § 103.

27 I.R.C. § 164.

28 Amendment No. 313, H.R. 13,270, 91st Cong., 1st Sess., 115 CONG. REC. 37,289, 37,305 (1969). The proposed credit was limited to $325 per year and would have declined gradually as adjusted gross income rose above $15,000, reaching zero at an adjusted gross income of $31,250.

of tax credits for nonpublic education expenses.[29] In 1978, intensive agitation for tax relief for education expenditures in general led to the passage by both the House[30] and the Senate[31] of a proposal initially sponsored by Senators Daniel Patrick Moynihan (D-N.Y.) and Robert Packwood (R-Ore.) which would have provided tax credits to parents paying tuition to any institution of higher education or to nonpublic primary and secondary schools.[32] The Carter Administration attacked the measure on constitutional grounds,[33] and Congress ultimately deleted all tuition tax credits provisions from the Revenue Act of 1978.[34]

C. *Tax Treatment of Education Expenditures in a Tax on Net Income*

1. Education Expenditures and Tax Theory

Tax experts have often criticized the tax treatment of expenditures for education and proposals to provide new tax benefits for such expenses. The problems of higher education expenses have been the subject of most of the discussion. Some critics have argued that the law now discriminates against people employed in personal service industries for whom education is their most important asset. Investment in education cannot be

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29 *See Tax Credits for Nonpublic Education: Hearings on H.R. 16,141 and Other Pending Proposals Before the House Comm. on Ways and Means,* 92d Cong., 2d Sess. (1972) (three volumes) [hereinafter cited as *1972 Tax Credit Hearings*]. Several of the bills introduced in 1972 are reprinted in *id.* at 4-10, 14-16.

30 *See* H.R. 12,050, *passed,* 124 CONG. REC. H4799 (daily ed. June 2, 1978) (237-158 roll call vote).

31 *See* H.R. 12,050, *passed as amended,* 124 CONG. REC. S13,387 (daily ed. Aug. 14, 1978) (65-27 roll call vote).

32 *See Private School Aid Denied: Tuition Tax Credits: Senate Limits Aid to College Expenses,* 36 CONG. Q. WEEKLY REP. 2205 (1978); *Veto Threatened: House Votes Tuition Tax Credit for College, Private School Students,* 36 CONG. Q. WEEKLY REP. 1379 (1978).

33 *See, e.g.,* 124 CONG. REC. S13,316-17 (daily ed. Aug. 15, 1978) (Moynihan-Packwood unconstitutional under *Nyquist*). *See also* note 121 *infra* for a short analysis of the constitutionality of Moynihan-Packwood.

34 *See* H.R. REP. NO. 95-1800, 95th Cong., 2d Sess. 203 (1978), *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 440,451; *Key Issues Go Down to Adjournment Wire,* 36 CONG. Q. WEEKLY REP. 2919, 2922 (1978).

The Carter Administration had threatened to veto any bill containing any provision for tuition tax credits. *See, e.g., House Approves Credit for Tuition by a 237-158 Vote,* N.Y. Times, June 2, 1978, at A1, col. 5.

written off through depreciation, while those who make capital expenditures in machines or buildings may take deductions over time.[35] The existence of such a distinction in tax law fails to recognize that tuition payments represent a substantial investment which will contribute to the production of income over the long run.[36] Ideally, people whose education forms the basis of their productive capacity should be allowed to amortize the cost of education over their expected working lives. Legislatures enacting such measures would, in effect, be taking action to refine the definition of net taxable income.[37]

Arguably, students, not parents, should be allowed to employ the deduction, as expenses for education are not incurred by a parent to increase his own income.[38] Some advocates of tax relief for higher education have argued, however, that deductions should not be allowed for expenses of elementary or secondary education, as such expenditures are made for personal consumption, not in preparation for a trade or profession.[39]

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35 Wolfman, *The Cost of Education and the Federal Income Tax,* 42 F.R.D. 435, 549-50 (1966) (address before the Judicial Conference of the Third Circuit) [hereinafter cited as Wolfman]; Goode, *Economic Definition of Income,* in COMPREHENSIVE INCOME TAXATION 1, 23 (J. Pechman ed. 1977); R. GOODE, THE INDIVIDUAL INCOME TAX 80 (rev. ed. 1976) [hereinafter cited as GOODE, INCOME TAX].

Professor Wolfman has asserted, however, that deductions or tax credits for expenditures for higher education would be wasteful inasmuch as they would provide aid to the well-off, who need no incentive to spend money on education, rather than making funds available to those who would not or could not purchase an education without such aid. Wolfman, *supra,* at 540-41. Administration opponents of the current tax credit proposal have raised similar objections. *See* Wall St. J., Feb. 24, 1978, at 6, col. 1; Washington Post, Feb. 24, 1978, at 1, col. 6 (reporting remarks of HEW Secretary Joseph Califano). *See also* Goode, *Tax Treatment of Individual Expenditures for Education and Research,* 56 AM. ECON. REV. 208, 213 (1966) [hereinafter cited as Goode, *Tax Treatment*].

36 Wolfman, *supra* note 35, at 547.

37 *Id.*; GOODE, INCOME TAX, *supra* note 35, at 83; Goode, *Tax Treatment, supra* note 35, at 209-10. Kahn suggests the same approach, C. KAHN, *supra* note 11, at 16, 31.

Professor Wolfman believes that an argument can be made that any deduction should be confined to graduate and professional education, but on the other hand he recognizes that a connection may exist between undergraduate education and increased income. Wolfman, *supra* note 35, at 548-49. *See* Goode, *Tax Treatment, supra* note 35, at 209-13.

38 Wolfman, *supra* note 35, at 539; GOODE, INCOME TAX, *supra* note 35, at 83-84; Goode, *Tax Treatment, supra* note 35, at 211.

For convenience, the pronoun "his" will be used throughout this Note to signify parents of either sex.

39 *See, e.g.,* Wolfman, *supra* note 35, at 550-51. Goode finds a disallowance of a

The literature on the role of education expenditures and the tax system has not concentrated on problems involving the costs of elementary and secondary education. Yet an argument may be made that expenses incurred by parents of children in nonpublic schools should be taken into account in calculating net income. This argument is premised upon the simple notion that the consumption of educational resources for which parents do not pay should be reflected in parents' taxable income, inasmuch as the assumption of the costs of educational services by others raises the income of such parents, allowing them to allocate income among other goods and services.

Over recent years the so-called "comprehensive income tax" has been the subject of much debate.[40] Under such a system, individuals would be taxed on their accretion of wealth and consumption over a given period. The only deductions allowed would be those which effectively define net income.[41] According to this view, a comprehensive income tax scheme would include in income the value to the recipient of government services

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deduction for high school education expenses "debatable" in view of the overlap between many advanced high school courses and introductory college courses. GOODE, INCOME TAX, *supra* note 35, at 86. *See* Goode, *Tax Treatment, supra* note 35, at 210-11.

If an education amortization deduction could only be applied against a student's earned income, the inclusion of secondary and elementary education costs in the scheme proposed by Wolfman and Goode would be of limited effect, because few students are liable to pay tax on earned income. Wolfman has argued that no deduction should be allowed for educational expenditures against unearned income, Wolfman, *supra* note 35, at 549; *see also* GOODE, INCOME TAX, *supra* note 35, at 86. Although a parent may supply the funds necessary to "invest" in educational services, the student-recipient ought to be allowed to amortize the expenditure, inasmuch as it is the student who benefits from the expenditure. Wolfman, *supra* note 35, at 549; GOODE, INCOME TAX, *supra* note 35, at 84; Goode, *Tax Treatment, supra* note 35, at 211.

40 *See* B. BITTKER, C. GALVIN, R. MUSGRAVE & J. PECHMAN, A COMPREHENSIVE INCOME TAX BASE? (1968) [hereinafter cited as A COMPREHENSIVE INCOME TAX BASE?] (reprint of articles in 80 HARV. L. REV. and 81 HARV. L. REV. plus new material); Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget,* 22 NAT'L TAX J. 244 (1969); Surrey & Hellmuth, *The Tax Expenditure Budget — Response to Professor Bittker,* 22 NAT'L TAX J. 528 (1969); Bittker, *The Tax Expenditure Budget — A Reply to Professors Surrey & Helmuth,* 22 NAT'L TAX J. 538 (1969); COMPREHENSIVE INCOME TAXATION (J. Pechman ed. 1977). Bittker seems to be the only visible critic of the concept. He has argued that it is logically unclear and not applicable to actual policy making. He has also questioned some of the conclusions that flow from the concept. Bittker arguably takes an *ad hoc* approach to tax policy, although he might reject such a characterization.

41 This Note cannot consider the nuances of the various definitions of income which have been proposed. For a good discussion of these definitions, *see generally,* Goode, *The Economic Definition of Income,* in COMPREHENSIVE INCOME TAXATION (J. Pechman ed. 1977).

which benefit a taxpayer[42] — *e.g.*, garbage collection and tax-subsidized public education. However, a consensus has developed against including the value of government services in net income, because of "insurmountable" difficulties of valuation.[43] But these problems are far from insurmountable in the case of education. The value of scholarships and similar grants can easily be included in net income. That value can be measured objectively by the tuition which would otherwise be charged to students. Some difficulties of valuation may be created, however, when a school does not charge tuition or when the tuition charged does not cover the full cost of education because an institution is supported by taxes, charitable contributions, or endowment income. Even if the costs of education not borne by the recipient could be determined, problems might still exist, as a taxpayer's income should reflect the value to the taxpayer of services received, a value which may have no relation to those costs. Yet in the case of educational services, the cost of providing such services to students in free, tax-supported schools may be used to measure their value to parents.

Expanding this view in the area of higher education, critics of the present tax system have pointed out that nonpublic school parents are actually discriminated against by the deductibility of state taxes under the Internal Revenue Code.[44] Public colleges and universities have relatively low tuition because many of their costs are actually paid by deductible local taxes. Tuition

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42 Aaron, *What is a Comprehensive Tax Base Anyway?*, 22 NAT'L TAX J. 543, 544 (1969); Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 935-38 (1967), *reprinted in* A COMPREHENSIVE INCOME TAX BASE?, *supra* note 41, at 11-14; Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 54-55 (1967), *reprinted in* A COMPREHENSIVE INCOME TAX BASE?, *supra* note 41, at 72-73. *See generally* Goode, *The Economic Definition of Income*, in COMPREHENSIVE INCOME TAXATION 17-19 (J. Pechman ed. 1977).

43 Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 54-55 (1967), *reprinted in* A COMPREHENSIVE INCOME TAX BASE?, *supra* note 41, at 72-73; Aaron, *What is a Comprehensive Tax Base Anyway?*, 22 NAT'L TAX J. 543, 544 (1969). Bittker argues that the problem of valuation undercuts the whole notion of comprehensive income taxation. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 936-38, *reprinted in* A COMPREHENSIVE INCOME TAX BASE?, *supra* note 41, at 12-14.

44 I.R.C. § 164(a).

— "real tuition" — paid to a private institution is not deductible.[45] Therefore, it has been proposed that a percentage of tuition paid to nonpublic schools should be deductible to equalize tax burdens. Professor John K. McNulty has challenged this argument that an inequitable tax burden results from the failure to include the value of subsidized higher education in the taxable income.[46] Because parents of students in *all* colleges and universities benefit from the deductions for taxes paid, he considers ill-founded the suggestion that a deduction be allowed for tuition paid to nonpublic schools.[47]

But McNulty's argument may not be applicable in the case of elementary and secondary education. Parents may see a closer tie between taxes paid and the benefits their children receive when a local entity, perhaps relying on property taxes, operates the schools than they would when their taxes go to a large university system supported by state-wide, broadly based levies. In other words, a parent-taxpayer may equate local school taxes with tuition and thus be more willing to pay such taxes. The deductibility of state and local taxes assessed for schools under the Internal Revenue Code should be contrasted with the nondeductibility of property taxes assessed to provide improvements which tend to increase the value of the property assessed.[48] In addition, the net cost of tuition paid through taxes by the public school parent is, in effect, less than tuition paid by the nonpublic school parent because the availability of a deduction for local taxes allows public school "tuition" to be paid out of "before-tax" income.

McNulty continues his analysis by observing that a tuition payment is "a personal consumption expenditure which [parents] are free to make or not. Since their children

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45 In 1972, "federal aid" in the form of the deductibility of state and local taxes was estimated to amount to $65 per public school student. 1 *1972 Tax Credit Hearings, supra* note 29, at 36 (statement of Secretary of the Treasury Schultz).

46 McNulty, *Tax Policy and Tuition Credit Legislation: Federal Income Tax Allowances for Personal Costs of Higher Education,* 61 CALIF. L. REV. 1, 39-42 (1973) [hereinafter cited as McNulty].

47 *Id.* at 39-40.

48 I.R.C. § 164(c) provides, in part, "No deduction shall be allowed for . . . (1) [t]axes assessed against local benefits of a kind tending to increase the value of the property assessed."

presumably could attend public colleges and get much the same benefits, tuition-free, as those enjoyed by the families of children attending public schools, they are not being treated unequally by the tax law."[49] In McNulty's view, a claim that special tax treatment be provided for tuition expenditures is no more than a complaint that tuition in general must be paid from income after taxes. Such contentions are not based on equity but on a given parent's ability to pay for "unique" benefits which may be conveyed by nonpublic higher education.[50] McNulty's criticism, however, rests on more than an assumption that the payment of tuition from after-tax income raises no questions of equity. He concedes that such problems exist:

> To the extent the complaint of private school parents is based on unfairness in the federal tax system itself, the argument is that the tuition-free education received in public universities is not included in the gross income of those students or their families, while the earnings necessary to pay private school tuition are included in family income and not taken out again by a deduction, credit, or other allowance.
>
> This argument has some force. . . .[51]

McNulty makes several observations which he believes weaken this position in the context of higher education. It is another question entirely whether they are valid in the context of elementary and secondary education.

McNulty has asserted that an income tax adjustment is not necessary to correct any perceived inequities within the tax system. Instead, "[d]irect subsidies in cash or vouchers from the government, or a tuition increase at public colleges, or other non-tax changes could address the perceived inequity."[52] Yet McNulty does not explain what these "other non-tax changes" are to be. The suggestion that tuition at public institutions be raised is also unrealistic since public colleges are unlikely to increase tuition merely to rectify the difference in costs between public and nonpublic education. Outside of higher education,

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49 McNulty, *supra* note 46, at 40.
50 *Id.*
51 *Id.* at 41.
52 *Id.*

this remedy is impractical, for public elementary and secondary schools do not charge tuition, and historic policies of free education are unlikely to be changed. Subsidies in the form of cash or vouchers paid to nonpublic school parents appear to have been foreclosed by the specific holdings of *Lemon v. Kurtsman*[53] and *Nyquist*.[54]

McNulty has also observed that if the logic of equity-based arguments were followed "the tax bill of private school parents [would also increase] . . . since private school students also receive their education at a great discount, a discount that should be taxable if the bargain element at tuition-free or low tuition state schools is to be counted as income."[55] Whatever its weight in the context of higher education, McNulty's view cannot be applied to elementary and secondary schools. It is true that many private educational institutions on all levels receive substantial income from endowments and charitable contributions, enabling their tuition to be equal to or less than that imposed by public institutions. But to the extent this is true of nonpublic elementary and secondary schools,[56] an equalization measure should take account of this fact, not employ it as a justification for inaction.

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53 403 U.S. 602 (1971) (state purchase of secular educational services in parochial schools invalid).

54 413 U.S. 756 (1973) (tuition reimbursement grants to parents of children attending parochial elementary and secondary schools unconstitutional). *See* text accompanying notes 78 to 100 *infra*. For discussion of the voucher concept, *see* Pfeffer, *Aid to Parochial Schools: The Verge and Beyond*, 3 J.L. & EDUC. 115, 119 (1974); Robinson, *Little Room Left to Maneuver*, 3 J.L. & EDUC. 123, 124 (1974); Morgan, *The Establishment Clause and Sectarian Schools: A Final Installment?*, 1973 SUP. CT. REV. 57, 88-93; Thomas, *Public Subventions to Nonpublic Education: Values, the Courts, and Educational Policy*, 1976 DET. C.L. REV. 199, 299-31; Note, *Voucher Systems of Public Education After Nyquist and Sloan: Can a Constitutional System Be Devised?*, 72 MICH. L. REV. 895 (1974). Only Note, *Voucher Systems*, argues that a serious possibility exists that vouchers are constitutional.

55 McNulty, *supra* note 46, at 41.

56 The revenue base for Catholic schools nationwide for the school year 1970-1971, expressed in percentages, was as follows:

	Elementary	*Secondary Parish/Diocesan*	*Private*
Tuition and fees	31	61	80
Parish/Diocesan subsidy	60	27	—
State and other	9	12	20
	100	100	100

1 *1972 Tax Credit Hearings, supra* note 29, at 93 (supplemental statement of the Na-

2. Tuition Tax Aid and "Conventional" Tax Law

Creating a tax system that recognizes the existence of a difference between the real income of parents whose children use public elementary and secondary schools and the income of parents whose children use nonpublic schools would only require that long-established principles of tax law be carried over to the field of education. Simply put, when the state assumes a parent's obligation to finance the education of his children, a parent's taxable income should be increased much as it would be if any other debt has been paid by a third party or forgiven by the lender.[57]

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tional Catholic Educational Association). *See also* D. SULLIVAN, PUBLIC AID TO NONPUBLIC SCHOOLS 24, 30 (1974).

Since charitable contributions are deductible and tuition payments are not, one might suspect that a large portion of the parish/diocesan subsidy comes from parents who contribute to the parish church in lieu of paying tuition directly to the school. Thus, if tuition becomes deductible church-related schools might rely on tuition payments to cover a greater percentage of school costs. The interdependence of church contributions and parochial school tuition was demonstrated in Philadelphia recently when church collections decreased after an increase in tuition at Catholic schools. The Report of the Archdiocesan Advisory Committee on the Financial Crisis of Catholic Schools in Philadelphia and Surrounding Communities (1972) (commonly called "The Gurash Report" after its chairman), *excerpted in* 2 *1972 Tax Credit Hearings, supra* note 29, at 196, 210.

57 While many might find it illogical and possibly even outrageous to consider the provision of public education services as income to parents, a close look at the structure of the American educational system should make this concept seem less unreasonable than at first glance. It may be hard to determine whether free public schools were established to enable parents to fulfill their legal obligation to properly educate their children or whether the obligation was the product of the availability of free education. Threats of legal sanctions, however, may not influence many parents because the desire that their children be financially independent or that they be intellectually, morally, and spiritually prepared for assuming the role of an adult is the primary motivation for educating their children. Thus, the availability of free elementary and secondary education relieves the vast majority of parents of a moral, as well as a legal, obligation they would otherwise be required to meet from their own financial resources.

In considering whether free public education constitutes income to parents, it must also be remembered that schools often provide services in addition to basic academic education. Most public schools offer extracurricular activities, such as interscholastic athletics or music programs, to their students. If free public schools did not offer such programs, many parents would incur expenditures on their own to provide recreational and cultural activities for their children. In addition, many families where both parents are wage earners would face added expenditures for full or part-time child care if public schools did not provide these services for free.

The best proof of the notion that public school services constitute income to parents is simply to ask the question "What would parents do if there were no free schools?" Since most parents would make substantial expenditures to provide substitute services it is clear that schools are of great economic value to parents.

Every state with a compulsory education law[58] obligates parents to educate their children.[59] A parent who fails to fulfill this obligation may be subject to loss of custody of the children[60] or the imposition of criminal sanctions.[61] A state has the power to insist that parents enroll their children in schools that provide a minimum level of education in specified subjects.[62] Although a state may open free public schools which will allow parents to fulfill their obligation to their children and the state,[63] the state cannot limit parents to only *one* set of educational options for their children, once minimum standards have been reached. The fifty-year-old cases of *Meyer v. Nebraska*[64] and *Pierce v. Society of Sisters*[65] deny states power under the Constitution to interfere with the choices of parents in guiding the upbringing and education of their children or to forbid the operation of nonpublic schools. Thus a parent may satisfy the statutory obligation to educate his children in two ways. A parent may elect to have the state relieve him of the financial responsibility of elementary and secondary education through use of the free public schools. Alternatively, a parent may exercise the constitutional right to provide his child with a nonpublic education.[66]

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58 *See, e.g.*, N.Y. EDUC. LAW § 3205 (McKinney 1970). Mississippi, the last state without a compulsory education statute in force, enacted such a law in 1977. See Ch. 483, § 4, 1977 Miss. Laws 927, 929 (codified as MISS. CODE ANN. § 37-13-95 (Cum. Supp. 1978)).

59 MISS. CODE ANN. § 37-13-101 (Cum. Supp. 1978); N.Y. EDUC. LAW § 3212 (McKinney Cum. Supp. 1978-79).

60 *See, e.g.*, N.J. STAT. ANN. § 9:2-9 (West 1976).

61 *See, e.g.*, N.Y. EDUC. LAW § 3233 (McKinney Cum. Supp. 1978-79). *But cf.* State v. Whishner, 47 Ohio St. 2d 181, 351 N.E.2d 750 (1976) (criminal penalty cannot be imposed on parents sending children to fundamentalist Christian school which could not comply with minimum standards established by state without violating religious beliefs).

62 *See* N.Y. EDUC. LAW §§ 3204, 3210 (McKinney 1970 & Cum. Supp. 1978-79). *But see* State v. Wishner, 47 Ohio St. 2d 181, 351 N.E.2d 750 (1976).

63 *Cf.* San Antonio Independent School Dist. v. Rodriguez, 411 U.S. 1 (1973) (states are not obliged to provide equal public educational facilities to all localities regardless of size of local tax base); Griffin v. County School Bd., 377 U.S. 218 (1964) (local government may not close down free public schools in order to evade desegregation order).

64 262 U.S. 390 (1923).

65 268 U.S. 510 (1925). *See also* Wisconsin v. Yoder, 406 U.S. 205 (1972) (Amish parents not required to send children to school after eighth grade under free exercise clause of U.S. CONST., amend. I).

66 *See* Pierce v. Society of Sisters, 268 U.S. 510 (1925).

Thus, public education may be seen as providing a real benefit to parents of school-age children. It relieves them of the expenses that are imposed upon them by compulsory education laws. And such a release from what is, in reality, an enforceable financial obligation has generally been deemed to be taxable income, even though it is not received in the form of cash.[67] Whether stated in terms of the payment of a parent's "debt" (payable in educational services) to a child[68] or cancellation of a parent's obligation to the state to provide a child with an education through use of the public schools,[69] public education provides a parent with "income" that parents who purchase services from nonpublic schools do not receive. In a tax system where the cancellation of indebtedness or its payment by third parties is routinely treated as income to the beneficiary, the assumption by the state of a parent's obligation to fund the education of his children may be viewed by a legislature as a component of income. Any other result is arguably a use of the tax system to discourage parents from exercising their right to obtain an alternative education for their children.[70] Such disincentives can be neutralized through adoption of a credit or deduction reflecting the costs some parents choose to pay for nonpublic education.

D. *Formulating an Equitable Tax Program*

The equalization argument has merit in the context of elementary and secondary education. Yet the form a tax equalization program would take is open to question. There are several possible "formulas" for equalization which could be enacted by the Congress or individual state legislatures.

Income Addition: The cost per pupil of public education multiplied by the number of children in public elementary and secondary schools would be added to the taxable income of

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67 *See* I.R.C. § 61(a)(12).

68 *Cf.* Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929) (discharge of income tax obligation by employer taxable as income to employee).

69 *Cf.* United States v. Kirby Lumber Co., 284 U.S. 1 (1931) (cancellation of bonded indebtedness through repurchase at discount results in income to debtor).

70 *See* Pierce v. Society of Sisters, 268 U.S. 510 (1925); Meyer v. Nebraska, 262 U.S. 390 (1923).

parents with children enrolled in such institutions. Nonpublic school parents would have added to their taxable income a sum equal to the difference between the cost of their children's education in nonpublic schools and the actual tuition paid by those parents (if less than the actual cost of education).

Total Cost Deduction: Parents of children in nonpublic schools would be allowed to deduct from their taxable income a sum equal to the cost of educating a child in a public institution for each child enrolled in a nonpublic school.

Tuition Deduction: Parents of children enrolled in nonpublic schools would be allowed to deduct from taxable income all tuition paid to such schools.

Net Cost Deduction: Parents whose children attend nonpublic schools would be allowed to deduct from their taxable income a sum equal to the excess of the per pupil costs of public education over the cost per pupil of nonpublic education, multiplied by the number of their children enrolled in nonpublic schools. The deduction would be augmented by the amount of any tuition paid by a nonpublic school parent.

Several things should be noted about how all these formulas would be applied if enacted. For ease of administration, the income addition, total cost, and net cost formulas would employ, in practice, average per pupil costs for public and nonpublic schools to measure additions or deductions from income. Composite figures would be used because of the difficulties inherent in computing the actual cost of the education of individual children. Statewide figures will be employed in this Note, inasmuch as they are already available and could be employed if the formulas discussed herein became law.[71] The use of statewide average figures for per pupil costs of nonpublic schools may also be justified by the difficulty of obtaining

71 This figure could also be arrived at by using the per pupil costs of the school district or even of the actual public school the child would otherwise attend. The use of local figures might be particularly appropriate in districts with low per pupil expenditures where parents might resist being taxed for services not actually available.

precise figures from individual privately administered institutions.[72] However, actual tuition payments by parents to nonpublic schools are easier to measure than the cost per individual pupil of nonpublic education, and average figures for tuition paid need not be employed. Parents should receive the deduction because they are legally obligated to educate their children.

The income addition formula would most closely approximate the comprehensive income tax base. However, this formula would be politically unpalatable given the present state of dissatisfaction with some public schools. The cost of education for tax purposes may be grossly greater than its real value to many frustrated parents. More importantly, additions to taxable income may be perceived by the parents of all school-age children as a covert means of increasing their taxes.[73]

While legislators might find the total cost deduction formula more politically acceptable than the income addition formula, the total cost formula will not lead to so great a degree of tax equalization. The total cost formula does not take account of the value of education which nonpublic school parents may receive above cash tuition paid. This added value frequently results from a school's use of endowment income, charitable gifts, and support from religious institutions. The failure to account for the benefits conferred on these parents may create difficulties, for the untaxed value of these school's services (under the total cost formula) to parents consists, in part, of the provision of non-secular services.

The tuition deduction formula would be the easiest one to administer, and it would allow nonpublic school parents to pay tuition out of before-tax income. But this formula, like the total cost deduction, is a relatively inefficient means of tax equalization, as it also fails to recognize that when tuition falls below the cost of providing an education in a nonpublic school, parents of children in those schools receive some income.[74]

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72 Extensive investigation of nonpublic schools' costs may create problems of entanglement between the government and religious institutions. *See* text accompanying notes 127 to 128 *infra*.

73 Dollars which are taken away with taxes might be returned through adjustments in the personal exemption or the tax rate.

74 The Supreme Court in *Nyquist* explicitly declined to reach the question of whether

The net cost deduction formula is functionally equivalent to the income addition formula, except that the net cost deduction uses an exclusion from taxable income, rather than an addition to income, to achieve tax equalization.[75] The enactment of the net cost formula might also be more acceptable politically, inasmuch as it would reduce some parents' taxable income. The net cost formula may be criticized for its use of the costs of public and nonpublic education to measure the deduction, when expenditures for education may bear no relationship to the value parents and children place on educational services.[76] These arguments may be answered by a frank admission that the use of cost figures theoretically is "second best" but is the most practical means of achieving tax equity. Computing the value to individual parents and children of education is administratively impossible, but failure to take action at all would perpetuate existing inequities in the tax system. Thus, a legislature may find the net cost formula to be the most practical means of applying the equitable comprehensive income concept to the tax treatment of elementary and secondary education expenses.[77]

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a tax adjustment structured like the tuition deduction was constitutional. *See* 413 U.S. at 791 n.49.

75 The income addition and net cost formulas do not have identical economic effects. The net cost formula may penalize taxpayers without children who, like parents of nonpublic school children, derive no income from public education but would not receive benefits under that plan. While the income addition formula treats non-parents most fairly, since only the taxable income of parents is affected, the non-receipt of income from education services provided at less than cost by either public or nonpublic schools by non-parents cannot be accounted for by the net cost formula, centered around a deduction available only to nonpublic school parents. However, for parents of school-age children, there is little practical or substantive difference between the income addition and net cost formulas.

76 D. SULLIVAN, PUBLIC AID FOR NONPUBLIC SCHOOLS 20-22 (1974), argues that costs in religiously controlled schools are lower not only because religious personnel provide services at less than market wages and maintenance expenses can be shared with churches but also because nonpublic schools have larger classes and fewer high-cost facilities such as laboratories, industrial shops, and athletic facilities.

77 While the net cost deduction may be more politically acceptable than the income addition plan, there is really no substantive difference between the two as far as all parents of students are concerned. *But see* note 75 *supra*. The net cost deduction will be used in the remainder of this Note because of its similarity in form to previous legislative attempts to provide a tax credit for parents of students attending nonpublic elementary and secondary schools. *See* text accompanying 107 to 109 *infra*.

Once it is found that a deduction to reconcile income inequities is proper, it should be possible to design a credit which will have the same effect as the deduction. If the credit is not to provide an incentive but to define income it must increase proportionately with progressive tax rates. For example, a $1000 deduction would be equal to a $50 credit in a five-percent tax bracket and a $60 credit in a six-percent bracket. Use of a credit would ensure that tax benefits would not be lost by those who prefer to employ the zero bracket amount. It is important to recognize that such a credit would not be designed to aid nonpublic education but to create an easy means for administering what might otherwise be a complicated deduction scheme.

A credit can be used as an income-defining device for parents who use the services of public schools. The real difference between earlier tax credit plans and the one proposed in this Note does not rest in how the amount of the credit is to be calculated or on statutory language. The difference lies in the justification for and the economics underlying the credit — the difference between providing an incentive to use nonpublic schools and more fairly defining net income.

II. NYQUIST AND TAX CREDITS FOR NONPUBLIC EDUCATION

A. *The* Nyquist *Case*

In *Committee for Public Education & Religious Liberty v. Nyquist*[78] the Supreme Court considered the constitutionality of three financial aid programs for elementary and secondary schools enacted by the New York legislature.[79] One aid program was designed to provide direct money grants to nonpublic schools for use in the maintenance and repair of facilities and

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78 413 U.S. 756, *aff'g in part and rev'g in part* 350 F. Supp. 655 (S.D.N.Y. 1972).

79 Examining the statutes on their face, a three-judge district court had found unanimously that a program of maintenance and repair grants and tuition reimbursement grants was unconstitutional. Two out of three judges were willing to hold that the income tax provisions in *Nyquist* were constitutional. *Compare* 350 F. Supp. at 670-74 (majority opinion) *with id.* at 674, 674-76 (Hays, J., concurring in part and dissenting in part). The Supreme Court affirmed the holding that maintenance and repair grants and tuition reimbursement were unconstitutional, 413 U.S. at 774-89, but reversed the holding that the New York tax adjustment program was constitutional, *id.* at 78-94.

equipment to ensure the health, welfare, and safety of students.[80] Another program aided parents of children attending nonpublic elementary or secondary schools whose income was less than $5000 through tuition reimbursements of no greater than $100. The third program provided tax relief to all other parents in the form of a deduction from adjusted gross income of a stipulated sum for each child attending a nonpublic school.

The Court employed a three-part test to determine whether the New York plans were valid:

> [T]o pass muster under the Establishment Clause the law in question, first, must reflect a clearly secular legislative purpose, *e.g., Epperson v. Arkansas,* 393 U.S. 97 (1968), second, must have a primary effect that neither advances nor inhibits religion, *e.g.,* McGowan v. Maryland [366 U.S. 420 (1961)]; *School District of Abington Township v. Schempp,* 374 U.S. 203 (1963), and, third, must avoid excessive government entanglement with religion, *e.g., Walz v. Tax Comm'n* [397 U.S. 664 (1969)].[81]

The Court found that the reimbursement plan posed few problems under the first part of the test, holding that the New York legislature's finding of secular purpose was adequately supported by legitimate, nonsectarian state interests.[82]

However, the reimbursement plan was held to be improper under the "primary effect" standard. Approximately 70 percent of the schools for which tuition could be reimbursed were under Roman Catholic auspices.[83] The Court approved findings by a three-judge district court that many schools that benefited from the parent aid program had

> (a) impose[d] religious restrictions on admissions; (b) require[d] attendance of pupils at religious activities; (c) require[d] obedience by students to the doctrines and dogmas of a particular faith; (d) require[d] pupils to attend instruction in the theology

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80 Eight justices of the Supreme Court agreed that grants to nonpublic schools for maintenance and repairs were unconstitutional under the Establishment Clause because their primary effect was to advance religion, since no attempt was made to restrict the use of such grants to the upkeep of facilities used exclusively for secular purposes. *See id.* at 774-89 (majority opinion); 798, 798 (Burger, C. J., concurring in part and dissenting in part); 805, 805 (Rehnquist, J., dissenting in part).

81 *Id.* at 773.

82 *Id.*

83 *Id.* at 768.

> or doctrine of a particular faith; (e) [were] an integral part of the religious mission of the church sponsoring it; (f) [had] as a substantial purpose the inculcation of religious values; (g) impose[d] religious restrictions on faculty appointments; and (h) impose[d] religious restrictions on what or how the faculty may teach.[84]

The provision of direct aid to religious schools would have been unconstitutional "[i]n the absence of an effective means of guaranteeing that the state aid derived from public funds will be used exclusively for secular, neutral, and nonideological purposes."[85] The tuition grants were not so restricted. Reimbursing parents for a portion of tuition payments, in the Court's view, thus had the "unmistakabl[e]" effect of "provid[ing] desired financial support for nonpublic, sectarian institutions."[86]

In *Nyquist* the Court refuted a number of arguments which had been made for the validity of tuition reimbursements. First, it held that no substantive distinction could be based on the fact that low-income parents were not required to apply reimbursements received to tuition but could spend the payment as they chose. The Court stated it was immaterial whether the actual dollars received were paid to a religious school.[87]

It was also argued that, inasmuch as reimbursement was limited to 50 percent of tuition expenses and it was estimated only 30 percent of the total cost of nonpublic education was covered by tuition income, only 15 percent of educational costs in nonpublic schools would be reimbursed, although New York's minimum standards required more than 15 percent of school time to be devoted to the teaching of secular courses. The Court did not find these facts to be constitutionally significant,[88] concluding that "mere statistical assurances will [not] suffice to sail between the Scylla and Charybdis of 'effect' and 'entanglement.' "[89]

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84 *Id.* at 767-68, *quoting* 350 F. Supp. at 663.
85 413 U.S. at 780.
86 *Id.* at 783.
87 *Id.* at 785.
88 *Id.* at 787-88.
89 *Id.* The *Nyquist* opinion also cited Lemon v. Kurtzman, 403 U.S. 602, 619 (1971) (salary supplements for nonpublic school teachers unconstitutional), for the proposition that teachers could not segregate religious beliefs from secular teaching responsibilities in religiously controlled institutions. 413 U.S. at 778.

The income tax modification plan was designed to benefit those parents who failed to qualify for tuition reimbursements. Parents were allowed to deduct from adjusted gross income a designated amount for each dependent for whom they paid at least $50 in nonpublic school tuition. The amount of the deduction varied with the income of the parent in order to provide equal benefits to parents in different tax brackets and was not contingent upon how much the taxpayer actually paid in tuition to nonpublic schools.[90]

The Court refused to characterize the tax provisions explicitly as providing credits or deductions. The tax benefits were offered in the form of a deduction, but they had the effect of a credit because "the deduction [was] not related to the amount actually spent for tuition and [was] apparently designed to yield a pre-determined amount of tax "forgiveness" in exchange for performing a specific act which the State desires to encourage — the usual attribute of a tax credit."[91] The Court drew no constitutional distinction between the tax modification plan and reimbursements. Both were characterized as an "encouragement and reward" for educating children in nonpublic schools.[92]

While the Court refused formally to characterize the benefit as either a "credit" or a "deduction," it did say that the New York plan did not constitute a "genuine tax deduction": "Since the program here does not have the elements of a genuine tax deduction such as for charitable contributions, we do not have before us, and do not decide whether that form of tax benefit is constitutionally acceptable under the 'neutrality' test in *Walz*."[93] The Court indicated that only when an income tax

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90 *Id.* at 765-66.

91 *Id.* at 789.

92 *Id.* at 790-91.

93 *Id.* at 790 n.49. *See* Note, *Constitutional Law — Establishment Clause: No Tuition Grants, No Tax Benefits for Parents of Non-Public School Children,* 50 WASH. L. REV. 653, 672 (1975), which argues that the Court's language suggests that a deduction for tuition payments might be a component of a "genuine" tax deduction. Since tuitions at many religiously affiliated schools are low, such a deduction might be of little value to most taxpayers. *See also* Freund, *Public Aid for Church-Related Education: Federal Constitutional Problems* (1972), *reprinted in* 2 *1972 Tax Credit Hearings, supra* note 29, at 449, 458 (report prepared for President's Commission on School Finances) (constitutionality of tuition deduction questionable without provision for "negative" taxes for low-income parents and in light of unconstitutionality of direct grants).

deduction is allowed for an actual cash expenditure would arguments for the constitutionality of such measures based on *Walz v. Tax Commission*[94] be considered.

Walz was an attack on the practice of the New York City Tax Commission of granting property tax exemptions to religious organizations for properties used solely for religious worship. The Supreme Court held that property tax exemptions for real property owned by an association organized exclusively for religious purposes and used exclusively for carrying out those purposes is not an unconstitutional attempt to establish, sponsor, or support religion. Speaking for the Court, Chief Justice Burger asserted, "[T]he grant of a tax exemption is not sponsorship since the government does not transfer part of its revenue to churches but simply abstains from demanding that the church support the state."[95] He noted that the Establishment and Free Exercise Clauses were intended to prevent excessive entanglement between government and religion;[96] the test of excessive government entanglement with religion was inescapably one of degree, and either taxation or exemption would occasion some degree of involvement with religion. "Elimination of exemption," the Chief Justice observed, "would tend to expand the involvement of government by giving rise to tax valuation of church property, tax liens, tax foreclosures, and the direct confrontations and conflicts that follow in the train of those legal processes."[97] The Court found no genuine nexus between tax exemption and the establishment of religion, since exemption created only minimal and remote involvement between church and state, compared to the involvement that taxation would entail. By restricting the fiscal relationship between church and state, the Court asserted, exemptions tend to complement and reinforce the desired separation.[98]

As it had in the case of tuition reimbursements, the Court in *Nyquist* squarely rejected the so-called "child benefit" theory,

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94 397 U.S. 664 (1970).
95 *Id.* at 675.
96 *Id.* at 670.
97 *Id.* at 674.
98 *Id.* at 675-76.

which places controlling significance on the fact that parents, not schools, are the direct recipients of aid.[99] This allowed the holding of *Walz* to be used as an affirmative argument against income tax modifications. The long history of property tax exemptions was weighed by the Court against the innovative use of tax credits for nonpublic education.[100] The exemption in *Walz* was neutral compared to credits which clearly aided nonpublic education.[101] Finally, the exemption in *Walz,* in the view of the *Nyquist* court, was one of the broad class covering property devoted to religious, educational, or charitable purposes, while reductions implicit in the New York plan went primarily to parents of children attending sectarian, nonpublic schools.[102]

Even though the Court in *Nyquist* found that the tax "credits" were unconstitutional under the primary effect test, it also considered the question of excessive entanglement. It asserted political divisiveness could be created by government aid programs through "the need for continuing annual appropriations" and "the likelihood of larger demands as costs and population grow."[103] Tuition tax credits posed a threat of entanglement on the latter ground, because they "[would] not necessarily require annual re-examination, but the pressure for frequent enlargement of the relief [would be] predictable."[104]

In the final analysis, the majority viewed the New York tax program as a form of direct aid to nonpublic schools. The Court acknowledged that the purpose of the statute was secular inasmuch as it gave taxpayers an incentive to purchase educational services.[105]

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99 *Nyquist,* 413 U.S. at 780-85, 791.

100 *Id.* at 792.

101 *Id.* at 793.

102 *Id.* at 794. The Court added: "Without intimating whether this factor alone might have controlling significance in another context in some future case, it should be apparent that in terms of the potential divisiveness of any legislative measure the narrowness of the benefitted class would be an important factor." *Id.*

Some commentators found Justice Powell's efforts to distinguish *Walz* unpersuasive. *See* Morgan, *The Establishment Clause and Sectarian Schools: A Final Installment?,* 1973 SUP. CT. REV. 57, 79-80. Morgan's criticism in particular seems to be based upon the Court's failure to draw a distinction between the New York plan and tax deductions for charitable contributions to religious organizations. *See* I.R.C. § 170.

103 413 U.S at 796, *citing* Lemon v. Kurtzman, 403 U.S. 602, 623 (1971).

104 413 U.S. at 796-97.

105 The statute invalidated in *Nyquist* stated:

But the combination of tuition reimbursements and the tax program within a single measure suggested to the Court that the statute considered in *Nyquist* was designed to provide incentives to parents to employ the services of nonpublic schools and, by doing so, indirectly provided aid to religiously supported schools.

However, the degree to which the holding of *Nyquist* forecloses under the first amendment the enactment of plans designed to equalize the tax burdens of parents who use nonpublic schools with those of parents who send their children to public institutions is unclear. Briefs on both sides of *Nyquist* conceded that the New York plan provided incentives to parents.[106] No arguments were made that the New York tax deduction provisions were intended to refine the definition of taxable income. Whether such a plan would be constitutional was a question left open by *Nyquist.*

B. Nyquist *and Programs Equalizing Tax Burdens*

Under one reading of the majority opinion in *Nyquist,* tax programs with the effect of providing incentives primarily to and for parents who use nonpublic, predominantly religiously

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The Legislature hereby finds and declares that:

1. Statutes already provide for the deduction from gross income for tax purposes of amounts contributed to religious, charitable and educational institutions.
2. Nonpublic educational institutions are themselves entitled to a tax exempt status. . . .
3. Such educational institutions not only provide education for the children attending them, but by their existence, relieve the taxpayers of the state of the burden of providing public school education for those children.
4. The laws also authorize deductions for education related to employment.
5. The legislature hereby finds and determines that similar modifications of federal adjusted gross income should also be provided to parents for tuition paid to nonpublic elementary and secondary schools. . . .

Ch. 414, § 3, 1972 N.Y. Laws 881, 887.

106 The argument the proponents presented to the Court centered on the claim that a state has broad power to select the objects of taxation. *See, e.g.,* Brief for Appellees Boylan, Ducey, Ferrarella, and Roos and for Appellants Cherry, Ferguson, and Ruiz at 19-21; Brief on Behalf of Appellee Warren M. Anderson at 34-35; Brief Amicus Curiae for the National Jewish Commission on Law and Public Affairs at 7-11. The opponents conceded that legislatures have wide discretion in taxation but claimed that *Walz* established that it must be exercised within the confines of the first amendment. Brief for Appellants at 43.

controlled elementary and secondary educational institutions are forbidden by the first amendment. Yet *Nyquist* should not be read as forbidding legislative attempts to recognize in tax statutes that parents who employ public education facilities receive imputed income unavailable to nonpublic school parents. Close analysis of the New York tax plan struck down in *Nyquist* indicates that the plan was a version of a net cost formula that merely equalized the tax burden of all parents — and thus, under the three-prong test set forth in *Nyquist,* was constitutional. Furthermore, the net cost formula of tax equalization outlined earlier can be enacted without running afoul of the secular purpose, primary effect, and excessive entanglement tests outlined in *Nyquist.*

1. The New York Program as a Tax Equalization Plan

This Note has suggested that the net cost deduction formula for tax equalization might be the most appropriate means for equalizing the income of parents.[107] The New York tax plan struck down by *Nyquist* may, in fact, have been one version of this formula.

Because of the substantial administrative burden of operating any system which takes account of the per pupil costs of a particular child, average per pupil costs calculated at either the local or state level must be used in any tax benefit system. These approximate figures from New York for calendar year 1972 will suffice for purposes of discussion of the actual nature of the New York tax plan.[108]

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107 *See* text accompanying notes 75 to 77 *supra.* It will be remembered that under the net cost deduction formula, parents whose children attend nonpublic schools would be allowed to deduct from taxable income a sum equal to the excess of the per pupil costs of public education over the cost per pupil of nonpublic education, multiplied by the number of their children enrolled in nonpublic schools. The deduction would be augmented by the addition of any tuition paid by nonpublic school parents.

108 These figures were developed by taking average per pupil expenditures in public primary and secondary schools and average per pupil costs and tuition charged by nonpublic schools. A fuller explanation of these derivations is on file with the *Harvard Journal on Legislation. See* NATIONAL EDUCATION ASSOCIATION — RESEARCH, ESTIMATES OF SCHOOL STATISTICS, 1972-73, at 35; *See also* President's Panel on Nonpublic Education, *Nonpublic Education and the Public Good, reprinted in* 1 *1972 Tax Credit Hearings, supra* note 29, at 107.

New York Public Schools [Statewide Averages]	
Per pupil cost	$1392
Average tuition	0
New York Nonpublic Schools [Statewide Averages]	
Per pupil cost	$ 624
Average tuition	208

Under the net cost formula, the deductions that would be necessary to put the average nonpublic school parent on an equal plane with the average public school parent would be calculated as follows:

Average Public per pupil cost	$1392
Average Nonpublic per pupil cost	624
Deduction	$ 768

This deduction should be augmented by the amount of any tuition the parent actually paid. The net cost formula employs actual tuition paid instead of an average.[109] But because the New York plan did not include a calculation for tuition paid, average tuition figures will be used in order to approximate the actual effect of the system struck down by *Nyquist*.

Public average per pupil cost	$1392
Nonpublic average per pupil cost	624
Excess value	$ 768
Nonpublic average tuition	$ 208
Deduction	$ 976

Thus, a reasonable argument could have been made that the maximum $1000 deduction under the New York plan was part of an income-defining scheme. No one would have received a deduction that was significantly greater than that which was necessary for the average nonpublic school parent to be placed on a plane equal with the average public school parent.

109 One possible justification for using a statewide average for tuition rather than actual tuition would be that use of actual tuition as the basis for the deduction may grossly distort the calculation in favor of those parents sending their children to schools with high tuitions. This distortion will occur anytime the actual tuition exceeds the average per pupil cost of nonpublic education, and may be alleviated by using either an average tuition or by placing a ceiling equal to the average nonpublic per pupil cost onto the deduction for tuition paid.

The language of the majority opinion in *Nyquist* does not indicate whether *any* tax deduction or credit made available to nonpublic school parents would be unconstitutional where the purpose of the deduction is merely to refine the definition of income. The New York tax modification held to be improper in *Nyquist* may in reality have been a crude, perhaps unsuspecting, attempt to enact the principles of the net cost formula. If tax measures designed to recognize the disparities in incomes between parents are constitutional under the tests employed in *Nyquist,* the portion of that case that struck down the tax provisions aiding parents of children in nonpublic schools may have been wrongly decided — not so much as a matter of constitutional theory but on the basis of how that theory was applied to the tax plan actually before the Court.

2. The Validity of Tax Equalization Plans Under the *Nyquist* Tests

Nyquist struck down a statute which not only adjusted the tax burdens of parents who sent their children to nonpublic schools, but which also provided direct aid to some religiously supported schools and tuition reimbursements to low-income parents who used such schools.[110] It is not surprising, therefore, that the Court concluded that the New York statute, taken as a whole, had a primary effect of aiding religiously controlled institutions and thus was unconstitutional under the Establishment Clause.[111] Yet in its effort to strike down a statute of questionable facial validity, the *Nyquist* court did not engage in a lengthy discussion of tax theory. Had it done so, the *Nyquist* court could have found that tax equalization and the three-pronged Establishment Clause test it set forth may not be incompatible.

Courts asked to decide the propriety of income-defining deductions or credits must divorce themselves from the notion that deductions must bear some relation "to the amount actually paid for tuition"[112] and the belief that the absence of such a

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110 *See* notes 78 to 89 and accompanying text *supra.*
111 *See Nyquist,* 413 U.S. at 789-91.
112 *Id.* at 790 n.49.

relationship necessarily indicates that the state is attempting to encourage the use of religiously affiliated schools. It must be stressed that a parent's choice not to enroll his child in a public school is an economic transaction, an act of nonconsumption of a publicly provided good utilized by other parents. Yet in the area of education, a deduction or credit cannot take account of the income differences between parents if it is based only upon tuition paid. Even nonpublic schools do not charge all students tuition, and the amount of money that does change hands may not fully reflect the underlying economic costs or the value of educational services received. The income addition formula proposed earlier could be used to take account of parents' use of the "free" services of public schools. The same result can be achieved through the adoption of the net cost deduction formula, which offers an exclusion from gross income to those parents who use nonpublic schools.

The *Nyquist* court, in applying the three-prong test to a tax measure, also failed to realize that significant differences exist between tuition reimbursements and income tax deductions. The *Nyquist* court asserted that both plans provided an "encouragement and reward" for the education of children in nonpublic schools.[113] Such a broad statement applicable to all deductions and credits for education expenses cannot be supported. A deduction in an income tax system may be employed to define the "income" which is to be taxed. The personal exemption deduction[114] is not merely an "encouragement or reward" for continuing to live or for supporting a dependent. Rather, the personal exemption deduction defines the universe to be taxed.[115] The deduction for business expenses[116] does not provide "encouragement and reward" for being self-employed. Deductions merely establish a tax on net income as opposed to a tax on gross income. Only a showing that the purpose of a given deduction or credit is *wholly* extraneous to the purposes of a tax on net income should lead to a conclusion that it is an "encouragement or reward."

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113 *Id.* at 790-91.
114 I.R.C. § 151.
115 *See generally* Bittker, *Churches, Taxes and the Constitution*, 78 YALE L. J. 1285, 1287-304 (1969).
116 I.R.C. § 162.

Thus, writing in dissent in *Nyquist,* Justice Rehnquist may have correctly noted that the majority opinion of *Nyquist* is hard to reconcile with *Walz,* and the conclusion that the New York plan was an impermissible subsidy to religion was not compelled by the plan's flat-rate character.[117] A tax provision "aid[s] or advance[s]" specific conduct only if the expenses deducted or exempted under the law are properly within the universe that ought to be taxed. Professor Bittker has pointed out that it may be improper to use terms like "tax exemption" in discussing the property tax rules applicable to religious institutions. For reasonable secular reasons, church property may simply not be within the universe to be taxed.[118] Similarly, the New York plan did not "benefit" or "aid" religion simply because the legislature determined that a portion of the income of nonpublic school parents was not properly within the universe to be taxed in order to place those parents in an equivalent position with parents who derive "income" from the use of public schools. The fact that a flat-level tax benefit is made available to parents across a wide variety of tuition expenditures or incomes in a system of progressive rates should not lead to the conclusion that a provision is an impermissible "reimbursement" solely benefiting sectarian schools. For example, the flat rate personal exemption is a device for refining the definition of income. The exemption is supported by a theory that a minimum level of expenditure is necessary to sustain life and that only when one's income rises above that level is there an accretion of capital that may be taxed. Similar arguments may be made for elementary and secondary education expenditures which a parent is obligated by law to make,[119] employing either his own resources or those provided by the state through the public school system.

The language in the *Nyquist* majority opinion ought not to be applied directly to an income-defining deduction. Thus, the significant question is whether a plan based on the net cost

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117 *See Nyquist,* 413 U.S. at 805, 808-10.

118 Bittker, *Churches, Taxes and the Constitution,* 78 YALE L. J. 1285, 1287-304 (1969).

119 *See* text accompanying notes 58 to 66 *supra.*

deduction[120] can pass the three-part test. Given the way in which the Court has interpreted and applied the three-part test, such a program could prevail over any constitutional challenge.[121]

First, a net cost deduction would have the clear secular purpose of increasing the fairness of the income tax system. If the plan in *Nyquist* passed the test,[122] the equalization scheme should do so.

Second, such a plan's primary effect would not be to aid religion, because there would be no "aid" as such. Rather, the net cost deduction would adjust the income tax to take into account the consumption of educational resources. The absence of an equalization scheme arguably imposes an inequitable income tax burden upon those utilizing nonpublic elementary and secondary schools vis-á-vis those utilizing public elementary and secondary schools.

Furthermore, in order to avoid the conclusion that a plan has an impermissible primary effect, there is no need to rely upon the grant of similar deductions or credits to taxpayers other than parents of nonpublic school students.[123] First, tax ad-

120 *See* text accompanying note 75 *supra.*

121 The Senate Finance Committee believed the Moynihan-Packwood tax credit proposal, *see* notes 30 to 32 *supra,* would have satisfied the primary effect test because "[t]he bill will benefit a broader class of beneficiaries than any legislation of this type on which the Supreme Court has ruled so far." S. REP. No. 95-642, 95th Cong., 2d Sess. 7 (1978). To avoid excessive governmental entanglement with religious schools, the financial records of religious schools could only have been checked to see if the school is indeed an educational institution, but not to determine that tuition paid goes for items for which the credit is available. The burden would have been upon the individual taxpayer to prove his eligibility for the credit. *Id.*

This proposal might be held constitutional if the courts find that there is one class made up of all students — a class in which parochial students are a minority. But if it were found that there are several relevant classes, one consisting of college students and another made up of secondary and elementary students, then a tax credit for tuition paid to secondary and elementary schools would probably be struck down as having an impermissible primary effect of aiding religion.

122 *See* 413 U.S. at 733.

123 Kosydar v. Wolman, 353 F. Supp. 744, 756, 761 (S.D. Ohio 1972) (per curiam) (three-judge court), *aff'd mem. sub. nom.* Grit v. Wolman, 413 U.S. 901 (1973). In addition to credits for parents whose children attended nonpublic Ohio schools, 98% of whom attended religiously affiliated schools, tax credits were available for (a) persons enrolled in certain home instruction programs, (b) persons enrolled in public adult high school continuation programs, schools for tubercular persons, and certain vocational and basic literacy programs, (c) persons who make nonresident public school tuition payments, and (d) persons who incur tuition or fee expenses in public or private programs for the deaf, blind, crippled, emotionally disturbed, neurologically handicapped,

justments, as such, do not constitute "aid." Moreover, even if a court does consider the breadth of the class benefited by the plan, the group affected by the net cost deduction includes more than the parents who actually receive a deduction or credit. It contains all parents of school-age children. The relevant class consists not only of those who employ a deduction or credit, but also of the persons whose income the tax statute purports to define. The net cost deduction would serve to define the income of all parents of school-age children.

One of the best ways of determining whether the net cost deduction is constitutional under the primary effect test is to ask if the income addition formula which would affect public school parents' income would have the primary effect of advancing religion. An affirmative response to that question would indicate that there are serious problems with the primary effect test of constitutionality. If the income addition plan, which affects only public school parents directly, is permissible under the primary effect test, a net cost deduction must also be proper, inasmuch as there is almost no substantive economic difference between the two plans.[124]

One possible objection to an income tax equalization scheme is that the effect of no other governmentally provided service is accounted for in the income tax. Those who consume nonpublic school services instead of those of public schools would enjoy an advantage vis-á-vis those who do not consume any educational resources, public or private, or other state-provided services such as parks, garbage collection, and public hospitals. Opponents of tuition tax aid might see in the unique treatment given education expenditures an indirect, covert, "ingenious plan" to channel public aid to nonpublic schools.

In *Kosydar v. Wolman*[125] the state of Ohio argued that the act of sending a child to private school was reimbursable. But a three-judge court concluded that not every person who foregoes

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or mentally retarded. While actual statistics were unavailable for these classes, the district court noted that the "aggregate of new beneficiaries would not alter in a meaningful fashion the sectarian nature of the recipient class." *Id.* at 761.

124 *See* text accompanying notes 75 to 77 *supra.*

125 353 F. Supp. 744 (S.D. Ohio 1972) (per curiam) (three-judge court), *aff'd mem. sub. nom.* Grit v. Wolman, 413 U.S. 901 (1973).

use of a public service for which the general populace is taxed is entitled to a reimbursement of that portion of his tax burden: "[F]or the state to allow a credit to the parent who foregoes the use of the provided public facility in order to send his child to a private school, is to grant that taxpayer a relative economic advantage when compared to taxpayers generally."[126]

This argument may be applied against a net cost deduction only with difficulty. It is not necessarily improper for the tax system to consider those who utilize educational services and not to consider consumption or nonconsumption of other government services. The personal exemption deduction places all parents into a distinct class. A $1000 deduction can be claimed no matter what the gross income of a dependent is, if the dependent is a child of the taxpayer and is a fulltime student.[127] The tax equalization scheme does not raise the question of whether parents are to receive "aid" at all in the tax system but asks instead what form the aid will take.

The net cost deduction would not produce excessive government entanglement with religion or political divisiveness along religious lines. One possible objection to the enactment of this formula is that the calculation of the average per pupil cost of nonpublic schools will result in impermissible governmental administrative entanglement with religious institutions. Under the Supreme Court's opinion in *Lemon v. Kurtzman,*[128] which seems to indicate that such a plan would lead to an impermissible level of entanglement on these grounds, this objection must be seriously considered. One of the laws under attack in *Lemon* was a Rhode Island statute which granted salary supplements to teachers in some nonpublic schools. Teachers employed by nonpublic schools whose average per pupil expenditures on secular education were equal to or greater than the comparable figures for public schools were ineligible for salary supplements. Administration of the system necessitated examination of school records in order to determine how much of the nonpublic school's total expenditures was attributable to

126 353 F. Supp. at 761.
127 I.R.C. § 151(e).
128 403 U.S. 602 (1972).

secular education and how much to religious activity. The Court noted:

> This kind of state inspection and evaluation of the religious content of a religious organization is frought with the sort of entanglement that the Constitution forbids. . . . [T]he government's post-audit power to inspect and evaluate a church-related school's financial records and to determine which expenditures are religious and which are secular creates an intimate and continuing relationship between church and state.[129]

Under the proposed formulas, the averages used as a deduction base should likewise exclude the value of religious education. Merely arguing that the purpose of the statute held invalid in *Lemon* was to aid nonpublic schools, while the measures discussed herein are designed to achieve tax equity would not save the constitutionality of these systems. The relative lack of entanglement in exemptions compared with the entanglement supposed to be entailed in taxation helped to move the Court in *Walz v. Tax Commission* to find property tax exemptions constitutional.[130] The fact that the adoption of the net cost deduction may lead to more governmental inspection of religious institutions than at present may force a conclusion that the plan would lead to impermissible entanglement, even though such a program was intended to promote greater tax equity.

On the other hand, a legislature should be able to avoid these constitutional problems in arriving at a cost for nonpublic school services. One mechanism that could be adopted would simply be to accept the cost figures which appear on a school's financial records without regard to whether they are for religious or secular activities. Errors in labeling as secular expenditures which are in fact religious will not benefit the parents of children attending nonpublic schools or the schools themselves, but will simply reduce the value of the tax modification allowed. Such a mechanism would tend to limit confrontations between the government and religiously controlled schools on the allocation of educational costs. However, problems would continue to exist, inasmuch as the financial

129 *Id.* at 620, 621-22.
130 *See* Walz v. Tax Comm'n, 397 U.S. 664, 673-74 (1970).

statements of religious schools might not adequately account for the value of services performed by persons working for zero or below-market wages (such as members of religious orders) or the values of expenses shared with an affiliated church (such as utility bills). Additional adjustments might be necessary to reflect these costs. Another mechanism for determining educational costs would look at certain objective factors rather than a school's financial records. The government could determine the costs on the open market of obtaining services provided by nonpublic schools, taking into account the number of teachers, class size, professional qualifications of the staff, and the courses and extra-curricular activities offered. These figures would probably be already available to state education authorities charged with enforcing the minimum education standards of compulsory education laws. Use of these mechanisms, separately or in combination, should lead to resolution of the entanglement problems.

Fears that a system of tax equalization for parents who use nonpublic schools would lead to excessive "political" entanglement between church and state should not block its enactment. First, it is unlikely that to enact a tax credit or deduction would end the debate over public assistance to nonpublic, particularly religiously affiliated, schools. The recent success of the Moynihan-Packwood tax credit proposal in Congress in the face of *Nyquist* and other decisions holding aid schemes to be unconstitutional[131] indicates that the Supreme Court's pronouncements on such programs have not stemmed political debate on the topic.[132] Furthermore, arguments that a measure is unconstitutional because it would lead to increased debate between religious groups in the political arena would seem to fly

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131 *See* sources cited in note 1 *supra*. *See also* 124 CONG. REC. S13,316-17 (daily ed. Aug. 15, 1978) (Opinion of Attorney General Bell that Moynihan-Packwood plan is unconstitutional in light of *Nyquist*).

132 Many states have continued to test the Court's standards of invalidity under the Establishment Clause by enacting aid to nonpublic school statutes. Ohio, for example, has attempted since 1972 to enact an aid program that would satisfy the courts. *See, e.g.*, Wolman v. Walter, 433 U.S. 229 (1977), *aff'g in part and rev'g in part* Wolman v. Essex, 417 F. Supp. 1113 (S.D. Ohio 1976), *on remand from* 421 U.S. 902 (1975); Kosydar v. Wolman, 353 F. Supp. 744 (S.D. Ohio 1972) (per curiam) (three-judge court), *aff'd mem. sub. nom.* Grit v. Wolman, 413 U.S. 901 (1973); Wolman v. Essex, 342 F. Supp. 399 (S.D. Ohio), *aff'd mem.* 409 U.S. 808 (1972).

in the face of the guarantees of free expression on all questions, regardless of the motivation for that expression, contained in the first amendment.[133]

Additionally, systems of tax equalization proposed in this Note would appear to pose only a small practical risk of political entanglement. Debate over annual appropriations to nonpublic schools will not take place, as the administration of the equalization scheme would be part of the permanently established tax system.[134] Once a net cost deduction is incorporated into the tax statute, it will not require annual reconsideration by the legislature, unlike a program of direct monetary grants to parochial schools. Thus, the fears of entanglement through political divisiveness may be alleviated through enactment of a measure such as the net cost deduction.

Nyquist, therefore, should not be read as foreclosing a tax deduction or tax credit scheme which takes into account the disparity in the values which parents of nonpublic school students receive in comparison with that received by parents of public school students. It is possible that such a scheme may never be enacted and a court may never be presented with the necessity of deciding its constitutionality. But the notions underlying such a scheme should make the *Nyquist* decision even harder for tax credit proponents to accept.

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133 *See* L. TRIBE, AMERICAN CONSTITUTIONAL LAW 866-69 (1978). Another way of stating this proposition is that religious groups have the right under the Constitution to advocate programs that may not be put into force under the Free Exercise and Establishment Clauses of the first amendment.

134 Furthermore, political entanglement should not be considered to be the product of the fact that religious groups are among those seeking to change the status quo. To do so places a premium on historical accident and ignores the fact that secular groups (*e.g.*, parents of children enrolled in non-sectarian private schools) may also support measures favored by religious organizations. *Cf.* Walz v. Tax Comm'n, 397 U.S. 664, 678 (1970) (unbroken practice over 200 years of providing property tax exemptions to churches "openly and by *affirmative state action, not covertly or by state inaction,* is not something to be lightly cast aside" (emphasis added)).

NOTE

INCENTIVES FOR *PEOPLE*: THE FORGOTTEN PURPOSE OF THE PATENT SYSTEM

JAY DRATLER, JR.*

Resulting in part from the lack of effective incentives for innovation, the rate of innovation in American technology has declined in recent years. In this Note, Mr. Dratler contends that the current patent laws fail to provide effective incentives to inventors, most of whom work for large corporate or government employers, because the laws allow employers to require employee-inventors to assign all potential inventions to their employers. Moreover, incentives for supervisors and middle-level managers, whose support is critical in the process of innovation, do not exist.

To provide the needed incentives, Mr. Dratler propose that the patent laws be revised to divide ownership of patent rights in an invention between inventor and employer, according to how much "extraordinary" effort each has invested in the innovative process. Such division would be accomplished through private bargaining between inventor and employer, with arbitration in cases of impasse.

Introduction

During the past decade, commentators on the state of American technology have noted a decline in the rate of innovation in America. Imports of technology-intensive manufactured products have been growing faster than exports of these products, contributing to a serious balance of payments deficit.[1]

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1 *See, e.g., Hearings on Federal Incentives for Innovation Before the Special Subcomm. on Science, Technology and Commerce of the Senate Comm. on Commerce,* 93d Cong., 1st Sess. 35 (1973) (imports of technology-intensive manufactured products growing 2½ times as fast as exports) (remarks of Charles Anderson, Pres., Stanford Research Institute) [hereinafter cited as *Innovation Hearings*]; *id.* at 57 (statement of Dr. William Miller, Vice Pres. & Provost, Stanford Univ.); *id.* at 150 (remarks of John Stephens, Excel Mineral Corp., representing Dr. William Bollay) (in 1968, international trade deficit occurred for the first time in 93 years, while trade surplus in high technology fields dropped from 80% of market to 65%).

Foreign inventors have increased their share of newly issued American patents at the expense of domestic inventors.[2] In addition, the national rate of production of patented inventions has decreased, whether measured per dollar of research funding or per research worker.[3] These statistics evidence what appears to be a decline in the productivity of American research and development.[4]

A plausible explanation for this decline may be found in the profound changes in the institutional environment and methods of technological innovation which have occurred since the beginning of the Second World War.[5] Before the war, universities and private industry conducted most of the nation's applied research; by the end of the war, however, the federal government provided more than three-quarters of all the money spent on research, either directly or through contracts and grants.[6]

The federal government's preemption of applied research had two consequences. First, the lone inventor, guided primarily by his imagination and intuition, was replaced by the research task force, a large group of scientists, engineers, mathematicians, and technicians subject to fragmented responsibilities, nontechnical management, and fixed budgets.[7] Second, the

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2 Orkin, *The Legal Rights of the Employed Inventor: New Approaches to Old Problems* (pt. II), 56 J. PAT. OFF. SOC'Y 719, 730 (1974).

3 *Id.* at 728-29.

4 The decline in productivity cannot be blamed solely on a shortage of research funds due to the recent energy crisis and high rates of inflation, since the decline began much earlier, in 1958. *See id.* at 743-45.

5 *See, e.g.*, 1 DEP'T OF JUSTICE, INVESTIGATION OF GOVERNMENT PATENT PRACTICES AND POLICIES: REPORT AND RECOMMENDATION OF THE ATTORNEY GENERAL TO THE PRESIDENT 14-16 (1947) (Thomas C. Clark, Attorney General) [hereinafter cited as CLARK REPORT]; V. BUSH, PROPOSALS FOR IMPROVING THE PATENT SYSTEM, STUDY OF THE SUBCOMM. ON PATENTS, TRADEMARKS, AND COPYRIGHTS OF THE SENATE COMM. ON THE JUDICIARY PURSUANT TO S. RES. 167, STUDY NO. 1, 84th Cong., 2d Sess. 7-10 (1956) [hereinafter cited as BUSH STUDY].

6 1 CLARK REPORT, *supra* note 5, at 14-15.

7 To a certain extent, the complexity and interdisciplinary nature of modern research required this institutional change. Scientific and technical knowledge had become so complex that no one person could master the several related fields whose confluence might lead to new developments. *See* BUSH STUDY, *supra* note 5, at 9. *See also Hearings on Patent Law Revision Before the Subcomm. on Patents, Trademarks, and Copyrights of the Senate Comm. on the Judiciary Pursuant to S. Res. 56 on S. 1321*, 93d Cong., 1st Sess. 391, 400 (1973) (remarks and statement of Prof. John Stedman, Univ. of Wis.) [hereinafter cited as *Revision Hearings*].

government, which was paying the piper, began to insist on calling the tune.[8] The exigencies of wartime demanded government determination of the objectives of research and government supervision of its progress. Both the use of the task force and the practice of directing research from outside the laboratory persisted after the war was over.[9]

While the war was transforming the institutional environment of research and development, the legal environment of the employed inventor was also changing. The common law had allowed an inventor to retain title to his creations unless he had developed them at the specific direction of his employer.[10] Employers soon realized, however, that the common law right to retain title could be modified by contract and required their employees to agree to assign to them all rights in employment-related inventions in advance. The courts, imbued with the gospel of freedom of contract, specifically enforced these agreements. Moreover, the government, whose employees had enjoyed the same common law rights as employees in private industry, drafted administrative regulations as well as assign-

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8 Between 1938 and 1944, the federal research budget increased from 50 million to 700 million dollars. (The latter figure does not include the 2 billion dollars spent to develop the atomic bomb.) 1 CLARK REPORT, *supra* note 5, at 14.

9 *See, e.g., Innovation Hearings, supra* note 1, at 41-43 (remarks of Dr. Hans Mark, Dir., NASA Ames Research Center) (intensive directed research for defense is politically justifiable because everyone benefits from an effective national defense, military objectives do not vary with time, and the perceived importance of defense work often justifies disregarding the cost; consequently the civilian sector has relied upon military research).

Indeed, consensus that the nation's research effort should be directed at the pressing needs of peacetime now appears to be growing. *See id.* at 25-27 (remarks of Kenneth Arrow, Prof. of Economics, Harvard Univ.) (government subsidy of applied research needed to meet environmental and safety standards in industry); *id.* at 37, 40-41 (remarks of Charles Anderson, Pres., Stanford Research Institute) (government should fund industrial research to develop new ways of conserving energy and using domestic energy sources); *id.* at 48-49 (statement of Dr. Hans Mark, Dir., NASA Ames Research Center) ("fall out" from military research can no longer be relied on to meet pressing civilian needs); *id.* at 53, 56 (remarks of Dr. William Miller, Vice Pres. & Provost, Stanford Univ.) (government laboratories needed for massive research efforts in energy and transportation); *id.* at 71-72 (remarks of Robert Kuntz, past Pres. & Nat'l Dir., Cal. Soc'y of Professional Eng'rs) (national commitment to civilian technology needed); *id.* at 136-37 (remarks of James Quillin, Pres., District 727, Int'l Ass'n of Machinists & Aerospace Workers) (federal assistance needed for development of new civilian aircraft).

10 *See* text accompanying notes 34 to 48 *infra.*

ment agreements to achieve the same effect.[11] As a result of these agreements and regulations, the government stripped both its employees and government contractors of virtually all their rights, in advance, in any inventions which might be made pursuant to government contract.

Although the notions of freedom of contract which led courts to enforce invention assignment agreements indiscriminately are largely outdated,[12] modern observers have raised public policy arguments to justify the government's refusal to give the inventor the entire interest in inventions developed under government contract.[13] Since the government supplies the funds and the direction for such innovation, these observers have argued that a private patent monopoly cheats the public, which paid the research and development bill, and may lead to economic inefficiencies in the exploitation of new products.[14] Those who advanced these arguments, however, focused primarily upon the large research institutions which government sponsorship of research and development had spawned.[15] They considered the equitable interests of large corporations with government financed research laboratories and the economic consequences of private monopolies held by large corporate patentees. Yet they largely ignored both the equitable interests of the individual inventor and his role as creator in the patent system. While concentrating on the struggle of big government and big business over the fruits of cooperative research, they lost sight of both the equitable interests and the contribution of the individual.

Yet corporations and task forces do not by themselves invent. It is the creativity and hard work of *individuals* that make scientific and technical progress possible. Institutions, as abstract entities, are relevant only insofar as they motivate or

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11 For references and a detailed discussion of the legal rights of the employed inventor under assignment agreements and government regulations, *see* text accompanying notes 34 to 120 *infra*.

12 *See* text accompanying notes 66 to 82 *infra*.

13 These arguments are discussed in detail at text accompanying notes 83 through 120 *infra*.

14 These arguments were first put forward just after the Second World War. *See* 1 CLARK REPORT, *supra* note 5, at 28-54, 87-103.

15 *See generally* 1 CLARK REPORT, *supra* note 5.

impede the efforts of people. From its inception, the American patent system has recognized the importance of encouraging the efforts of individuals through suitable rewards.[16] Today, however, the law has forgotten the individual inventor and the delicate and peculiar nature of the inventive process. Herein may lie the reason for our nation's recent technological decline.

This Note suggests that both the constitutional purpose of the patent system and wise public policy require that employed inventors retain some rights in their creations. Although governmental and private employers should enjoy complementary rights where appropriate to promote innovation and serve the public interest, they should not automatically acquire all patent rights in employment-related inventions. Rather, the allocation of patent rights between inventor and employer should depend on the nature of the inventive process in the particular case, the precise incentive which the law desires to create, and the economic effect of the patent monopoly. In an effort to develop a standard for allocation, this Note introduces a theoretical model of the innovative process, which it uses to explore the effect of incentives on the various actors in that process.

The first part of this Note examines the history and current status of the employed inventor's rights, both in legal theory and in practice. Following a discussion of the purpose of the patent system, it explores the common law and contractual principles governing employed inventors. Next it reviews the complex history of the federal government's patent policy, as manifested in contractual provisions, administrative regulations, and executive orders. Finally, it outlines the current legal status of the employed inventor and analyzes some of the arguments advanced for government ownership of inventions conceived with government aid.

The second part begins by developing a realistic model of the innovative process as it exists today. Using this model, it shows how restoring patent rights to the inventor can provide an effective incentive for innovation and, at the same time, foster desirable competition in the development of new ideas. After

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16 *See* text accompanying note 24 *infra.*

examining the political and practical drawbacks of giving the inventor absolute ownership of patent rights, it proposes an intermediate approach in which employer and employee share ownership, so that both feel a substantial incentive toward innovation. The standard for division of ownership is based upon an assessment of the relative efforts of the employer and employee in overcoming human resistance to new ideas. To implement the standard efficiently and effectively, the Note proposes a statutory system based upon private bargaining and compulsory arbitration, with safeguards against patent suppression and demands for unreasonable royalties.

I. THE EMPLOYED INVENTOR'S RIGHTS IN LAW AND IN PRACTICE

The patent statutes, which rest on a firm constitutional foundation,[17] provide that an inventor may, upon satisfaction of the statutory standard for inventiveness[18] and in return for full disclosure of his creation,[19] enjoy a monopoly in the practice of his invention for seventeen years.[20] The statutes also provide, however, that the right to enjoy this monopoly has the attributes of personal property and may be assigned to any legal or natural person.[21] Consequently, although the inventor has a statutory right to a monopoly in his creation, he also has the power to sell, barter, or give away that right, even before the patent itself comes into being.

This part reviews the meaning and interpretation of the constitutional clause governing patents and discusses the rights which an inventor-employee retains at common law in the absence of a specific agreement to assign inventions to his employer. After exploring judicial enforcement of employees' agreements to assign future inventions, the section criticizes the judiciary's failure to apply modern concepts of adhesion con-

17 "The Congress shall have Power . . . to promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries. . . ." U.S. CONST. art. I, § 8, cl. 8.

18 35 U.S.C. §§ 102-103 (1976).

19 35 U.S.C. §§ 111-112 (1976).

20 35 U.S.C. §§ 101, 154 (1976).

21 *See* 35 U.S.C. § 261 (1976).

tracts and public policy. It then sketches the history of the federal government's policy regarding inventions made by its own employees and contractors and summarizes the practical effects of current law and that policy upon the rights of the employed inventor. Finally, it reviews and refutes some of the arguments for government ownership of government-sponsored inventions.

A. *The Constitutional Purpose of Patent Protection*

As Justice Douglas once noted, the patent statutes rest upon a constitutional provision that is unusual in that it conditions a grant of power to Congress upon the fulfillment of a particular purpose.[22] The exclusive rights which Congress may grant inventors must be designed "[t]o promote the Progress of Science and useful Arts."[23] While the reward of a monopoly and the incentive which it creates are two sides of the same coin, both Founding Fathers[24] and the courts[25] have made it clear that the Constitution authorizes the monopoly not as a bonus or reward for past services, however meritorious, but as an incentive for future effort. The law tolerates a seventeen-year monopoly only to encourage the advancement of science and technology.

Congress has sought to carry out this mandate of the Patent Clause through two kinds of incentives. First, it has encouraged inventors to disclose their creations to the public. This is the great *quid pro quo* of the patent law: a seventeen-year legal monopoly in return for disclosure of the invention at the outset and its dedication to the public at the end of the seventeen-year term.[26] The Founding Fathers offered to trade the limited

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22 *See* Great Atl. & Pac. Tea Co. v. Supermarket Equip. Corp., 340 U.S. 147, 154 (1950) (Douglas, J., concurring) ("unlike most of the specific powers which Congress is given, that grant is qualified").

23 U.S. CONST. art. I, § 8, cl. 8.

24 *See* 6 WRITINGS OF THOMAS JEFFERSON 180-81 (Washington ed. 1853), *quoted in* Graham v. John Deere Co., 383 U.S. 1, 8-9 n.2 (1966).

25 *See* Goldstein v. California, 412 U.S. 546, 555 (1973); Graham v. John Deere Co., 383 U.S. 1, 10-11 (1966); Mazer v. Stein, 347 U.S. 201, 219 (1954).

26 *See, e.g.*, Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 480-81 (1974); Scott Paper Co. v. Marcalus Mfg. Co., 326 U.S. 249, 255 (1945); Special Equip. Co. v. Coe, 324 U.S. 370, 378 (1945); United States v. Dubilier Condenser Corp., 289 U.S. 178, 186-87 (1933). *See also* Sutton & Williams, *Employed Inventors: The Case for the Moss*

monopoly for the perils, uncertainties, and furtiveness of trade secret protection, a bargain whose success is evidenced by the rapid growth in the volume of patent applications and in American technology.[27]

Disclosure is not the only purpose of the patent statutes, however. Public disclosure under law is not necessary for inventions like the safety pin, whose secrets are inevitably disclosed in the course of marketing. Moreover, inventors cannot protect such inventions under trade secret law because that which a product itself discloses is not a trade secret.[28] For such inventions, Congress could have denied legal protection entirely, allowing the most efficient producer to satisfy the market. But Congress did not do so. Rather, it apparently perceived the necessity of granting a short-term monopoly to stimulate the successful development and exploitation of inventive ideas. Evidently, it realized that the second purpose of the patent system is to create incentives for the exploitation of new ideas and for invention itself.

Although expressions of this second purpose do not appear in judicial opinions as frequently as do references to public disclosure, there can be little doubt that incentives for innovation are a legitimate purpose of patent law.[29] Such incentives seem necessary because of a fundamental human characteristic: resistance to new ideas. When an inventor proposes to work on a new problem, or to solve an old problem in a new way, his colleagues and his superiors question the worth of the project and the practicability of the method. Once he solves the problem and needs money to test his solution, potential backers question the importance of the problem, the economics of production, and

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Bill, 8 U.S.F.L. REV. 557, 570 (1974); *Innovation Hearings*, *supra* note 1, at 19 (remarks of Edward Teller, Prof. of Physics, Univ. of Cal.); *id.* at 95 (remarks of Burt Raynes, Chm. & Chief Exec. Officer, Nat'l Ass'n of Mfrs.).

27 *Cf.* note 239 *infra*.

28 *See* RESTATEMENT OF TORTS § 757, Comment a at 4 (1939): "One who discovers another's trade secret properly, as, for example, by inspection or analysis of the commercial product embodying the secret . . . is free to disclose it or use it in his own business without liability to the owner."

29 *See* Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 480 (1974) ("The patent laws promote . . . progress by offering a right of exclusion for a limited period as an incentive to inventors to risk the often enormous costs in terms of time, research, and development").

the marketability of the proposed product. Once he has built a working prototype and needs money for production and marketing, potential backers again question the need for the product, the advantages of its particular form, and its marketability. Even after the product is marketed, potential buyers question its usefulness and its price. They need to be convinced, by advertising, education, demonstration, and experience, that the new product is useful and does what it is designed to do. Thus at every stage of innovation, from defining priorities to advertising the finished product, the inventor or his company must expend time, energy, and money, both in doing the necessary physical work and in overcoming human resistance to new ideas.[30]

Not only is the innovative process made difficult by human resistance to change, but it is also quite risky.[31] There is never a guarantee that a new idea will prove both physically realizable and economically practicable. In addition, it is often impossible to predict accurately the costs of raising money for development or production or of convincing management or potential financial backers that a project is worthwhile. Thus, until a new idea actually turns a profit, the entire innovative process is a gamble.[32]

Although some observers maintain that inventors are motivated by a certain intellectual fanaticism and are oblivious

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30 *See* text accompanying notes 173 to 203 *infra*.

31 This discussion assumes that the new idea is valid and that the invention has some apparent commercial value. In that case, the primary costs are those of development and of convincing the appropriate persons and institutions to proceed and supply the necessary capital. In most cases, however, the worth of the idea is itself unclear at the outset, and the risks and uncertainties are compounded.

32 According to one source, the gamble is quite a long shot. Only one out of ten disclosures made by employed inventors to their employers results in a patent application, and only one out of a hundred produces an economically worthwhile invention. *Innovation Hearings, supra* note 1, at 74 (remarks of Robert Kuntz, Past Pres. & Nat'l Dir., Cal. Soc'y Professional Eng'rs).

Exploitation of a new idea may be an even bigger gamble, however, if there are no economic barriers to competition. Without patent protection, competitors can begin to produce the new device without incurring any of the inventor's costs of physical development or of overcoming human resistance to change. If they can modify their production equipment at a cost less than the inventor's costs, the competitors can undercut the inventor's price and drive him out of business. *See Innovation Hearings, supra* note 1, at 90-91 (remarks of Dr. William McLean, Dir., Naval Underseas Laboratories).

to worldly gain,[33] in fact, no inventor would spend his time and energy and no company or backer would incur the necessary costs to engage in such a risky venture without a special incentive. In recognition of this fact, the patent laws wisely confer upon the inventor a monopoly that lasts long enough to permit him to recoup the costs of development and of overcoming human resistance to change.

B. *The Common-Law Rights of Employed Inventors*

In the absence of an express contract between an inventor and his employer, the common law determines the allocation of rights between employer and inventor in an invention made in the course of employment.[34] If the employee is hired to invent or is assigned to develop a specific device or process, all rights in the invention belong to the employer.[35] In these situations, the employer has paid for innovation, and the law allows him to keep what he has purchased.[36] At the other extreme, when an employee not assigned to invent makes an invention on his own time, without using the supplies or facilities of his employer, and pays the expenses of obtaining the patent out of his own pocket, the invention belongs to him, and his employer has no rights in it,[37] whether or not the subject matter of the invention relates to the employer's business. The law gives the employee the fruits of his independent labor, and the employer must protect his interest in those fruits by contract, if at all.[38]

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33 *See* note 190 *infra.*

34 Although patent law requires that *individuals* be named as inventors, an inventor may assign rights in an invention to a legal entity once a patent issues. *See* text accompanying notes 48 to 49 *infra.*

35 *See, e.g.,* United States v. Dubilier Condenser Corp., 289 U.S. 178, 187 (1933) (dictum); Standard Parts Co. v. Peck, 264 U.S. 52, 58-60 (1924); Solomons v. United States, 137 U.S. 342, 346 (1890); 4 A. DELLER, WALKER ON PATENTS § 378, at 491-93 (2d ed. 1965).

36 *See, e.g.,* Standard Parts Co. v. Peck, 264 U.S. 52, 59-60 (1924); Solomons v. United States, 137 U.S. 342, 346 (1890).

37 *See, e.g.,* United States v. Dubilier Condenser Corp., 289 U.S. 178, 188-89 (1933) (by inference); Ocean Science & Engineering, Inc. v. United States, 194 U.S.P.Q. (BNA) 380, 388 (Ct. Cl. 1977); Tripp v. United States, 406 F.2d 1066, 1069-70 (Ct. Cl. 1969); Aero Bolt & Screw Co. v. Iaia, 180 Cal. App. 2d 728, 736-37, 739, 5 Cal. Rptr. 53 (1960). *See generally* 4 A. DELLER, WALKER ON PATENTS § 378, at 484-89 (2d ed. 1965).

38 *Cf.* Dalzell v. Deuber Watch Case Mfg. Co., 149 U.S. 315, 320, 326 (1893) (specific performance of alleged agreement to assign denied for lack of proof that contract ex-

If the employee was not hired to invent but uses the employer's facilities and resources to make an invention, the law splits the rights in the invention between the employer and the employee. Because the employee has done more than his job requires, he receives ownership of the patent, with full rights to grant licenses and collect royalties. The employer, however, is given a "shop right," *i.e.,* a nonexclusive, nontransferable, royalty-free license to make or use the invention during the life of the patent,[39] so that he, too, can reap some benefit in return for his contribution to the innovative process.

Commentators have criticized these common-law rules for their use of vague concepts to delineate the three categories of ownership.[40] Whether an employee has been "hired to invent" or "assigned to develop a specific device" is a matter of interpretation and degree, as is whether the employee used the employer's materials or facilities in more than *de minimis* amounts. Indeed, one commentator has noted that the common law's attempt to adhere to the three rigid categories of inventor ownership, employer ownership, and shop rights is "like decreeing that only three sizes of shoes shall be sold."[41]

As long as courts must make the decisions, however, this criticism seems unrealistic. Courts cannot recognize the infinite gradations of real life without estimating in each case the relative values of time spent and materials and facilities provided by the inventor and his employer. Such a task would require significant judicial resources and might well produce results as arbitrary as those of the common law. On balance, then, these common-law rules, like much of the contract law

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isted; question of implied license not decided); Tripp v. United States, 406 F.2d 1066, 1070 (Ct. Cl. 1969) (fact that plaintiff was not "Technical Personnel" and invention was not "Subject Invention" precludes finding express license).

39 *See, e.g.,* United States v. Dubilier Condenser Corp., 289 U.S. 178, 188-89 (1933); Solomons v. United States, 137 U.S. 342, 346-48 (1890). *See generally* 4 A. DELLER, WALKER ON PATENTS § 378, at 507-20 (2d ed. 1965).

40 *See, e.g.,* Orkin, *The Legal Rights of the Employed Inventor: New Approaches to Old Problems* (pt. I), 56 J. PAT. OFF. SOC'Y 648, 649-50 (1974); Stedman, *The Employed Inventor, the Public Interest, and Horse and Buggy Law in the Space Age,* 45 N.Y.U.L. REV. 1, 3, 18 (1970) [hereinafter cited as *Space Age*]; Stedman, *Employer-Employee Relations,* in F. NEUMEYER, THE EMPLOYED INVENTOR IN THE UNITED STATES 42-43 (1971).

41 *Space Age, supra* note 40, at 18.

near the turn of the century, when they were developed,[42] created reasonable categories with enough flexibility for interpretation and manipulation to achieve justice in the individual case.[43]

A more profound criticism of the common-law decisions is that they failed to consider the special nature of inventions and their place in the constitutional scheme of patent law. Despite the statutory declaration,[44] inventions are not really just another form of personal property, like a table or a lawn mower. The common-law cases, however, do not seem to have recognized the special place of patent rights in the constitutional scheme. There are hints in one Supreme Court opinion that an invention, as an *idea,* is somehow different both from the device which embodies it and from other forms of personal property[45] and that the idea belongs inalienably to the inventor as a sort of "moral right."[46] None of the cases, however, analyzes how or whether the common law promotes the constitutional purposes of encouraging disclosure and innovation.[47]

Despite the failure of judicial opinions to advert specifically to the constitutional purposes of the patent system, the common-law rules often produced results consistent with those purposes. Perhaps because they attempted to allocate patent rights fairly in light of the inventor's equitable interests as well as those of the employer, common-law courts maintained incentives for both employee and employer. As a result, the rules they developed seem more consistent with the central purpose of the patent system today than do the contractual provisions and administrative policies which have in practice replaced them.

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42 *See* notes 35 to 39 *supra.*

43 *Cf.* G. GILMORE, THE DEATH OF CONTRACT 62-64, 76-85 (1974) (manipulability of classical contract doctrine).

44 35 U.S.C. § 261 (1976) (patents have attributes of personal property).

45 *See* United States v. Dubilier Condenser Corp., 289 U.S. 178, 188 (1933) ("the embodiment is not the invention and is not the subject of a patent").

46 *See id.* at 188-89. *See also* Ramsey, *The Historical Background of Patents,* 18 J. PAT. OFF. SOC'Y 6, 14-20 (1936) (language of constitutional clause, which refers to "securing" inventors' "rights," indicates that American patents, unlike their British predecessors, are not grants of sovereign grace, but recognition of the natural rights of inventors in their creations).

47 The *Dubilier* Court mentions the incentive for disclosure of inventions, but does not rely on the purposes of the patent system in making its decision. *See* United States

C. *The Rights of Employed Inventors Under Employment Contracts*

Although the patent statutes allow only individuals — not corporations or other legal entities — to be named as inventors in patent applications,[48] an inventor can *assign* rights in his invention to any legal entity, even before that invention is conceived.[49] Employers have taken advantage of this fact[50] by forcing employees to sign "invention assignment agreements," which obligate employees to assign to their employers all rights in any inventions made or conceived by them in the course of employment.

Early provisions of such agreements varied considerably in their effectiveness. Sometimes they failed to reserve rights effectively in the employer[51] and sometimes they attempted to reserve too much.[52] Over the years, however, they have become somewhat standardized. Typical clauses reserve to the employer all rights in inventions relating to the business in which the employer "is or may be engaged"[53] that are "made or conceived" by employees "during the course of" their employment. Occasionally, an employer adds so-called "trailer clauses" to reserve rights in inventions made by the employee during a

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v. Dubilier Condenser Corp., 289 U.S. 178, 186-87 (1933); text accompanying notes 139 to 152 *infra*.

48 *See* 35 U.S.C. § 111 (1976); 5 A. DELLER, WALKER ON PATENTS § 439, at 57 (2d ed. 1972).

49 "Applications for patent, patents, or any interest therein, shall be assignable in law by an instrument in writing." 35 U.S.C. § 261 (1976).

50 *See* Doherty & Iandiorio, *The Law of the Employed Inventor — Time for a Change*, 57 MASS. L.Q. 27, 30 (1972); Orkin, *supra* note 40, at 650.

51 *Compare* Lamson v. Martin, 159 Mass. 557, 35 N.E. 78 (1893) (contract to assign "all inventions" did not cover crude conception which was refined and reduced to practice after term of contract) *with* Morgan Adhesives Co. v. Questel, 162 U.S.P.Q. (BNA) 61, 62 (Ohio Ct. C.P. 1969) (inventor required to assign invention allegedly unperfected during term of employment where contract covered "all inventions made or conceived" during employment).

52 *See* note 59 *infra*.

53 *See generally* F. NEUMEYER, THE EMPLOYED INVENTOR IN THE UNITED STATES 87, 89, 103-04, 109-10, 114-15, 120-21, 126-28, 132-33, 136-37, 142, 147-50 (1971) (case studies).

For the precise wording of a typical patent assignment agreement, *see id.* at 157-59; Orkin, *supra* note 40, at 650-51 n.10. For an example of an agreement covering inventions made during the term of employment without limitation as to subject matter, *see* F. NEUMEYER, *supra*, at 156-57.

certain period after termination of employment.[54] Today nearly all employees with any scientific or technical responsibility sign such agreements.[55]

Fortunately for employers, patent assignment agreements first became popular at a time when the gospel of freedom of contract was preached in every judicial pulpit.[56] Not only did the courts of that era uphold such contracts at law, but they also enforced them at equity, granting the employer specific performance.[57] Courts relied on both the "uniqueness" of a patentable invention and uncertainty in its value to justify their findings of an inadequate damage remedy at law.[58]

Where the employer's reservation of rights was overbroad, the courts sometimes declined to enforce the agreement literally.[59] Rather than invalidate the agreement as a whole, however, they reinterpreted it to avoid employer overreaching or invalidated it only in part, leaving the inventor still bereft of rights in his invention.

The leading case of *Guth v. Minnesota Mining & Manufacturing Co.*[60] illustrates this judicial approach. In that case, Guth, a chemical engineer assigned the task of making masking tape

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54 *See, e.g.,* F. NEUMEYER, *supra* note 53, at 136-37, 148-49, 156.

The courts will enforce such clauses if they are reasonable in duration and scope. *See, e.g.,* Dorr-Oliver, Inc. v. United States, 432 F.2d 447, 452 (Ct. Cl. 1970) (dictum); Universal Winding Co. v. Clarke, 108 F. Supp. 329, 331-33 (D. Conn. 1952); Doherty & Iandiorio, *supra* note 50, at 36. *See generally* R. ELLIS, PATENT ASSIGNMENTS §§ 183-94 (3d ed. 1955).

55 F. NEUMEYER, *supra* note 53, at 89; Orkin, *supra* note 40, at 651 (citing Rines, *A Plea for a Proper Balance of Proprietary Rights,* IEEE SPECTRUM, Apr. 1970, at 43); F. NEUMEYER, *supra* note 53, at 153 (citing O'Meara, *Employee Patent and Secrecy Agreements,* in NAT'L INDUSTRIAL CONF. BD., STUDIES IN PERSONNEL POLICY, No. 199, at 15 (1965)) (36% of 83 companies surveyed required *all* employees to sign invention assignment agreements).

56 *See Space Age, supra* note 40, at 13-15.

57 *See generally* 4 A. DELLER, WALKER ON PATENTS § 378, at 484-507 (2d ed. 1965).

58 *See* 5A A. CORBIN, CONTRACTS § 1142 (1964).

59 *See* Gas Tool Patents Corp. v. Mould, 133 F.2d 815, 816, 818 (7th Cir. 1943) (assignment agreement literally unlimited in subject matter construed as inapplicable to invention useful in several fields unrelated to that of inventor's employment where inventor had expended his own resources in development and patenting); Guth v. Minnesota Mining & Mfg. Co., 72 F.2d 385, 388-89 (7th Cir. 1934), *cert. denied,* 294 U.S. 711 (1935) (part of agreement unlimited in duration and subject matter invalidated).

60 72 F.2d 385 (7th Cir. 1934), *cert. denied,* 294 U.S. 711 (1935). *See also* Universal Winding Co. v. Clarke, 108 F. Supp. 329 (D. Conn. 1952) (one year "trailer clause" in assignment agreement held valid as confined to certain subject matter).

less prone to splitting, had agreed, for an unspecified period, to assign to his employer all inventions which related to specified areas of work or to any business in which the employer, during the term of employment, "is or may be concerned."[61] Guth helped develop a patentable product, and, after he left work, his employer sued to compel him, *inter alia,* to sign a patent application naming him as the inventor and to assign his rights in the invention to the employer. The court found that

> [t]hose provisions of the contract which were limitless in extent of time and in subject matter of invention were contrary to public policy. Guth was a chemical engineer . . . prepared to devote his life to discoveries of value to industry. Under this contract he was, however, if he worked in another laboratory or for another manufacturer, required to assign his discoveries to appellee. This would effectively close the doors of employment to him....Such a contract conflicts with the public policy of the land, which is one that encourages invention and discourages exclusion of an employee from engaging in the gainful occupation for which he is particularly fitted for all time, anywhere in the United States.[62]

Despite this forceful condemnation of overbroad assignment agreements, the court upheld those provisions of the contract which were limited to the period of employment and to the subject matter of Guth's employment, finding them separable from the invalid ones.[63] Perhaps the fact that similar circumstances would have been grounds for compelling an assignment at common law influenced the court's decision.[64] Other courts, however, have given employers greater rights than those

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61 Guth v. Minnesota Mining & Mfg. Co., 72 F.2d 385, 387 (7th Cir. 1934), *cert. denied,* 294 U.S. 711 (1935).

62 *Id.* at 388-89 (citations omitted).

63 *Id.* at 389.

The limited contractual obligations which the court found "separable," however, were in fact intertwined with the invalid provisions in the same paragraphs. *See id.* at 387.

The court did excuse Guth from signing the patent application on the ground that his employer had not proved that Guth could in good faith claim to be the inventor, a status which Guth denied. *Id.* at 390-91.

64 *See id.* at 389. ("Appellant was employed as a researcher. His new product was conceived while he was so employed . . . [and] related to the very subject matter for which he was employed. . . .") Under the common-law rules, Guth might have been required to assign his rights to his employer because he had been employed to develop a specific new product.

available at common law as long as the agreements with their employees did not overstep the limits of time and subject matter set forth in *Guth.*[65]

In light of the turn-of-the-century idolatry of freedom of contract, it is not surprising that courts of that era allowed employers to replace the carefully calibrated equities of the common law with contractual boiler plate. It is surprising, however, that courts have slavishly followed these precedents to the present day,[66] despite their growing willingness in other areas of law to look behind form contracts to see whether in fact they represent the free and equal bargain which the law presumes.

Modern courts have two judicial weapons to strike down standard patent assignment agreements. First, they may invalidate them as paradigmatic contracts of adhesion. Assignment agreements consist of standard forms, drawn up by the employer's counsel, which the employee must sign as a condition of employment.[67] Although key employees of unique reputation may be allowed to write their own terms, the assignment agreement is not negotiated in the vast majority of cases.[68] With a few exceptions, collective bargaining has yet to make its debut in this area,[69] and since virtually all industrial employers of any size require such agreements, the prospective employee is in no position to bargain. Indeed, technical employees are particularly powerless in times of cyclical business recession or cutbacks in government funding, when

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65 *See Space Age, supra* note 40, at 12.

66 *See, e.g.,* Treu v. Garrett Corp., 264 Cal. App. 2d 432, 436-37, 70 Cal. Rptr. 284 (1968); Thermo Electron Eng'r Corp. v. Lyczko, 151 U.S.P.Q. (BNA) 303, 304-05 (Mass. Super. Ct. 1966).

67 *See* Doherty & Iandiorio, *supra* note 50, at 27. *See also* sources cited in note 53 *supra.*

68 *See Hearings on the Economic Aspects of Government Patent Policies Before a Subcomm. of the Senate Select Comm. on Small Business,* 88th Cong., 1st Sess. 45 (1963) (remarks of Henry Blackstone, Pres., Servo Corp. of America) [hereinafter cited as *Economic Aspects Hearings*]; F. NEUMEYER, *supra* note 53, at 201-02; Sutton & Williams, *supra* note 26, at 572-73 ("Employers and employees are rarely, if ever, on an equal footing").

69 *See generally* F. NEUMEYER, *supra* note 53, at 163-206. Neumeyer dismisses collective bargaining agreements with provisions covering invention assignments as "negligible" in terms of the number of employees and corporations affected. *Id.* at 164. *See also* text accompanying notes 133 to 135 *infra.*

they are happy to have jobs at all.[70] Thus, in reality, an assignment agreement does not result from a "meeting of the minds," but is imposed upon the employee by the employer as a condition of employment.

When individual parties to standardized contracts have no power to bargain over terms, courts have struck down or limited the terms of contracts imposed upon the party with less bargaining power, at least when important considerations of public policy have been implicated.[71] When an individual's bargaining power is weak, he cannot negotiate the form of the particular provision but can only choose whether to enter a contractual relationship at all. If, in addition, the subject matter of the contract is a "necessity," the weaker party's need forecloses even this choice and negates the fundamental premise of contract law: that a bargain has been arrived at freely. In such cases, the contractual provision must fall.

In applying the doctrine of adhesion contracts, courts have not limited the concept of "necessity" to matters of life and death but have included such items as automobiles and automobile insurance.[72] Since without jobs most individuals cannot afford an automobile,[73] employment also should be con-

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70 *See* note 245 *infra*.

71 For example, clauses exculpating the drafter from liability for negligence in the provision of emergency medical care have been so modified. *See* Tunkl v. Regents, 60 Cal. 2d 92, 383 P.2d 441, 32 Cal. Rptr. 33 (1963) (en banc) (invalidation pursuant to state statute declaring, *inter alia*, that contractual exculpations from "violation of law, whether willful or negligent," are contrary to public policy). So, too, have been clauses disclaiming implied warranties of merchantability in contracts for the sale of an automobile, *see* Henningsen v. Bloomfield Motors, Inc., 32 N.J. 358, 403-04, 161 A.2d 69, 95 (1960), and clauses requiring that an insured notify his insurer of an automobile accident "as soon as practicable," *see* Brakeman v. Potomac Ins. Co., 472 Pa. 66, 76-77, 371 A.2d 193, 198 (1977) (clause reformed by court to permit forfeiture of right to recover only on company's proof of prejudice caused by late notice).

72 *See, e.g.*, Henningsen v. Bloomfield Motors, Inc., 32 N.J. 358, 386, 161 A.2d 69, 85 (1960) (automobile is a necessity for a multitude of persons); Brakeman v. Potomac Ins. Co., 472 Pa. 66, 73 n.6, 371 A.2d 193, 196 n.6 (1977) (motor vehicle is a practical necessity, which, under state's compulsory insurance law, cannot be operated without insurance).

73 *Cf.* Reich, *The New Property*, 73 YALE L.J. 733, 738 (1964), *quoted with approval in* Arnett v. Kennedy, 416 U.S. 134, 207-08 n.2 (1974) (Marshall, J., dissenting) ("To many . . . a job with a particular employer is the principal form of wealth. A profession or job is frequently far more valuable than a house or bank account, for a new house can be bought, and a new bank account created, once a profession or job is secure."). *See also* Wyman v. James, 400 U.S. 309, 326 (1971) (Douglas, J., dissenting) (government employment is important "property" right).

sidered sufficiently "necessary" to trigger application of the adhesion doctrine.[74]

A second ground on which invention assignment agreements may be attacked is public policy.[75] Such agreements implicate two important public policies. First, they raise the spectre of undue concentration of economic power in a given area of

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74 Even if a court cannot invalidate an oppressive term under the doctrine of adhesion contracts, it may interpret the term *contra proferentem* and in favor of the powerless individual. *See generally* 3 A. CORBIN, CONTRACTS § 559 (1960). In nearly every case involving an agreement to assign inventions, there are close questions of fact in applying the language of the contract. Such questions as when the invention was "made or conceived," whether the making or conception was in the course of employment, and whether the invention related to the employer's line of business can be answered only by careful investigation of the facts and careful interpretation of the contractual terms in light of those facts. In applying the terms to the facts of a given case, courts can invoke the doctrine that ambiguous terms in a form contract, or in a contract prepared by one party without significant opportunity for negotiation, should be construed against the preparer.

Although courts have invoked this doctrine with some regularity in interpreting contracts of insurance, *see id.* at 264-67, it so far has been little more than a makeweight in interpreting employee assignment agreements. *See, e.g.,* Jamesbury Corp. v. Worcester Valve Co., 443 F.2d 205, 213 (1st Cir. 1971); De Jur-Amsco Corp. v. Fogle, 233 F.2d 141, 144 (3d Cir. 1956) ("proverbial lily may be gilded" by invoking the doctrine). Moreover, even if used decisively, the doctrine can do little to promote real progress in the law. As long as courts are unwilling to control the substantive content of assignment agreements, employers will simply change the contractual language to eliminate the ambiguity perceived by the court. For example, the Massachusetts Supreme Judicial Court's early ruling that the term "invention" excludes conceptions not yet reduced to practice, *see* note 51 *supra,* undoubtedly led to inclusion of the words "all inventions made or conceived" in the standard boiler plate. *See id.;* F. NEUMEYER, *supra* note 53, at 156-57 (typical assignment agreements); Orkin, *supra* note 40, at 650-51 n.10 (agreement covering inventions "developed or conceived" during employment).

While such interpretations of terms may do justice in the case before the court, they can become traps for the unwary employer in a later case. *See* Jamesbury Corp. v. Worcester Valve Co., 443 F.2d 205, 210-13 & n.6 (1st Cir. 1971) (invention reduced to drawings by director of research less than two weeks after he left employment found not "made or worked out" during the term of employment as required by the contract); Doherty & Iandiorio, *supra* note 50, at 28-30. In general, application of doctrines of interpretation enables courts to avoid the hard issues of public policy and constitutional purpose.

75 Indeed, most courts will apply the doctrine of contract of adhesion only if important public policies are implicated. *See* Tunkl v. Regents, 60 Cal. 2d 92, 383 P.2d 441, 444-46, 32 Cal. Rptr. 33 (1963) (en banc); Henningsen v. Bloomfield Motors, Inc., 32 N.J. 358, 403-04, 161 A.2d 69, 95 (1960). Where, however, a particular term is by itself sufficiently inimical to public policy, as in *Guth,* a court may strike it down on that ground alone. Thus, the policy implications of employee assignment agreements may constitute both reasons for treating them as contracts of adhesion and independent grounds for invalidating them.

Even a degree of harshness or oppressiveness insufficient to avoid enforcement of the contract at law may be grounds for refusal of specific performance. *See* 5A A. CORBIN, CONTRACTS § 1164 (1964).

technology. Because only large enterprises have the scale to afford significant research, most government research contracts are awarded to them. These contracts further enlarge the facilities of those enterprises, thus generating expertise and eventually predominance in specific areas of technology.[76] This situation produces a spiraling technological agglomeration which may concentrate both expertise and the most modern facilities in a few of the largest concerns.[77]

Some of this technological agglomeration may be economically justifiable, since research, like other industrial endeavors, may benefit from economies of scale. Nevertheless, large concerns are often too sluggish or too disinterested to nurture and develop the new ideas which their employees conceive. Employed inventors often develop new ideas most quickly and efficiently by joining or forming spin-off companies to develop them outside the large institutions in which they were discovered.[78] Assignment agreements, however, abort this healthy spin-off process by foreclosing employees' opportunities to take their inventions outside the company in which they were discovered. By enforcing assignment agreements rigorously, large corporations can delay or prevent the exploitation of inventions whose development would contravene their economic interests. Enforcement of assignment agreements thus closes an important safety valve for the increasing concentration of technical and economic power in the nation's largest industrial firms.

The other public policy issue raised by employee assignment agreements is the second concern of the Patent Clause, the encouragement of innovation. Regardless of whether employees need or in fact respond to the incentive of a potential patent monopoly, assignment agreements do remove a powerful economic incentive from the people who do the day-to-day work

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76 *Cf.* BUSH STUDY, *supra* note 5, at 12 (interlocking patents can extend a permanent monopoly over a field of commerce).

77 *See Economic Aspects Hearings, supra* note 68, at 122 (remarks of Robert Lanzillotti, Prof. & Chm., Dep't of Economics, Mich. St. Univ.) (52% of patents received by Dep't of Defense contractors were concentrated in 15 companies during the period 1952-56).

78 *See* note 209 *infra.*

of innovation.[79] At best, automatic corporate ownership of patent rights takes the incentive from the technical employees who create and develop new ideas and gives it to the high-level corporate managers, who determine the direction of research and provide money for exploitation.[80] As will be shown below,[81] however, automatic corporate ownership deprives technical supervisors and middle-level managers, as well as employed inventors, of significant incentives toward innovation. As a result, assignment agreements destroy the incentive for innovation for all those people most intimately associated with it.

Despite these good reasons not to enforce assignment agreements, their judicial enforcement does not seem to be in jeopardy. Under present case law, the courts will specifically enforce an unambiguous assignment agreement unless the inventor can show that the agreement is overbroad or that the invention is outside the scope of the agreement in time or subject matter.[82] Moreover, courts are reluctant to engage in comparisons of the separate inventive contributions of the employee and employer, so the employee's assertion that he expended his own time, money, and supplies is an ineffective defense to an employer's actions for enforcement. Thus, until Congress acts, or until the courts face the hard issues of public policy and constitutional purpose, employers will continue to claim title to their employees' inventions under private law, and courts will enforce that law without considering the public interest in innovation.

D. *Government Employees and Government Contractors*

A majority of all technical research personnel are subject to federal government patent policies. Either they work in laboratories owned or operated by the government[83] or they

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79 *See* Stedman, *Employer-Employee Relations,* in F. NEUMEYER, *supra* note 53, at 46 ("There is some evidence . . . that contracts of the sort here described fall considerably short of providing the kind of stimulus and incentive to the employee that is contemplated and sought in the public interest").

80 *See* text accompanying note 187 *infra.*

81 *See* text accompanying notes 186 to 202 *infra.*

82 *See* cases cited in note 66 *supra. See generally* 4 A. DELLER, WALKER ON PATENTS § 378, at 494-98 (2d ed. 1965).

83 In 1957, for example, about one-quarter of the nation's total research and develop-

work under government contracts or grants to industry, universities, and other nonprofit institutions.[84] Consequently, the government's attitude toward the patent rights of employed inventors is of great practical importance.

Because each federal agency has developed its own patent policy,[85] the history of government patent policy is quite complex. Volumes have been written on the subject,[86] and a complete treatment of the history or present posture of government patent policy is beyond the scope of this Note. A rough outline of the history of federal patent policy, however, is necessary to illustrate the four basic types of policy and the stages through which the policy of most agencies has developed.

Until some time after the First World War, government agencies generally followed a "laissez faire" policy toward both employee and contractor inventions.[87] Express contracts allocating patent rights were rare, and the Navy and War Departments on occasion voluntarily compensated their own officers for the use of inventions conceived with the aid of government money.[88] Whenever the government asserted a right to use employees' inventions without royalty, the courts held that the government was not significantly different from any other employer[89] and refused to distinguish between individual

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ment effort was carried out with government funds in government facilities. Finnegan & Pogue, *Federal Employee Invention Rights — Time to Legislate,* 55 MICH. L. REV. 903-04 (1957). In the same year, the federal government was the largest single employer of scientists and engineers. *Id.*

84 *See generally* F. NEUMEYER, *supra* note 53, at 4-8. In Fiscal Year 1967, for instance, about 59% of the federal research and development budget supported applied and developmental research in industry, while 18% supported such research within the federal government itself. *See id.* at 5 (by inference). About 4% of the budget supported applied and developmental research in universities and colleges, and slightly more, about 5%, was allotted to basic research in the same institutions. *See id.* (by inference).

85 *See* F. NEUMEYER, *supra* note 53, at 209-10. *See generally* 2 CLARK REPORT, *supra* note 5.

86 Among the most comprehensive are F. NEUMEYER, *supra* note 53, at 207-424; HARBRIDGE HOUSE, INC., GOVERNMENT PATENT POLICY STUDY, FINAL REPORT (1968); CLARK REPORT, *supra* note 5.

For a selected bibliography, *see* F. NEUMEYER, *supra* note 53, at 207 n.1.

87 *See* 2 CLARK REPORT, *supra* note 5, at 79-80 (Dep't of Commerce); *id.* at 142 (Public Health Service); *id.* at 169 (Dep't of the Interior) (by inference); *id.* at 223 (Nat'l Academy of Sciences, Nat'l Research Council) (by inference); *id.* at 246-53 (Navy Dep't); *id.* at 414-23 (War Dep't). *But see id.* at 4-10 (Dep't of Agriculture).

88 *See id.* at 250-53, 418-19.

89 *See, e.g.,* Solomons v. United States, 137 U.S. 342, 346 (1890); Gill v. United States, 160 U.S. 426, 435 (1896); Ordnance Eng'r Corp. v. United States, 68 Ct. Cl. 301,

employees and corporate contractors. Consequently, unless a special compensation statute applied to a particular inventor or invention, the courts resolved the government's claims by applying the common law.[90]

The lack of government concern with patent rights reflected in this "laissez faire" policy was made possible by the doctrine of sovereign immunity. Although special statutes did allow certain classes of inventors to sue the government for compensation,[91] sovereign immunity generally protected the government against suits for infringement. It was not until 1910 that Congress by statute permitted patent owners to sue for compensation for the government's use of their inventions.[92] Even under that statute, however, the government retained shop rights in inventions made with substantial government support.[93] Moreover, the statute precluded federal employees from receiving any government compensation.[94]

As inventors' claims for compensation or royalties became more frequent, several government agencies initiated a new policy, now known as "license policy."[95] Under this policy, the

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352-53 (1929), *aff'd in supplemental opinion on new evidence,* 73 Ct. Cl. 379 (1931), *cert. denied,* 302 U.S. 708 (1937).

90 *See generally* 2 CLARK REPORT, *supra* note 5, at 246-59 (Navy Dep't); *id.* at 414-23 (War Dep't).

91 *See* 3 CLARK REPORT, *supra* note 5, at 141-42, 151-53. To recover compensation, the patentee had to establish a contract, express or implied, by which the government agreed to pay for its use of the invention. *See id.* at 142; Finnegan & Pogue, *supra* note 83, at 926-27 n.86.

92 Act of June 25, 1910, Pub. L. No. 61-305, ch. 423, 36 Stat. 851. *See* United States v. Dubilier Condenser Corp., 289 U.S. 178, 204-05 (1933).

93 *See* United States v. Dubilier Condenser Corp., 289 U.S. 178, 206 (1933); 3 CLARK REPORT, *supra* note 5, at 143.

94 The statute precluded suit for compensation if the device at issue had been "discovered or invented," or if suit had been filed, while the inventor was in government employment or service. Though it did not preclude the government from voluntarily giving a bonus for the invention, Act of June 25, 1910, Pub. L. No. 61-305, ch. 423, 36 Stat. 851, it denied "any remedy against the United States for the use of patented inventions made or owned by a Federal employee in virtually all situations." 3 CLARK REPORT, *supra* note 5, at 143.

In 1948, the provision was amended to permit suits by employees who were not in a position to influence the government's use of patented products and to preclude recovery only where the invention was made within the employee's line of duty or involved the use of government resources. Act of June 25, 1948, Pub. L. No. 80-773, ch. 646 62 Stat. 869, 941-42 (codified at 28 U.S.C. § 1498 (1976)). *See generally* Finnegan & Pogue, *supra* note 83, at 926-28.

95 *See* Finnegan & Pogue, *supra* note 83, at 928-29.

government asserted the right to use without royalty inventions made with its support and maintained this right by vigorously defending inventors' suits for compensation and by instituting departmental regulations that codified the common-law doctrine of shop rights.[96] These regulations and the doctrine of shop rights were used to deny compensation to contractors as well as to government-employed inventors.[97] This license policy was followed by most agencies within what is now the Department of Defense from shortly after the First World War until 1950.[98]

As the government began to support more and more research, particularly during and after the Second World War, policymakers began to question whether inventors supported by government funds were entitled to any private benefit at all. Certain agencies developed the policy of asserting title, rather than merely a royalty-free license, to patents on inventions made with their support.[99] Although this so-called "title policy" was unsuccessfully tested in litigation as early as 1933,[100] and although some agencies had adopted it before the Second World War, it was not adopted on a government-wide basis until 1950.

In that year, President Truman promulgated Executive Order 10096,[101] which established a uniform policy, similar in most instances to title policy, for the disposition of rights in government employees' inventions. The Order, still in effect today, divides employees' inventions into three categories. The government retains title to patents on all inventions in the first category, which includes inventions made by government

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96 *See* 2 CLARK REPORT, *supra* note 5, at 257-61 (Navy Dep't); *id.* at 423-26 (War Dep't).

97 *See* Ordnance Eng'r Corp. v. United States, 68 Ct. Cl. 301, 353 (1929), *aff'd in supplemental opinion on new evidence,* 73 Ct. Cl. 379 (1931), *cert. denied,* 302 U.S. 708 (1937).

98 *See* F. NEUMEYER, *supra* note 53, at 228.

99 *See, e.g.,* United States v. Dubilier Condenser Corp., 289 U.S. 178, 182 (1933) (government denied request for title to patents on airplane radio receivers); Houghton v. United States, 23 F.2d 386, 387 (4th Cir.), *cert. denied,* 277 U.S. 592 (1928) (government assigned title to patent on improved fumigant gas valuable for public health purposes).

100 *See* United States v. Dubilier Condenser Corp., 289 U.S. 178 (1933). For a discussion of the facts and the holdings in *Dubilier, see* notes 139 to 153 and accompanying text *infra.*

101 3 C.F.R. 292 (1949-1953 compilation), *reprinted in* 35 U.S.C. § 266 note (1976).

employees during working hours, those developed with the aid of government resources, or those directly relating to or resulting from the inventor's official duties.[102] Inventions fall into the second category if the government's contribution to them, as measured by the criteria of the first category, is "insufficient equitably" to justify the government's taking full title. Title to patents on these inventions remains with the inventor, subject to a nonexclusive, irrevocable, royalty-free license in the government.[103] Employed inventors have full rights only to inventions in the third category: those to which the government cannot claim title and does not choose to reserve a license.[104] Although President Truman's Order conformed approximately to the contours of the common law,[105] the breadth of its first category ensured that the government retained title to most inventions produced with its support.

In 1963, another executive order, the "Kennedy Memorandum," extended title policy to inventions made by government contractors.[106] The Memorandum set up two categories of inventions. In one, the government reserved "principal or exclusive rights throughout the world," while in the other the contractor could acquire greater rights than he would possess with

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102 *Id.* at 292. *See* 37 C.F.R. § 100.6(b)(1) (1978).

103 3 C.F.R. 292, 292 (1949-1953 compilation). *See* 37 C.F.R. § 100.6(b)(2) (1978).

104 3 C.F.R. 292, 292-93 (1949-1953 compilation). *See* 37 C.F.R. § 100.6(b)(4) (1978). The Order also created a Government Patents Board to coordinate and advise on policy and to resolve disputes between employees and the various agencies over rights in inventions. *See* 3 C.F.R. 292, 293-94 (1949-1953 compilation). In 1961, President Kennedy abolished this Board and transferred its functions to the Department of Commerce, *see* Executive Order 10930, 3 C.F.R. 456 (1949-1953 compilation), where it remains today, *see* 37 C.F.R. § 100.2 (1978).

105 Despite its resemblance to common law, *see* Orkin, *supra* note 40 at 652; F. NEUMEYER, *supra* note 53, at 235, President Truman's Order effected a substantial change in existing practice. During the period from 1950 to 1954, the percentage of patented inventions assigned to the government by employees increased from 20% to 41%, while the percentage of inventions subject only to a royalty-free government license decreased from 80% to 59%. *See* F. NEUMEYER, *supra* note 53, at 234-35. *See also* Finnegan & Pogue, *supra* note 83, at 923-24, 923 n.73. This change in practice was especially significant at the Department of Defense, where employees at the time of the Order submitted 82% of all government employee patent applications. The Defense Department had previously favored a more liberal incentive policy toward employees' rights and had fought a losing battle to keep title policy out of Order 10096. *See* F. NEUMEYER, *supra* note 53, at 228.

106 28 Fed. Reg. 10,943-46 (1963). *See generally* F. NEUMEYER, *supra* note 53, at 243-48.

a nonexclusive license.[107] The classification of inventions depended primarily upon the purpose of the government contract. Inventions fell into the first category if a principal purpose of the contract was innovation for commercial use by the general public or research directed toward the public health or welfare. Inventions also fell into the first category if the contract was in a field dominated by government-sponsored research or if the contract was for operation of a government research or production facility or for the coordination of other government work.[108] In essence, the outlines of the first category reflected a title policy based upon a combination of common law and solicitude toward the public interest: the government retained title to inventions when it controlled the innovative process and when those inventions were vital to an essential public interest.

To a certain extent, however, the Kennedy Memorandum represented a backlash from the rigid title policy of the Truman Order. It recognized that complete uniformity of patent policy among the many governmental agencies was not feasible.[109] More importantly, the outlines of the second category of inventions, those to which the contractor could retain more than nonexclusive rights, reflected a sensitivity to contractors' commercial interests and the needs of federal agencies for discretion in allocating patent rights. Inventions fell into this second category if innovation were not a principal purpose of the contract, if the contractor had an established nongovernmental patent position in the area of research, or if the agency head certified that giving the contractor more than nonexclusive rights would best serve the public interest.[110] These rules allowed private concerns to accept government research contracts in their areas of technological dominance without fear of government preemption of their research.

The title policy of the Kennedy Memorandum remained in effect for only eight years, however. In 1971, President Nixon in-

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107 28 Fed. Reg. 10,944-45 (1963); *see* F. NEUMEYER, *supra* note 53, at 245-46.
108 28 Fed. Reg. 10,944 (1963).
109 28 Fed. Reg. 10,943 (1963).
110 28 Fed. Reg. 10,945 (1963).

itiated a new phase of government patent policy now known as "exclusive licensing policy."[111] Under the Nixon Memorandum, which is still in force today, the government retains title to patents where required by the Truman Order or Kennedy Memorandum, but it can grant exclusive licenses to private industry.[112] Agencies are permitted to revoke nonexclusive licenses and grant exclusive ones where exclusivity is necessary to encourage exploitation.[113] Even when a contract would fall in the first category of the Kennedy Memorandum, the Nixon Memorandum allows an agency to grant exclusive rights if they are "a necessary incentive to call forth private risk capital and expense to bring the invention to the point of practical application," or if the government's contribution to the invention is relatively insignificant.[114] With certain limitations, the Nixon Memorandum allows exclusive rights to be granted in inventions in the Kennedy Memorandum's second category under regulations promulgated by the agencies.[115]

It is too soon to tell whether the Nixon Memorandum actually has changed the direction of government patent policy. The notion of granting exclusive rights in government property is still controversial,[116] and the government's power to make such grants has been disputed.[117] For two reasons, private firms may not take full advantage of the opportunity under the Nixon Memorandum to take exclusive licenses on other companies' inventions made with government funds. First, smaller firms and entrepreneurs are unlikely to be aware of the existence or value

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111 36 Fed. Reg. 16,887-92 (1971). *See generally* Note, *Waiver and Exclusive Licensing of Government-Financed Patents: The Due Process Requirement,* 41 GEO. WASH. L. REV. 348, 348-49 (1972).

112 36 Fed. Reg. 16,891 (1971).

113 *Id.*

114 *Id.* at 16,890.

115 *Id.*

116 *See* Note, *supra* note 111, at 349-50.

117 In a private action, Ralph Nader's organization, joined by 17 Congressmen, sued on constitutional grounds to void the regulations promulgated by the Administrator of the General Services Administration, 38 Fed. Reg. 23,782-91 (1973), to implement the Nixon Memorandum. The court, however, dismissed the suit for lack of standing. Public Citizen, Inc. v. Sampson, 379 F. Supp. 662, 664, 667 (D.D.C. 1974), *aff'd without opinion,* 515 F.2d 1018 (D.C. Cir. 1975).

of government-owned patents.[118] Second, the company which originally makes an invention has certain natural advantages over competitors in developing it.[119] Consequently, the practical effect of the Nixon Memorandum may simply be to allow those agencies, like the Department of Defense, which traditionally have favored liberal grants of exclusive rights to contractors[120] to return to their former policies.

E. *The Employed Inventor's Position in Practice*

In 1966, there were 1.4 million scientists and engineers in the United States. Of these, 71 percent were employed in industry, 15 percent in federal, state, and local government, 13 percent in universities and colleges, and less than 1 percent in nonprofit institutions (including self-employment).[121] Nearly all large companies responsible for the bulk of industrial research require their technical employees to sign invention assignment agreements, and, given the relative liberality and uncertainty of the common law, it is in every corporation's interest to demand such agreements of all employees who might conceivably invent anything.[122] It is therefore reasonable to assume that nearly all of the 71 percent of American scientists and engineers who work in industry have executed some sort of assignment agreement.[123]

Of the 15 percent of all scientists and engineers employed by government, about two-thirds are employed at the federal level.[124] These personnel are governed by the Truman Order, which deprives them of all rights in work-related inventions.[125] Thus, if self-employed inventors and those employed by univer-

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118 *See* Note, *supra* note 111, at 359 (doubtful that ordinary small businessman would recognize value of invention from brief notice in Federal Register).

119 *See* text accompanying notes 224 to 225 *infra*.

120 *See* F. NEUMEYER, *supra* note 53, at 228.

121 *See id.* at 17.

122 *See, e.g.*, Orkin, *supra* note 40, at 650. *But see* Doherty & Iandiorio, *supra* note 50, at 32-34 (courts, by narrow construction of assignment agreements, seek to minimize the employee's loss in the transition from common law status to contract).

123 *See* F. NEUMEYER, *supra* note 53, at 89; Orkin, *supra* note 40, at 650-51.

124 *See* F. NEUMEYER, *supra* note 53, at 18 (by inference).

125 *See* text accompanying notes 101 to 105 and note 105 *supra*.

sities and nonprofit institutions are considered to be free agents,[126] about four out of five technical employees in the United States are subject to some sort of obligation, either contractual or administrative, to relinquish rights in their inventions.

Can these four out of five inventors in practice retain any rights in their creations? Federal employees do have the right to appeal adverse decisions allocating patent rights to the Commissioner of Patents and Trademarks within the Department of Commerce.[127] Because of the Truman Order's title policy, however, those employees are likely to lose such appeals if the invention relates more than minimally to their government work.[128] Perhaps the security of a civil service job would allow a federal employee the luxury of challenging his superiors' allocation of patent rights without adverse effects on his working environment,[129] but such a challenge would be costly and time-consuming. Consequently, a federal employee would find it difficult successfully to claim rights in a valuable invention from the federal government and would be reluctant to try to do so unless business wanted the invention very badly, or unless he were in a position to exploit it himself.

The patent rights of the 71 percent of scientists and engineers employed in private industry are in practice circumscribed even more than those of federal employees. Courts routinely grant employers specific enforcement of assignment agreements, and those agreements are typically at least as comprehensive as Truman's Order.[130] Moreover, an industrial employee, unprotected by civil service tenure, faces far more severe sanc-

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126 Although most universities and colleges require their research personnel to sign assignment agreements, the patent policies of these institutions vary widely. Many are relatively liberal and either allow the inventor to take a patent on his own or grant him a percentage of royalties on patents prosecuted by the institution. *See Space Age, supra* note 40, at 10-11. *See generally* F. NEUMEYER, *supra* note 53, at 425-95 (case studies).

127 *See* 37 C.F.R. § 100.7 (1978); note 104 *supra.*

128 *See* 37 C.F.R. §§ 100.2, 100.6 (1978).

129 *See Space Age, supra* note 40, at 10.

130 *Cf. id.* at 9 ("The [Kennedy] Memorandum is generally more generous to the contractors than the latter are likely to be to their employees"). *But see* Doherty & Iandiorio, *supra* note 50, at 32-34 (courts, by narrow construction of assignment agreements, seek to minimize the employee's loss in the transition from common law status to contract).

tions for his decision to assert rights in his invention than does his governmental counterpart. Even if he is not dismissed,[131] his superiors may strip him of significant research responsibility or shift him into an area of research which is unlikely to produce commercially important results. In addition, the displeasure of management may make the inventor's work unpleasant and tense, even without such overt sanctions.

Whether or not the inventor remains with the employer, the cost of challenging a facially valid assignment agreement, facing a wealthy corporate opponent, would probably dissuade the inventor from instituting any legal action. Even if the inventor quit his job and started a spin-off company, the fight over patent rights would likely drain the lifeblood of the fledgling enterprise.[132] Although the employee has the option of joining another company large enough to pay the legal bill, the new employer would also have enough bargaining leverage to demand in return a sizable share of rights in the invention.

If technical employees joined unions,[133] they could oppose assignment agreements through the collective bargaining process. Scientists and engineers have not organized, however, and, for several reasons, they are not now likely to do so.[134] First,

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131 A retaliatory firing may be further grounds for legal action. *See* Pstragowski v. Metropolitan Life Ins. Co., 553 F.2d 1, 2-3 (1st Cir. 1977) (applying New Hampshire law); Frampton v. Central Indiana Gas Co., 260 Ind. 249, 253, 297 N.E.2d 425, 427-28 (1973) (retaliatory discharge for filing workmen's compensation claim held actionable); Monge v. Beebe Rubber Co., 114 N.H. 130, 133, 316 A.2d 549, 551 (1974) (retaliatory discharge of woman employee who refused to socialize with foreman held malice and breach of contract); Nees v. Hocks, 272 Or. 210, 219, 536 P.2d 512, 515-16 (1975) (en banc) (retaliatory discharge of employee serving on jury held actionable). *But see* Becket v. Welton Becket & Associates, 39 Cal. App. 3d 815, 819-22, 114 Cal. Rptr. 531, 532-35 (1974). The prospect of maintaining such an action while unemployed, however, in addition to claiming title to the invention, would discourage all but the most hardy inventors.

132 *Cf. Economic Aspects Hearings, supra* note 68, at 34-37, 43-46 (remarks of Henry Blackstone, President, Servo Corp. of America) (even valid patent may not be valuable to small company as large companies can litigate it to death). *See also* Picard v. United Aircraft Corp., 128 F.2d 632, 641-42 (2d Cir.), *cert. denied,* 317 U.S. 651 (1942) (Frank, J., concurring) (well-financed patentee can enforce monopoly on "spurious" patent by threat of litigation).

133 *See generally* F. NEUMEYER, *supra* note 53, at 163-206. In a few instances, collective bargaining has succeeded in moderating the more oppressive terms of assignment agreements. For case studies of 11 corporations, *see id.* at 177-96.

134 *See Space Age, supra* note 40, at 27-28; F. NEUMEYER, *supra* note 53, at 163-65; *Innovation Hearings, supra* note 1, at 72-73 (remarks of Robert Kuntz, Past Pres. & Nat'l Dir., Cal. Soc'y of Professional Eng'rs).

they consider unionization unnecessary and demeaning to their status as white collar employees and independent professionals. Second, many inventors aspire to management positions and have no desire to alienate their superiors. Third, even when inventors do attempt to organize, conflicts with blue collar workers create difficulties in defining the appropriate bargaining unit, because those workers, represented by existing unions, often do similar or related work. Finally, when technical personnel do join existing unions, the patent rights issue is of concern only to a minority of union members, and so falls to the bottom of the agenda.[135]

Thus, the prevalence of mandatory assignment agreements and the inability of all but a small fraction of employees to modify the standard form of those agreements, mean that most employed inventors lose all rights in their inventions at the outset.[136] Surveys show that they react to this state of affairs by becoming indifferent to the patent system and somewhat apathetic toward the innovative process.[137] Without the patent incentive, employees hesitate to "fight city hall" and do not attempt to goad the ponderous institutions in which they work into accepting new ideas. Thus, in practice, the administrative and contractual restrictions of the employed inventor's legal rights eliminates the incentive that the Constitution intended Congress to provide.

F. *The Fundamental Question of Patent Policy*

Although employers and the courts bear greater responsibility for the destruction of patent incentives than does the government, part of the blame lies with the increasing acquisitiveness of government patent policy. The government,

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135 *See* F. NEUMEYER, *supra* note 53, at 196-98.

136 *See id.* at 197-98; *Space Age, supra* note 40, at 19-22; *Innovation Hearings, supra* note 1, at 73 (remarks of Robert Kuntz, Past Pres. & Nat'l Dir., Cal. Soc'y of Professional Eng'rs).

137 *See* Orkin, *supra* note 2, at 734-35 (citing Rines, *A Plea for a Proper Balance of Proprietary Rights,* IEEE SPECTRUM, Apr. 1970, at 45) (85% of engineers surveyed reported that patent system had no meaning for them as individuals; 84% noted lack of incentive to embark on "risky and unpopular" role of fighting for adoption of significantly new concepts or for expansion of employer's operations).

however, did not change its patent policy blindly. Policymakers argued that the efficient use of government funds and the need to avoid the evils of monopolization demanded government ownership of patents. The difficulty was that these arguments did not address directly the fundamental question of patent policy: whether special incentives are necessary and effective in promoting "the Progress of Science and useful Arts."[138]

This fundamental issue was first raised, but ultimately avoided, in a 1933 United States Supreme Court opinion, *United States v. Dubilier Condenser Corp.*[139] That case involved two government employees in the Bureau of Standards who had been assigned to work on "airplane radio." Without instructions from their superiors, the two men tackled problems assigned to other groups, as well as problems suggested by their own scientific curiosity.[140] They produced several important inventions, which they patented and assigned to a private company.[141]

The government filed suit to compel assignment of the inventions to it, arguing that "[i]t is against public interest that private individuals should collect royalties for the use of inventions developed at public cost."[142] The inventors, however, argued that under common law the government's interest in the inventions should be limited to shop rights.[143]

Writing for the majority, Justice Roberts upheld the inventors' position by straightforward application of the common law.[144] He ruled that the United States had no more rights in patents than would any other employer, and that the government would therefore be limited to shop rights unless it could prove that the employee had been hired to invent or assigned to

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138 *See* note 17 *supra.*

139 289 U.S. 178 (1933).

140 *Id.* at 183-85. Although their superiors later approved their work, the Court found it to have been "independent . . . and voluntarily assumed." *Id.* at 185. *Cf.* Houghton v. United States, 23 F.2d 386, 387-90 (4th Cir.), *cert. denied,* 277 U.S. 592 (1928) (employee working on well-defined government assignment, with avenues of research suggested by his government supervisors, forced to assign patent title to government).

141 289 U.S. at 184-86.

142 *Id.* at 181.

143 *Id.* at 185-86.

144 *Id.* at 182.

develop the specific inventions at issue.[145] Since he saw no evidence that either of the two employees had been hired to invent or assigned to develop those devices which they later patented, Justice Roberts limited the government to shop rights.[146]

The *Dubilier* decision is interesting not because of its pedestrian application of the common law, but because of the responses of the dissent and the majority to the government's public interest argument. Justice Stone, in his dissent, adopted the government's argument entirely.[147] He objected to treating the government like a private employer, because the government conducts research work in the public interest, not for private gain.[148] Moreover, he felt that a patent monopoly held by individual employees would destroy the government's freedom to use the invention for the public good in the most effective way, shop rights notwithstanding.[149] Finally, he argued that the two inventors, by accepting employment in the public service, "necessarily renounced the prospect of deriving from their work commercial rewards incompatible with [that service]."[150]

Justice Roberts was more cautious. Concerned about the lack of apparent limits to the public interest doctrine, he posed a series of incisive rhetorical questions, which laid bare the heart of the matter — the unanswered questions of legislative policy upon which the Court's decision logically should depend:

> Will permission to an employee to enjoy patent rights as against all others than the Government tend to the improvement of the public service by attracting a higher class of employees? Is there in fact greater benefit to the people in a dedication to the public of inventions conceived by officers of government, than in their exploitation under patents by private industry? Should certain classes of invention be

145 *Id.* at 189-92.
146 *Id.* at 193-99.
147 *Id.* at 217-18 (Stone, J., dissenting).
148 *Id.* at 217 (Stone, J., dissenting). *Cf.* Houghton v. United States, 23 F.2d 386, 390-91 (4th Cir.), *cert. denied,* 277 U.S. 592 (1928) (that employee's invention is very useful for improving the public health is alternative ground for giving government title to patent).
149 289 U.S. at 217 (Stone, J., dissenting).
150 *Id.* at 218 (footnote omitted) (Stone, J., dissenting):

> treated in one way and other classes of invention be treated differently? These are not legal questions, which courts are competent to answer. They are practical questions, and the decision as to what will accomplish the greatest good for the inventor, the Government and the public rests with the Congress.[151]

Unwilling to face the unresolved issues of policy, Justice Roberts and the majority felt compelled to decide the case according to established principles of common law.

The crux of the difference between majority and dissent in *Dubilier* seems to be that the latter treated the invention as a *fait accompli,* whose benefits were to be apportioned after the fact. Because the government had supplied the necessary resources and materials for innovation, Justice Stone correctly realized that the inventors did not deserve the patent monopoly as a *reward.* What Justice Stone failed to realize was that, while the patent monopoly does not serve as a reward for the past efforts of inventors, it must serve as an incentive for future innovation by others. As the majority noted, a monopoly in existing goods "takes something from the people," but an inventor's patent monopoly "deprives the public of nothing which it enjoyed before his discoveries."[152] Thus the majority recognized that the underlying policy issue is not simply how to divide the rights in a patented invention, but how best to encourage invention itself.

Thirteen years after Justice Stone's dissent, an exhaustive report by the Attorney General to the President wholeheartedly embraced the policy supported by the government in *Dubilier.*[153] Authored by then Attorney General Thomas Clark, this Report recommended that all government employees be re-

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151 *Id.* at 198-99. Justice Roberts also reasoned that certain congressional enactments, as well as Congress' failure to adopt a proposed statutory requirement for compulsory assignment of all inventions made by federal employees, indicated general approval of license policy. *See id.* at 199-209.

152 *Id.* at 186.

153 1 CLARK REPORT, *supra* note 5, at 28-29, 76 (recommendation of "title policy" for inventions produced by both government employees and government contractors).

Even before the *Dubilier* decision, however, certain federal agencies had adopted title policy in restricted classes of cases. *See* 2 CLARK REPORT, *supra* note 5, at 7-8 (Dep't of Agriculture); *id.* at 82-85 (Dep't of Commerce); *id.* at 426-27 (War Dep't). *But see id.* at 260-64 (Navy Dep't); *id.* at 174-77 (Dep't. of Interior).

quired to assign to the government rights in their inventions and that, except in emergency situations, government contractors be covered by and held to assignment agreements[154] for inventions made in the course of performance of their contract.[155] The Attorney General's arguments for this position,[156] backed by voluminous statistics and numerous testimonials of corporate and government supervisors,[157] undoubtedly constitute the most forceful brief for title policy yet written.[158]

In essence, the Attorney General's Report attempted to prove that ownership of patents by government employees and contractors is unnecessary as a stimulus for innovation, disrupts orderly research and development work, and imposes unwarranted and unfair charges upon the public, which has paid for the research. The average government scientist or technician, according to the report, has little interest in patent rights, but is attracted to government employment by the security of tenure, good research facilities, and the opportunity for selfless public service.[159] Moreover, the Report argued that ownership of patent rights is but a weak incentive because the value of those rights in any given case is extremely uncertain,[160] and it noted that the experience of government agencies and private employers showed that retention of patent rights by the employer does not interfere with successful research.[161]

The Report went beyond asserting that patent incentives are

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154 1 CLARK REPORT, *supra* note 5, at 56-61.

155 *Id.* at 76, 87-88.

156 *See* 1 CLARK REPORT, *supra* note 5, at 38-54.

157 The "Final Report Proper" in volume 1 of the CLARK REPORT is supported by, and presumably derived from, 19 separate monographs on the law governing employees' inventions and the practices of various government agencies, foreign countries, educational and nonprofit organizations, and leading industrial laboratories. *See id.* at 1.

158 Neumeyer reports that "[t]his catalogue of disadvantages and possible misuses [of license policy] has never been officially analyzed or refuted," but he cites Finnegan & Pogue, *supra* note 83, as having "aptly pointed out some of the doubtful arguments." F. NEUMEYER, *supra* note 53, at 223-24.

Certain gaps in the refutation remain, however, and it is hoped that the following pages will fill them. *See* text accompanying notes 168 to 173 *infra*.

159 1 CLARK REPORT, *supra* note 5, at 40.

160 *Id.* at 40, 45-56.

161 *Id.* at 41-45.

unnecessary. It argued that ownership of patents by employees and contractors is positively detrimental to the progress of ongoing, cooperative research and development. Patent incentives, argued the Report, make employees "patent conscious" so that they become secretive, neglect assigned problems which have no potential commercial application, waste effort trying to circumvent existing patents, and refuse to cooperate fully with others.[162] In addition, patent ownership allegedly creates fears among cooperating private concerns that they may be foreclosed from participation in the results of research by other enterprises' patent monopolies,[163] and fosters conflicts of interest when technically expert employees must evaluate devices on which they hold patents for government procurement.[164] Finally, the Report viewed patent rewards as unfair to government employees because they single out the class of scientific and technical workers for special treatment and, within that class, those assigned to do work with potential commercial value, and because they arbitrarily select from among a whole task force the particular person who may have been responsible for the patentable portion of a project.[165]

But the most compelling of the Report's arguments were the economic ones. The Report asserted that private ownership of patent rights in government-financed inventions unfairly allows the employee or contractor to suppress the invention or to levy a private toll for public use of an invention developed with public funds, thus compelling the public to pay twice for the same benefit.[166] Furthermore, if the employee sells his invention to an exploiter who takes the bulk of the monopoly profits and gives the inventor only a small royalty, the public is forced to pay a further unfair levy to the extent that most of the royalties it pays do not benefit the inventor.[167] In any case, argued the Report, the public should not be burdened with a

162 *Id.* at 50-51.
163 *Id.* at 47-49.
164 *Id.* at 49-50.
165 *Id.* at 51-52.
166 *Id.* at 46-47.
167 *Id.* at 52.

seventeen-year monopoly merely to correct an inadequacy in the employee's compensation.[168]

To a certain extent, the Report's first two arguments are contradictory. On the one hand, the Attorney General argued that patent incentives are ineffectual[169] because government employees long only for secure tenure and selfless public service.[170] But on the other hand, he argued that patent incentives have widespread and powerfully disruptive effects. If the desire for patent rights is strong enough to disrupt cooperation in research, create a cadre of "patent-conscious" employees willing to neglect their assigned responsibilities, and foster conflicts of interest in government procurement, it must be a powerful incentive indeed. Thus the Attorney General's own arguments implicitly recognize that human beings, perhaps irrationally, will often work very hard for a small chance at a great reward. Moreover, the disruptive effects themselves — jealousy, conflicts of interest, "patent-consciousness," and discrimination among different classes of employees — can be minimized by proper management of cooperative research.[171]

In any case, the linchpin of the Attorney General's Report, often repeated by critics of license policy, is the economic argument. According to this argument, the public "pays twice" when it allows private ownership of patents on government-financed inventions: once for support of research and once for patent royalties.[172] Like Justice Stone's dissent in *Dubilier,*

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168 *Id.* at 52.

169 "The weight of informed judgment is that the man of science in Government invents because it is his bent . . . and that the highly problematical financial return from patent rights is not an important incentive towards scientific discovery." 1 CLARK REPORT, *supra* note 5, at 40.

170 "[T]he excellent research facilities, the security of tenure and other advantages of Government services are important attractions to the scientist and technician. . . ." *Id. But see* Finnegan & Pogue, *supra* note 83, at 945-48, 948-49 n.143 (possibility of exclusive rights in inventions, subject to government shop right, attracts qualified personnel from industry to government despite lower salaries).

171 *See* Finnegan & Pogue, *supra* note 83, at 933-35.

172 This argument takes its most vivid form in the analogy of inventions to toll bridges. Critics claim that research and development contracts which allow contractors to retain patent rights in inventions produced under the contract are like bridge construction contracts which allow contractors to collect a toll for traffic across the bridge after the funding agency covers building costs, plus a reasonable profit. *See, e.g., Economic Aspects Hearings, supra* note 68, at 48 (remarks of Richard J. Barber, Ass't

however, this argument depends on the fallacious premise that innovation is just another commodity, to be bought and sold at the market price. It assumes that once the government has provided a laboratory and paid the inventor an adequate salary, there is nothing more to be gained from extra or special incentives. It thus begs the question which lies at the heart of patent policy: does the potential patent monopoly provide an additional incentive to spur further creativity and further work? If in fact an employee works harder, or thinks more about his work in his spare time, or works *differently* due to his consciousness of the potential patent reward, then the argument falls flat.

The same holds true for the share of patent royalties which goes to the investor or company providing the capital for exploitation of the new idea. That share is not a mere superfluous reward for the development of an idea already paid for by the government, but an incentive to provide the capital and the effort necessary to overcome human resistance to change and transform that embryonic idea into a marketable finished product. The public "pays twice" for this innovative process only if government research funds provide the support for development, exploitation, and marketing of the innovation, as well as for its conception.

Nor does it suffice to argue, as the Attorney General did, that employer or government ownership of patents does not interfere with successful research. There is a vast gulf between noninterference and positive promotion of the type of successful innovation which has made this nation technologically preeminent. Moreover, the conclusion that title policy does not interfere with successful research may have been premature. The Report was written immediately after the Second World War, when the radical transformation caused by the wartime explosion in government research funding was still new. Although private employers had indeed insisted on invention

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Prof. of Law, Southern Methodist Univ.). *See also id.* at 19 (remarks of Sen. Russell B. Long, Chm.).

The argument errs, however, in assuming tacitly that a task like building a bridge, which may be planned entirely in advance, is similar to inventing, which may be entirely unpredictable in both method and chronology and may call for considerably more risk-taking.

assignment agreements for some time, there may not have been sufficient time for the full effect of that transformation — and the resulting reduction in incentives — to make itself known. The effect of incentives is often subtle, but nevertheless it is real. The collective force of millions of individual decisions to go home at five o'clock rather than to work and think after hours, because the rewards for greater effort are too remote, is perhaps only now becoming apparent.

If Attorney General Clark and Justice Stone were right, and if employee ownership of patents in government-financed inventions is counterproductive, then perhaps the patent system as a whole has outlived its usefulness and should be scrapped. Today most inventions are produced, either directly or indirectly, with government support, and it makes little sense to go to the expense and delay of patenting inventions when the government itself will ultimately hold almost all of the patents. But before policymakers accept a series of arguments which ultimately strikes at the heart of a system embodied in our Constitution, they should examine closely the nagging question left unanswered by all the arguments and statistics. Are a secure job and an adequate salary sufficient incentive for the scientists and engineers in our nation today to "promote the Progress of Science and useful Arts"?

II. Toward an Effective Incentive System for Innovation

A. *A Model of the Innovative Process*

Like the analysis of Attorney General Clark,[173] much discussion of the patent system merely restates the questions which lie at the heart of its policy and constitutional purpose. Can incentives spur innovation? If so, what incentives and how? These questions cannot be answered without careful analysis of the innovative process and the roles of the people who take part in that process.

Until now, most courts and commentators have viewed the

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173 *See* text accompanying notes 153 to 173 *supra.*

process of innovation as a performance by two hypothetical actors — the inventor and the investor.[174] This two-party model of invention probably reflected the structure of industry before the end of the Industrial Revolution. Then, an inventor worked alone or in a small business. Once he had conceived a new idea and had reduced it to practice sufficiently to prove its merit, the inventor sold it to the proprietor of a large business or an individual investor, who had little acquaintance with its technology but had the money or the organization to produce it. If the inventor and the investor could strike a deal on the basis of free and equal bargaining, the process of commercial development and exploitation could begin.

Even today, this "cottage industry" model of innovation has two advantages as an explanatory device. First, it is simple. Second, even where it does not apply precisely, it serves as a sort of allegory of the actual process of innovation. The hypothetical single inventor, oblivious to considerations of time, cost, and difficulty, stands for the forces of creativity. The "investor" stands for the forces of economic reality, *i.e.*, for those people who must decide whether and how to allocate resources to developing the new idea. The hypothetical investor's personal decision to commit resources to a new idea represents an

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174 Judicial opinions have concentrated on the patent's constitutional purpose as a spur to inventors. *See, e.g.*, Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 480-81 (1974); Sears, Roebuck & Co. v. Stiffel Co., 376 U.S. 225, 229 (1964); Mazer v. Stein, 347 U.S. 201, 219 (1954). Yet some judges and observers have recognized the role of the investor in providing risk capital for development and production. *See* Picard v. United Aircraft Corp., 128 F.2d 632, 643 (2d Cir.), *cert. denied*, 317 U.S. 651 (1942) (Frank, J., concurring) ("The [wartime] controversy between the defenders and assailants of our patent system may be about a false issue — the stimulus to invention. The real issue may be the stimulus to investment."); *Innovation Hearings, supra* note 1, at 90-92 (remarks of Dr. William McLean, Dir., Naval Underseas Lab.); BUSH STUDY, *supra* note 5, at 2-6 (scientists invent out of a desire to advance the art, oblivious to patent rights, but the patent system is necessary to call forth risk capital to develop inventions). *See also Innovation Hearings, supra* note 1, at 152 (remarks of John Stephens, Excel Mineral Corp., representing Dr. William Bollay) (patentable invention is only the starting point of development).

Occasionally, commentators have recognized the need for incentives for *both* the person who conceives the idea and makes it work *and* the person who provides the risk capital. *See, e.g., Innovation Hearings, supra* note 1, at 51 (remarks of Dr. William Miller, Vice Pres. & Provost, Stanford Univ.). However, the author has discovered no detailed discussion of incentives and the division of labor in the innovative process as it actually exists in modern research and development laboratories.

economic judgment that the inventor's idea is worth the cost of its development, refinement, and exploitation. Thus, the "cottage industry" model broadly depicts two desirable properties of the innovative process: creativity and efficiency.

Nonetheless, the "cottage industry" model can be quite misleading if applied literally today. The ultimate "investor" today is the corporate shareholder or the individual taxpayer, but neither of them has any direct control over particular investment decisions.[175] Rather, the decision whether to allocate economic resources to a particular innovation or area of research is made by supervisors and middle-level managers within a corporation or by bureaucrats within the federal government. Consequently, it is no longer adequate to assess incentives for innovation simply in terms of how they would affect two hypothetical persons, one with ideas and no money, and the other with money and no ideas. An effective incentive system must address itself to the real actors in today's innovative drama: the scientists and other technical personnel who invent in corporate and government laboratories, and the supervisors, managers, and bureaucrats who allocate resources among them.

1. Stages in the Innovative Process

It is no longer true, if it ever was, that innovation consists simply of conception by the inventor, a little work in the home laboratory, and the investor's decision to invest. In modern research and development, the innovative process involves many distinct stages, most of which require the cooperation, if not the active participation, of people performing several different roles. What follows is a description of the entire process, drawn from the author's experience in research and development.

The first stage in innovation is the recognition of a need. "Necessity," goes the old saw, "is the mother of invention."[176] Occasionally, successful conception may immediately follow

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175 *See* text accompanying notes 30 *supra* and 180 *infra*.

176 J. BARTLETT, FAMILIAR QUOTATIONS 133b, 151a (14th ed. 1968).

recognition of a need, but normally a lengthy period of trial and error separates recognition from conception of a successful new idea. Some innovations satisfy a "long felt need," which the patent law recognizes as one of the criteria of successful invention.[177]

Once the need is recognized, those who collectively play the role of "investor" must decide whether to commit resources to meet the need. Often this decision follows an inventive conception. In modern research institutions, it may involve considerable interaction among technical personnel, corporate managers, and government contract monitors, who may establish or modify priorities for various research and development projects, often basing their decisions on expensive and lengthy cost-benefit analyses.

After a decision is made to meet a particular need, those in charge of the innovative process must decide how to approach the problem, which areas of technology are relevant, and which individuals, groups, or laboratories should start the work.[178] A single manager, a single inventor, or, in large projects, a conference of managers and inventors may make this decision.

The next stage of invention is the most well-known stage: the imaginative conception, or "flash of genius" behind the innovation.[179] Conception is a peculiarly personal phenomenon; it can occur at any time, not necessarily during working hours, and it belongs to the inventor alone.

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177 *See, e.g.*, Eibel Process Co. v. Minnesota & Ontario Paper Co., 261 U.S. 45, 67-68 (1923); Evans v. Watson, 142 F. Supp. 225, 227, 229 (D.D.C. 1956).

178 Neglecting this stage in the process can increase the costs of later stages enormously. *See Innovation Hearings, supra* note 1, at 154 (remarks of John Stephens, Excel Mineral Corp., representing Dr. William Bollay).

179 Every innovation is, by definition, the realization of a new idea, but a patentable invention must satisfy the statutory criterion of nonobviousness. *See* 35 U.S.C. § 103 (1976). *See also* note 219 *infra*. Patentability, however, does not depend upon the "manner in which the invention was made." 35 U.S.C. § 103 (1976). Despite intimations in some judicial opinions that trial-and-error methods and step-by-step experimentation cannot produce true "invention," *see, e.g.*, Potts v. Coe, 145 F.2d 27, 28-29 (D.C. Cir. 1944) (Arnold, J.); Picard v. United Aircraft Corp., 128 F.2d 632, 636 (2d Cir.), *cert. denied*, 317 U.S. 651 (1942) (L. Hand, J.), or that patentable invention requires a "flash of creative genius," *see* Cuno Eng'r Corp. v. Automatic Devices Corp., 314 U.S. 84, 91 (1941), the Supreme Court has denied any intention to raise the traditional standard of invention. *See* Graham v. John Deere Co., 383 U.S. 1, 12-17 & n.7 (1966). Consequently, an invention may be patented whether the idea behind it arises from an individual's "brainstorm," a group discussion, methodical trial and error, or serendipity.

Because conception is a personal phenomenon, the inventor in the next stage must sell his idea to other participants in the innovative process before development can proceed. Occasionally, the inventor presents his idea to an audience that immediately appreciates its value. More often, however, the value of the new idea is not immediately apparent, and the inventor must convince his colleagues and management of its worth.[180] In such cases, the inventor or lower-level management may have to incur costs — time, energy, the risk of "sticking one's neck out," or even the costs of making a model outside normal channels — to avoid abortion of the innovative process. Indeed, the inventor may have to refine the idea on his own time in order to develop it to the point at which its value is evident. Thus, selling the idea may overlap, and indeed may require, subsequent stages of the innovative process.[181]

Once the decision is made to commit resources to a particular conception in order to meet a recognized need, a working model must be built[182] and refined for production and use. Refinement may be necessary to meet economic goals, to improve ease of production, or to solve problems encountered in the course of building the working model. If serious problems or new needs are encountered during this stage, the whole innovative process may begin again, in miniature, and distinct inventions may result.[183]

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180 *See* text accompanying notes 30 to 32 *supra*.

181 The costs involved in this step are significant. For example, the cost of preparing competitive bidding proposals for the space shuttle engine and the F-15 came to almost $50 million for the two projects. *See Innovation Hearings, supra* note 1, at 75 (remarks of Robert Kuntz, Past Pres. and Nat'l Dir., Cal. Soc'y of Professional Eng'rs).

182 This phase corresponds to "actual reduction to practice" in patent law parlance, *see* 1 A. DELLER, WALKER ON PATENTS § 46, at 205-06 (2d ed. 1964), a concept distinct from "constructive reduction to practice," which, for purposes of determining priority of invention, may mean simply diligent preparation and filing of a proper patent application, *see id.* at 210-13.

This stage is important legally because the government often reserves title to inventions "first actually reduced to practice" under a government contract, regardless of whether or not they were conceived under the contract. *See* Armed Services Procurement Regulations, 32 C.F.R. §§ 7-302.23(a) - .23(i) (1976). *See generally* Davis, *Patent Licenses under Government Contracts: New Judicial Scrutiny*, 55 J. PAT. OFF. SOC'Y 503 (1973).

183 The production and refinement of a working model may coincide if the first working model performs as desired. The innovative process, however, cannot continue without both *some* model that works and at least one model that meets the physical and economic criteria for profitable exploitation.

Before an innovation can be diffused throughout society, it must be capable of being produced economically. Reaching this goal may require considerable work even after the development of an acceptable refined working model. Moreover, economically feasible production may demand additional innovation in the form of product improvements, patentable processes, or production machines. Since the particular market may determine the method of production, the marketing and exploitation stage may overlap this stage of the process.

The final stage of the innovative process is that of exploitation and marketing. The new idea, embodied in a form capable of mass production, must be made available to its ultimate users,[184] the purchasing public. But the innovative process does not necessarily end with this stage. The marketing process may reveal defects or new needs which require further refinement or further innovation. Consequently, attempts to market a new idea may begin a new stage in, or a whole new cycle of, the innovative process.

The preceding paragraphs illustrate three important features of the innovative process. First, various actors in the process may participate at each stage, but all the actors incur significant personal costs at each stage. These costs take the form of sleepless nights thinking about a problem, extra work in developing or proving an idea, beating competition, or "bucking the system," and risks to one's career in backing an idea or device whose merit is not obvious. Moreover, managers and supervisors incur costs when they are called to account for resources used, as employees spend time and use space, supplies, and materials. In addition, managers and supervisors must accept the risk that employee morale, corporate prestige, or market share will suffer if the new idea is unsuccessful, as well as the risk that preconceived plans and schedules will be disrupted. These costs and risks are no less real because some of

184 Since "marketing" includes both advertising and educating potential users, this step could be considered part of selling the idea. This sort of "selling," however, is usually paid for by different people and involves a significantly different audience than that required to obtain resources to develop a new idea. Thus it seems useful to distinguish between ultimate marketing to the public and selling the idea to potential investors or higher management before the invention is ready for production.

them do not appear on the balance sheet. Each individual must take them into account in considering at each stage whether to proceed further. To encourage invention, an incentive system must impel all the actors in the process — supervisors and managers as well as potential inventors — to develop new ideas despite these personal costs and risks.

The second important feature of the innovative process is that the costs incurred at each stage are highly variable. They depend in general upon the details of the innovation at issue and the history of its progress through preceding stages. For example, the costs and personal risks which the inventor must incur in educating colleagues and superiors and in preparing for the next stage depend upon the novelty of the idea and upon the state of the art relative to the subject matter of the invention.[185] Because the costs at each stage are variable, a sound incentive system must be flexible enough to accommodate variations in the innovative process and to respond to the different degrees to which the various actors participate at each step.

The final notable feature of the process of innovation is that, although its stages may coalesce, change order, or telescope in individual cases, in general every stage is an essential part of the process. The entire process can be aborted at any stage if an important actor in that stage decides that the effort is not worth the cost or the trouble. Consequently, if an incentive system for innovation is to succeed, it must operate well, or at least must avoid disincentives, at every stage.

2. The Fallacy of "Corporate Incentives"

Most innovation today begins in large organizations, whether corporate or governmental. Even when later development or exploitation of an innovation occurs in spin-off companies, the innovation itself often owes its existence to a background of systematic research in government laboratories or large corporations.[186] Consequently, incentives for innovation must be

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185 Where, for example, a scientist can convince his colleagues in an informal laboratory conference to develop a new idea, the cost of selling the idea internally may be small.

186 Although small companies and individuals are responsible for the bulk of in-

aimed not at the hypothetical gentleman-philosopher-scientist, but rather at the people who work in, manage, and own the corporations and government laboratories which perform the bulk of modern research and development work.

Incentives act only on individuals within a corporation, not on the undifferentiated corporate entity. The problem, therefore, is not simply "How can we encourage corporations to be more innovative?" Within each corporation or government laboratory, each individual — whether he be employee, supervisor, manager, officer, director, or stockholder — has his personal set of values, goals, and corresponding motivations, and intelligent analysis requires that these individual motivations be recognized and exploited.

Patent law might encourage corporate innovation simply by insuring that *top* management personnel have incentives to innovate. Top management purportedly behaves in a way that maximizes profit for the corporation, and it therefore might be argued that effective incentives can be achieved simply by allocating patent rights so that innovation maximizes profits. Indeed, this philosophy underlies the present structure of the patent system, which attempts to encourage top corporate management by giving all patent rights in employees' inventions to their corporate employers, except where the invention is made under government contract.

Nevertheless, for two reasons, the corporate incentive for profit maximization, which acts primarily on top management, does not appear to be the answer.[187] First, top management

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novative products reaching the marketplace, *see* note 209 *infra,* most research and development is performed in large corporations or government laboratories. This apparent paradox has a simple explanation: new ideas are conceived and perhaps refined in large organizations, but those organizations are often incapable of rapid development and exploitation of new ideas. Therefore, once an idea's merit has been proven, technical personnel often leave the corporation in which they conceived it to develop the idea on their own.

The formation of spin-off companies is motivated by two factors: 1) their relative efficiency in development and exploitation of inventive ideas as compared to large corporations; and 2) the opportunity of technical personnel to participate in their growth in value as business expands — an opportunity usually foreclosed in large organizations.

187 *Cf.* H. Frech, *Are Managers an Elite Clique with Dictatorial Power?,* in LAW AND ECONOMICS CENTER, UNIVERSITY OF MIAMI SCHOOL OF LAW, THE ATTACK ON CORPORATE AMERICA 77, 78 (1978) (although "managers may best serve themselves by serving their

seldom invents or has any direct contact with those who do. Though top management may try to encourage innovation through intracorporate incentive systems, the incentive is often lost as it diffuses downward through the organizational hierarchy. For example, many corporations reward their technical personnel for inventive ideas by means of nominal bonuses and publicity.[188] These rewards, however, are only a small part of the complex of incentives and disincentives which daily affect each employee in the lower levels of a large organization. Employees may be rewarded for invention, but they are also rewarded for teamwork, cooperation, and meeting production and research schedules — objectives which are often inimical to innovation. Like all people, technical personnel, supervisors, and middle-level managers act in their own, rather than in the corporation's, best interests. If their best interests are served by following the prevailing ethic of large corporations, that ethic will dilute or counteract the incentives for innovation created by top management, and those incentives will be ineffective no matter how strongly the profit motive acts upon the people in top management.

The second reason the corporate profit motive is ineffective in spurring innovation is more fundamental: maximization of a particular corporation's profits often requires that innovation be discouraged or suppressed. When an individual employee owns his invention, he cannot profit from it by suppressing it, but only by developing, exploiting, and selling it. Large corporations, however, have vested interests in plant, personnel, market shares, and advertising that may make it more pro-

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stockholders," divergent interests between management and stockholders prevent the identification from being complete).

188 Monetary rewards are usually given only for patentable invention and are generally nominal. *See* F. NEUMEYER, *supra* note 53, at 88, 90-98. Though there are exceptions, the awards are usually limited to a few hundred dollars paid when a patent application is filed or when a patent issues. Moreover, the size of the award is independent of the value of the invention, so the award seems designed to encourage disclosure to the employer rather than invention itself. *See id.* at 90.

Studies show that employers regard salaries paid to technical personnel as full consideration for agreements to assign inventions and rely on ordinary corporate incentives, such as promotions and raises in pay, to encourage innovation. *See* Sutton & Williams, *supra* note 26, at 575. Any additional incentive created by an award system is diluted because the award is entirely discretionary with the employer and the employee has no legal right in it. *Id.* at 577-78.

fitable for them to delay or suppress innovation.[189] Thus, while a rational individual patentee would not be likely to suppress his inventions on his own, a rational corporation might have reasons for doing so.

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189 Before an invention is patented, a corporation may suppress it as a trade secret. Patenting requires disclosure of the invention, *see* text accompanying notes 19, 26 *supra*, but, after a patent issues, the corporation has an unlimited right to exclude others from making, using, or vending the invention for 17 years. Although a dictum in a Supreme Court opinion raises the possibility that suppression of an invention might be grounds for judicial refusal to enforce a patent, *see* Continental Paper Bag Co. v. Eastern Paper Bag Co., 210 U.S. 405, 430 (1908), the Court has so far not found such suppression. *See* Special Equipment Co. v. Coe, 324 U.S. 370, 378-80 (1945) (sustaining, for lack of evidence of intention to suppress, patentee's right of action to compel Commissioner of Patents to issue patent on subcombination of patented device, against claims that patentee intended to suppress subcombination).

In any case, as the Court itself has noted in *Continental Paper Bag Co.*, 210 U.S. at 428-29, there may be valid economic reasons for withholding or delaying the introduction of an innovation, *accord*, 3 P. AREEDA & D. TURNER, ANTITRUST LAW § 706c, at 129-30 & n.5 (1978), and the patent monopoly includes the right to practice or not practice the invention as the patentee chooses, *see* Special Equipment Co. v. Coe, 324 U.S. at 378-79; Continental Paper Bag Co. v. Eastern Paper Bag Co., 210 U.S. at 429-30. Two lower courts, however, have refused to enforce patents in equity when the invention suppressed was vital to public health. *See* Vitamin Technologists, Inc. v. Wisconsin Alumni Research Foundation, 146 F.2d 941, 946-47, 956 (9th Cir.), *cert. denied*, 325 U.S. 876 (1945) (refusal to license ultraviolet irradiation process for producing vitamin D to makers of oleomargarine could be misuse of patent) (dictum); City of Milwaukee v. Activated Sludge, Inc., 69 F.2d 577, 593 (7th Cir.), *cert. denied*, 293 U.S. 576 (1934) (damages granted but injunction denied for infringement of patent on sewage disposal system).

The monopoly power of a patent in the hands of a corporation may retard innovation in three ways. First, by refusing to license a dominant patent to holders of patents on improvements, *see Innovation Hearings*, *supra* note 1, at 28, 74, a corporation can prevent the practice of innovation by others which might render its products less attractive or obsolete. Secondly, through patent-pooling and cross-licensing, one corporation or a small oligopoly can dominate an entire area of commerce or technology and prevent entry by innovative newcomers. *See* BUSH STUDY, *supra* note 5, at 12-14. Finally, economic reliance on the monopoly power may reduce the corporation's incentive to better its own products. *See Innovation Hearings*, *supra* note 1, at 23 (remarks of Kenneth Arrow, Prof. of Economics, Harvard Univ.).

Nor are the antitrust laws effective in preventing suppression. Those practices which the antitrust laws condemn normally involve an attempt to build a monopoly beyond the extent of the patent. *See* 7 A. DELLER, WALKER ON PATENTS § 518, at 207-08 (2d ed. 1972). Where the patentee merely takes advantage of the literal scope of the patent monopoly, there is no violation of antitrust law. A patentee may impose conditions on a licensee's sale of patented products as long as they are "normally and reasonably adapted to secure pecuniary reward for the patentee's monopoly," *id.* at 210-11. Moreover, a patentee may accumulate a *group* of related patents as long as the process of accumulation does not constitute an attempt to monopolize and no attempt is made to extend the scope of the monopoly beyond the aggregate scope of the individual patents. *See generally id.* § 518. *See also* 3 P. AREEDA & D. TURNER, *supra*, §§ 705a, 706a (monopolist can acquire nonexclusive rights to inventions technologically related to those it already owns and exclusive rights in unrelated inventions and can build a patent

Suppose, for example, that corporation A has invested considerable capital in a large plant, which a new product discovered by corporation A would render obsolete. Profit maximization might demand that introduction of the new product be delayed until the plant had fully depreciated. Societal welfare, however, might be increased if corporation B, which does not have an investment in a potentially obsolete plant to recover, could produce the new product at a lower price. Corporation A might license corporation B to produce the invention, but, since corporation B's production would also render corporation A's plant obsolete, corporation A would have to charge a royalty sufficient both to recover its investment in the plant and to pay the transaction costs of negotiating the license. Thus, corporation B's production under corporation A's patent would be inefficient, and, assuming the most economically rational course is chosen, corporation A would delay or suppress production of the invention until it could profitably produce the invention itself.

Nor is investment in a potentially obsolete plant the only reason a corporation would delay or suppress innovation. A corporation might delay introduction of a new idea simply because it lacked the capital for successful development, production, and marketing. If it expected to have sufficient capital in the future, it might withhold development of the new idea and yet be reluctant to license that idea to companies with greater capital resources for fear of increasing competition and decreasing its market share. Thus, it might delay introduction of the new idea until the optimum time for the corporation and not necessarily for society at large.

If the new idea lay outside the mainstream of the corporation's business activity, the corporation might suppress it merely out of inadvertence or neglect. If the idea lay outside its major field of expertise, the corporation might not realize the

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pool through its own research). *But see id.* § 705a, at 118 (monopolist's acquisition of exclusive rights in inventions technologically related to those it already owns should be Sherman Act violation). In any case, "the antitrust laws are a blunt bludgeon with which to deal with the subtleties of . . . patent licensing." BUSH STUDY, *supra* note 5, at 14. A system in which natural human incentives encourage the most efficient use of patents would seem far preferable to judicial administration of the nation's economy.

importance or value of the idea in other industries, and consequently might lack the knowledge and incentive to sell it to other organizations better able to make use of it. Since in such a case the corporation would be unlikely to patent the idea, there probably would be no legal blockage of development by other industries. Nevertheless, an important innovation whose prompt practical introduction by other corporations might have been encouraged through different incentives would lie fallow until rediscovered serendipitously.

The danger of suppression or delay arises not from any evildoing on the part of corporate management, but rather from the very nature of corporate enterprise. A corporation is only a subunit of the larger society, and each corporation has its own financial difficulties, limited resources, and industrial and commercial goals. Since both patentable and unpatentable innovation occur in a random and haphazard way, it is too much to expect that the particular corporation in which a given innovation was first conceived will nurture it in a manner calculated to maximize the welfare of the larger society.

What is needed is a free marketplace for new ideas, in which various individuals and corporations can bid for the right to develop and exploit an innovation — at any stage of its development — to the best of their abilities and the fullest extent of their resources. Even though an innovation might render one corporation's assembly line obsolete, that corporation should not be allowed to suppress it. Rather, another corporation should be allowed to exploit it, and the purchasing public should decide, by continuing to purchase the old (and presumably cheaper) product rather than switching to the more desirable new one, or vice versa, whether continued operation of the expensive but outmoded assembly line maximizes the welfare of society as a whole. Similarly, if an innovation lies outside the mainstream of expertise in the corporation which gave it birth, other individuals and corporations should have an opportunity to nurture it to its full stature and importance in the larger industrial community. Productive innovation will in general be maximized only if each new idea is put up for sale to the highest bidder (presumably the one who can use it most efficiently), without requiring that bidder to pay for internal inefficiencies

in the corporation in which the idea happens to have been conceived.

Today, however, there is no such free marketplace of innovation. Each patentable new idea becomes legally and practically the property of the corporation which spawned it. A corporation develops and nurtures a new idea only insofar as it advances that corporation's narrow commercial interests. Even where a corporation might profitably license the new idea to another corporation, lack of communication among corporations and of incentive for the conceiving corporation's technical personnel to develop the new idea to the point at which licensing negotiations are likely to be fruitful may impede development and production.

3. The Inadequacy of Ordinary Corporate Incentives for Technical Personnel, Supervisors, and Middle Management

In a large modern corporation, incentives for innovation might act upon technical personnel, their immediate supervisors, middle management, top management, and stockholders. Top management and stockholders, however, seldom involve themselves in the day-to-day decisions of the innovative process. Their function is to make fundamental decisions on major corporate policy. Thus, effective incentives must act on the technical personnel, supervisors, and middle management, who collectively perform the functions of the creator and the investor in modern research and development.

Are the ordinary intracorporate rewards of salary, promotion, and public recognition effective to call forth the necessary effort from those who play these leading roles in the innovative drama? Some commentators have argued that inventors are driven to conceive new ideas — that they just cannot stop thinking about a problem until they have solved it — so that there is no need for special incentives to encourage the inevitable.[190] A

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190 *See, e.g.*, Picard v. United Aircraft Corp., 128 F.2d 632, 642 (2d Cir.), *cert. denied*, 317 U.S. 651 (1942) (Frank, J., concurring) (quoting W. Kaempffert, Invention and Society 19 (1930) (American Library Ass'n pamphlet): "To be sure, inventors long for wealth. So do poets. But the patent laws are no more responsible for great inventions than are copyright laws for great poems."); *Innovation Hearings*, *supra* note 1, at

corollary to this argument asserts that where ideas come to inventors in a flash of inspiration or through serendipity, conception is a fortuity which does not deserve a reward. While it may well be true that the pleasure of inspiration and of solving intellectual puzzles is its own reward, conception alone is only a small part of the innovative process.[191] Even if special incentives are unnecessary to encourage the inventor's imaginative conception, they may be needed to promote his participation in the other stages of the process of innovation.

Circumstantial evidence indicates that ordinary corporate incentives fail to motivate inventors effectively.[192] More importantly, those ordinary incentives are often at odds with the requirements for stimulating innovative behavior.

Corporations demand, and reward, team effort. Corporate personnel at all levels rise within the organization by cooperating with others and doing well the work they are assigned. Mavericks may be tolerated, but they cannot be encouraged if organization charts are to be followed and production schedules are to be met. Like most institutions, the corporation resists unplanned change,[193] and the larger the cor-

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92 (remarks of Dr. William McLean, Director, Naval Underseas Lab.) ("Inventors are peculiar people. They will work to a large extent whether or not they are rewarded directly . . ."). *But see* W. ROBINSON, THE LAW OF PATENTS § 36 (1890) ("I have met many [inventors], but I have never yet seen one who did not labor constantly and zealously in view of the reward which he hoped to reap as a result of his labor").

191 This may be one reason why proponents of the patent system have avoided basing its laws on a property right of the creator in disembodied ideas. *See* Graham v. John Deere Co., 383 U.S. 1, 8-9 & n.2 (1966) (Thomas Jefferson "rejected a natural-rights theory in intellectual property rights and clearly recognized the social and economic rationale of the patent system"). It may also be the reason why the law has not been sympathetic to claims of employees for patent rights in ideas dropped into suggestion boxes. *See* Raybestos-Manhattan, Inc. v. Rowland, 460 F.2d 697 (4th Cir. 1972) (suggestion of departed employee treated as trade secret of employer; employee compelled to assign patent application). *See generally* Comment, *Master and Servant — Rights to Inventions of Employees — Suggestion Boxes,* 1973 WIS. L. REV. 1203. When an employee has an idea, scribbles it down, drops it into a box, and forgets about it, he has completed only a small part of the process of innovation. Selling the idea and making it work are left to corporate management.

192 *See* text accompanying notes 1 to 3 *supra.* Some commentators have reached this conclusion instinctively, without detailed analysis of the deficiencies in ordinary corporate incentives: "We need more of the single-mindedness of earlier inventors in our history and less of the routine 'problem solvers on a salary' if we are to continue the inventiveness for which this country is famous." Sutton & Williams, *supra* note 26, at 560.

193 *See* P. DRUCKER, PEOPLE AND PERFORMANCE: THE BEST OF PETER DRUCKER ON

poration the greater the resistance.[194] Innovation, on the other hand, is inherently disruptive and revolutionary.[195] While general goals and directions may be set in advance, the precise methods, forms, and effects of invention cannot be predicted. In practice as well as in theory, then, the nature of innovation is antithetical to the corporate ethic and the natural predilections of corporate management for planning and order.

If, for example, a scientist gets a brilliant idea in the last month of a twelve-month research project, he can simply forget it, and he will still earn his salary.[196] If he presses it upon management, however, management will require him to produce, and his reputation and potential for advancement will be on the line. While the scientist might report the idea without recommendation and let management decide whether to use it, he might be the only person within the organization who understands the idea and believes in it enough to bring it to fruition.[197] Moreover, all the economic reasons for corporate suppression of invention may make it difficult, if not impossible, for him to sell the new idea. Thus, innovation might depend upon his initiative and his advocacy, but his desire to avoid rocking the corporate boat might still his voice.

The employee might "bootleg" the testing and development of his invention, spending his own time, and perhaps using com-

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MANAGEMENT 157 (1977) (Resistance to change, by executives and workers alike, has for many years been considered a central problem of management.).

194 *See* note 209 *infra.*

195 *See* J. SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY 83-84 (3d ed. 1950) (advancement of technology is part of the "perennial gale of creative destruction," which compels change and prevents monopoly and stagnation in a capitalist economy).

196 Compare the words of a federal district court in refusing at common law to force a factory superintendent to assign his rights in his invention to a former employer: "If he had never invented anything, he could not have been charged with a failure in the performance of his duties as superintendent, or with a failure fully to earn his compensation." Bowers v. Woodman, 59 F.2d 797, 802 (D. Mass. 1932).

197 Development and exploitation of a new idea are more efficient when the inventor, who is most familiar with the operation and potentialities of the innovation, takes an active part. As one observer has noted:

> [T]he inventor and his immediate colleagues [are] the ones best prepared to provide the intellectual input during development. It is most important and advantageous that this development in a private company take place close to the source of the invention. Opportunity and incentive for spin-off of this kind is [sic] very important.

Innovation Hearings, supra note 1, at 58 (remarks of Dr. William Miller, Vice Pres. & Provost, Stanford Univ.).

pany materials and facilities without authorization,[198] to develop the new idea to the point at which he can sell it to management. But in doing so, he would incur considerable personal risk. If his idea failed, or if he failed to sell it, he would have wasted his own time and might be accused of wasting company resources. Even if he succeeded, he might be treated with suspicion by management in the future for having proceeded without authorization. Only an extraordinary incentive, apart from the usual rewards of promotion and higher pay, could motivate people to incur these risks and costs in the face of uncertain success.

If purely intracorporate incentives are ineffectual in spurring technical personnel to innovate, they are the more so for supervisors and middle-level corporate managers. The scientist can achieve a certain degree of advancement in his career simply by disclosing a new idea to colleagues or supervisors. By publishing the idea, a scientist could conceivably enhance his scientific reputation outside the corporation, his value to the company, and his options for finding employment elsewhere. Though touting the idea within the corporate structure requires effort on the scientist's part, it may not entail serious risk to his career unless he becomes insubordinate or begins to engage in "bootleg" research.

In contrast, the middle-level manager gains nothing from the mere conception of an idea and bears full responsibility for the decision whether to proceed. Moreover, he must make that decision on both scientific and economic grounds. Since the project which the scientist offers is only one of a variety of possibilities for the investment of the corporation's internal capital, it must be evaluated, together with the others, in terms of the corpora-

198 For two reasons, it is ordinarily unrealistic to expect an employee to invest his own money or property in developing an idea without special incentives. First, modern technological development normally requires expensive materials and equipment beyond the means of anyone who must work for a living. *Cf.* BUSH STUDY, *supra* note 5, at 9 ("individual inventors do not have the technical ability, the equipment, or the money necessary to work out further developments on the basic inventions which have meant so much to modern industrial society"). Secondly, since the ordinary reward for success would be only a notation in the inventor's personnel file and the possibility of future promotion, the small probability of success inherent in home research would not justify extensive personal sacrifice.

tion's line of business, market share, facilities, and long-range goals, all of which may be unrelated to the potential value of the new idea to humanity.[199] Moreover, evaluation of the project alone may entail considerable investment of capital, even before the idea reaches the patentable stage, as when feasibility studies or market surveys are necessary to estimate a new product's potential worth. At every step, both because his criteria of decision are different and because he bears the responsibility for the final decision, the middle manager's decision is more likely than the scientist's recommendation to err on the side of caution and delay.

Such a response to innovative stimuli is natural and proper for corporate management. It is management's job to evaluate proposals in terms of the corporation's goals, not in terms of the larger objectives of technological progress or of maximizing societal welfare. Were a manager to apply the broader criteria, he would violate his fiduciary duty to the corporation and its stockholders,[200] particularly if the stockholders depended on existing business for a steady income and were not prepared to accept the risk of innovation.

The immediate supervisors of technical personnel occupy an intermediate position in the corporate hierarchy. They are responsible to management for the direction of research, but often they take part in it personally.[201] This dual role makes supervisors particularly important in the scheme of innovation. They are often people drawn from the ranks of research personnel, so they understand innovative ideas and appreciate their worth more than executives without technical training. Fur-

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199 All these factors must be considered in answering the only question that is relevant from the corporation's point of view: Is the expected rate of return on corporate investment in the new idea greater than the rate at which the market capitalizes the firm's dividends? If not, internal investment in innovation will be a poor idea from the point of view of corporate management regardless of its ultimate benefit to the larger society. *See* V. BRUDNEY & M. CHIRELSTEIN, CASES AND MATERIALS ON CORPORATE FINANCE 423-24 (1972).

200 *See* Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919) (board of directors has no legal power to withhold dividends for primary benefit of public at large and only incidental benefit to stockholders).

201 For example, one of the two inventors in *Dubilier* was chief of the research group in which both were working. United States v. Dubilier Condenser Corp., 289 U.S. 178, 183 (1933).

thermore, because their role is directive, and because they are identified with management, their recommendation may be instrumental — even essential — in developing a new idea.

Without some sort of extracorporate incentive, however, supervisors may have the worst of both worlds. They may be coinventors, but they are not usually as intimately involved with research work as the personnel under their supervision. Thus they may be more remote from the enthusiasm and excitement of creation and lack an intellectual "stake" in new ideas. To the extent that they have managerial aspirations, their viewpoint may merge with that of higher management, and they may adopt the same conservatism.[202] Consequently, supervisors, at least as much as technical personnel, require special incentives in addition to those of routine promotion within the corporate hierarchy to encourage them to take an active and early part in the process of innovation.

The middle-level managers and supervisors in this model of today's innovative process collectively perform the role of the "investor" in the old "cottage industry" model of innovation. They are the ones who decide, on a day-to-day basis, what problems need solving and where the corporation's technical and monetary resources should be allocated. Their decisions have a profound effect on the entire innovative process. Moreover, they often modify the innovative process long before a new idea has reached the stage of patentable invention. Because supervisors and middle management affect the innovative process at its very inception, their inherent conservatism, if not ameliorated by extracorporate incentives, can impede the process considerably. Therefore, no system of incentives which ignores their roles in the process can be fully effective.

B. *An Effective Incentive System*

If ordinary corporate incentives are too diffuse and misdirected to call forth the initiative required for genuine innovation, what type of incentive would be effective? Many cor-

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202 Since elevation to management is often one of the few ways for technical personnel to avoid stagnation in salary level and career opportunity as they get older, super-

porations provide small monetary rewards for patentable invention, but these are generally nominal in size[203] and therefore ineffective as incentives. In addition, the statutory compensation in effect in several European countries has not found favor in the United States.[204] Consequently, simple allocation of patent rights remains an attractive option.

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visors are likely to be even more cautious than higher management. These aspirations to higher management positions are similarly a reason for the failure of technical personnel to use collective bargaining techniques. *See* F. NEUMEYER, *supra* note 53, at 165, 204-05; text accompanying notes 133 to 136 *supra*.

203 *See* note 188 *supra*.

204 *See Orkin, supra* note 40, at 654-57; Sutton & Williams, *supra* note 26, at 564-65. There have been at least two attempts to introduce such statutory compensation in the United States. The first was a provision in a general patent reform bill which would have granted employed inventors "a minimum of 2 per centum of the profit or savings to the employer" due to an invention, in addition to regular compensation. S. 1321, 93d Cong., 1st Sess. § 263 (1973). Several observers, however, criticized this provision as unfair to employers and impossible to administer. *See Revision Hearings, supra* note 7, at 150 (remarks of John Pederson, Gen'l Pat. Counsel & Dir. of Patents, Zenith Radio Corp.); *id.* at 363 (statement of Stanley Clark, Pat. Counsel, Firestone Tire & Rubber Co.); *id.* at 407 (remarks & statement of John Stedman, Prof. of Law, Univ. of Wis.); *id.* at 620-22 (letter of Charles Stewart, Pres., Machinery & Allied Products Institute, to Sen. John McClellan, Chm.); *id.* at 626 (report from the Michigan State Bar). Some of these observers insisted that the issue of employee compensation should be considered separately from general patent reform. In any case, the bill containing the provision died in committee.

The second attempt to provide statutory compensation for employed inventors was a series of bills introduced by Rep. John Moss of California. Each of the bills proposed the same statutory scheme, modeled on West German law, to determine appropriate compensation by balancing the employee's duties with the employer's contribution in the invention and the worth of the idea. A board of arbitration was to be the final decisionmaker. *See Orkin, supra* note 40, at 658-60. Although the same bill has been introduced five times, H.R. 15512, 91st Cong., 1st Sess. (1969); H.R. 1483, 92d Cong., 1st Sess. (1971); H.R. 2370, 93d Cong., 1st Sess. (1973); H.R. 5605, 94th Cong., 1st Sess. (1975); H.R. 2101, 95th Cong., 1st Sess. (1977) [hereinafter collectively cited as Moss Bill], there have been no hearings on it.

Detailed discussion of the merits of the Moss Bill and the European compensation schemes on which it is modeled lies beyond the scope of this paper. *See Orkin, supra* note 40, at 658-60; *Orkin, supra* note 2, at 720-21, 727-35; Sutton & Williams, *supra* note 26, at 564-83. However, it is worth noting that any compensation system which avoids resolving the issue of patent ownership has several drawbacks. First, industrial owners retain the right to impede technological development by dragging their feet or suppressing innovation. Second, employee compensation must be set by an administrative commission or board of arbitration, either of which requires a whole new layer of bureaucracy in the patent system. Third, administrative resolution of compensation disputes may produce higher transaction costs than bargaining under the influence of market forces because the former lacks the natural incentive of private parties to minimize transaction costs and to weigh them against the ultimate benefits to be derived from the invention. Finally, the prospect of statutory compensation may open up a whole new front in the war over rights in inventions — quite apart from the battle over patent ownership — resulting in increased litigation, duplication of effort, and great potential for delay.

Allocation of patent ownership avoids the administrative difficulties of some of the other systems and has several inherently desirable properties. First, rewards in the form of patent royalties are naturally calibrated to the value which society places upon a particular innovation. Second, because patent royalties depend on the successful development and exploitation of an invention, an incentive system based on patent ownership impels each potential patent owner to contribute to that development and exploitation. Third, rewards based on royalties avoid distortion of a market economy because they are ultimately derived from those whom the innovation benefits, *i.e.,* the purchasers and users of the new product. Finally, patent ownership may allow an innovation to be taken outside the organization in which it was born when that organization is not the most efficient one to develop or exploit it. For these reasons, the incentive created by potential ownership of patent rights appears to be both effective and efficient.

1. The Present System

If the model advanced here is correct, however, and if technical personnel, their immediate supervisors, and middle-level managers are the preferred targets for incentives, the allocation of patent rights provided by the present legal structure entirely misses the mark. In most corporations anyone who might obtain a patent is currently obligated by contract to assign away in advance all rights in his inventions. Moreover, since the corporation is automatically entitled to *all* the patent rights in any invention developed by the corporation's employees, supervisors and middle-level managers (and top managers as well) have no general incentive to foster innovation. Of course, once a particular new idea has proven both valuable and patentable, their desire for advancement within the corporate hierarchy may impel them to aid its development. But when the new idea is in its infancy, supervisors and managers know that the corporation will own it if it proves patentable whether they foster its development or not. Hence, for them, as for inventors, the patent system provides no par-

ticular incentive to act in a way which will increase the rate of innovation generally.[205]

Even in cases of obviously patentable innovation within the mainstream of the corporation's business, a system of automatic corporate ownership of patent rights does not encourage innovation for two reasons. First, the effect of corporate ownership rarely penetrates to the lower levels of the corporate hierarchy, where the actual work of innovation is done. Second, absolute ownership by the corporation leaves no room for dedicated inventors to develop an idea elsewhere if the corporation should prove an inefficient or recalcitrant developer.

2. A Return to Inventor Ownership?

The search for an effective system of incentives might begin by returning all rights in an invention to its creator, the inventor. Congress might by statute prohibit any transfer of rights in an invention absent an assignment made voluntarily and *after* the invention is patented.[206] Such a rule would preclude both enforcement of agreements to assign inventions in advance and subsequent transfers of rights under common law, as when inventors are "hired to invent" or the doctrine of shop rights applies. Such a system would create powerful incentives not only to invent, but also to develop and exploit each new idea. These

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205 Potential ownership of patent rights creates a powerful incentive for development and exploitation of a *particular* idea known to be patentable, at least when the corporation is economically prepared to exploit it. But when an idea is not obviously patentable, when it lies outside the mainstream of the corporation's expertise, or when its prompt introduction would be economically disadvantageous for the corporation, the mere possibility that the corporation will obtain patent rights if the new idea proves patentable may be ineffectual as an incentive to foster its development.

206 In 1963, Rep. George E. Brown of California introduced a similar prohibition as an amendment to Title III of the Labor Management Relations Act, 1947, 29 U.S.C. §§ 185-187 (1976):

> It shall be unlawful for an employer to require as a condition of employment that any prospective employee of his or any of his employees agree to assign any patent or patentable invention to the employer or to maintain or enforce any agreement with any of his employees to assign any patent or patentable invention to the employer where such agreement was a condition of employment.

H.R. 4932, 88th Cong., 1st Sess. (1963). The bill was later reintroduced, H.R. 5918, 89th Cong., 1st Sess. (1965), but both bills died in committee without reported hearings.

incentives would span the entire process of innovation and would motivate the person with the greatest intellectual stake in, and the deepest understanding of, the new idea, namely, its creator.[207]

In addition, a system of inventor ownership of patent rights would have the advantage of subjecting monopoly rights in an invention to market forces. Any party desiring the exclusive right to exploit an invention, including the inventor's employer, would have to bid for that right in competition with others. In the ordinary case, the employer itself would be the most efficient exploiter, and therefore able to make the highest bid, both because its personnel would be acquainted with the invention and because any of the special equipment and facilities used in the creation of the invention would likely prove advantageous in its development and exploitation as well. The result thus would be much the same as under today's law, with one important exceptions: the inventor would be compensated for his effort and the personal incentive would be restored.[208] On the other hand,

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207 If inventors were given absolute ownership of their inventions, employers might resort to trade secret law to protect proprietary ideas. Obviously, the employer's right to prevent an employee from divulging trade secrets would be incompatible with the employee's right to patent, and thus to disclose, his inventions. Since the protection of trade secrets is based upon local law, *see* Franke v. Wiltschek, 209 F.2d 493, 494-95 (2d Cir. 1953), the conflict raises the issue of federal preemption.

The Supreme Court has ruled that federal patent law does not preempt the state law of trade secrets, *see* Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470 (1974), and the relationship between the law of trade secrets and the patent monopoly would have to be modified by Congress to give full play to employee ownership. An accommodation, however, could be reached rather easily. Patent applications are required by statute to be kept confidential, 35 U.S.C. § 122 (1976), so an inventor could be released by federal law to make an application for a patent in good faith without injuring his employer's interest in secrecy. While the application was pending, the inventor would remain bound by his duty not to disclose. *See* Aronson v. Quick Point Pencil Co., 47 U.S.L.W. 4219, 4222 (U.S. Feb. 28, 1979) (licensee would risk legal liability by trying to exploit design while patent is pending) (dictum); Picard v. United Aircraft Corp., 128 F.2d 632, 637 (2d Cir.) (L. Hand, J.), *cert. denied,* 317 U.S. 651 (1942) (inventor who discloses surrenders claim to patent).

If a patent issued, the invention would be disclosed automatically by the Patent Office, but the employer would have the option of protecting its investment by buying a license. If no patent issued, the inventor would remain bound to secrecy, and no harm to the employer's interests would have been done.

Whatever accommodation between patent and trade secret law is adopted, Congress should spell it out instead of leaving it to the vagaries of litigation. *Cf.* 17 U.S.C. § 301 (1976) (explicit statutory provision for preemptive effect of new copyright law).

208 This system would have the additional advantage that the inventor himself would have to pay for procuring patent protection. As a result, fewer frivolous patent

if the employer were unable or unwilling to develop and exploit the new idea, whether for legitimate or illegitimate reasons, then the inventor could sell the right to another party better able to make use of it, or he could form a spin-off company to develop and exploit the idea on his own.[209] In either case, the new idea would be placed upon the block in a free market, and, within the limits imposed by imperfect information, it would receive the most efficient treatment the larger economy could provide.

No doubt such a system would improve the incentives for innovation offered by the present legal structure. It would restore the personal incentive for technical personnel who might become inventors, and it would restore it to the form originally envisaged in the Constitution. By relying on the inventor's need

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applications might be filed. The "entrance fee" for patent prosecution would test the faith of the inventor, the person with the most intimate knowledge of the invention, in the economic value of the new idea.

209 Facilitating the formation of small spin-off companies to develop new ideas may be one of the most important objectives of patent law revision. There seems to be considerable agreement among modern observers that successful refinement and exploitation of new ideas occur primarily in small companies. As one observer put it:

> The record of individuals and small companies in achieving the highest degree of new products is clear. To a large extent, this is due to the fact that only small organizations can survive without excessive planning. A well-planned program is almost invulnerable to change and, hence, proof against innovation. . . . A new idea will always change schedules whether it works or not. An increasing requirement for more extensive planning, as our organizations become bigger, by its very nature does not leave room for new innovations as they develop.

Innovation Hearings, supra note 1, at 91 (remarks of Dr. William McLean, Director, Naval Underseas Lab.). *See also id.* at 29 (remarks of Dr. Kenneth Arrow, Prof. of Economics, Harvard Univ.) (twenty-year-old study shows 80 to 90% of major innovations come from relatively small firms); *id.* at 83 (statement of Robert Kuntz, Past Pres. & Nat'l Director, Cal. Soc'y of Professional Eng'rs) ("Most new technology reaches the market place through the actions of small entrepreneural [sic] enterprise. Few new innovations emanate from well established businesses.").

This does not mean, however, that all innovation begins and ends in small companies. Since small companies rarely have the capital to support extensive research and development, the bulk of innovative research occurs in large corporations or government laboratories. *See* note 186 *supra.* Only when new ideas have been developed to the point at which their potential for commercial exploitation is apparent can technical personnel afford to leave the large organizations in which the ideas were conceived, find private funding, and begin refinement and exploitation. Where the large organization holds a patent on the new idea, however, this healthy process of corporate branching can be nipped in the bud. Only a system which allows worthy innovative personnel to retain at least some share in the patent rights to their inventions can remove this important legal obstacle to the formation of spin-off enterprises.

to exploit the new idea to realize any gain from it, the system would preclude hoarding and suppression of patents, without recourse to the vagaries and expense of antitrust litigation. Finally, it would release the innovative idea from the corporate superstructure and place it in a free market where those who could do the most with it could bid for it and use it.

Nevertheless, a system of absolute inventor ownership of patents would have several serious disadvantages. While it would provide increased incentive for technical personnel, it would reduce the already scanty incentives for supervisors and middle-level managers. By forcing employers to negotiate for rights in inventions produced by their own employees, it would call forth strong opposition from industry. It would mark a radical departure from present law and would therefore undoubtedly encounter strong resistance from the patent bar.[210] Finally, the fear of employee ownership might discourage top management from directing company resources into industrial research.[211] If corporate investment in industrial research were in fact discouraged, the government might be forced to assume an even greater share of the nation's research and development costs, and hence to increase taxes — a result which would be politically unpalatable. These disadvantages of a system of absolute employee ownership,[212] while perhaps not outweighing the operational advantage of the added incentive it would provide, make its adoption by Congress unlikely.

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210 *Cf.* Sutton & Williams, *supra* note 26, at 558 (widespread opposition to Moss Bill, *see* note 204 *supra,* among patent bar).

211 Preserving an incentive for the employer's investment in research is also a consideration in antitrust rules governing the acquisition and disposition of patents by monopolists. *See* 3 P. AREEDA & D. TURNER, *supra* note 189, § 704c, at 116.

212 Without some modification, a system of inventor ownership would also retain a serious disadvantage of the old system. The inventor or his assignee could use the absolute right to exclude others from practicing the invention to hold out for an unreasonable royalty or to suppress new technology entirely. This problem might be solved by prohibiting assignment of a patent, but allowing the inventor to grant exclusive licenses, which could be nullified by suit or administrative action if the licensee did not exploit the invention with reasonable speed. *Cf.* Armed Services Procurement Regulations, 32 C.F.R. § 9-107.2(f) (1976) (provision of the Nixon Memorandum for revocation of exclusive licenses if the licensee does not make effective use of the invention within three years). Other potential exploiters and the government could be given standing to invalidate the license.

In addition, to prevent an inventor from holding out for an unreasonable royalty, the

3. Dividing Patent Ownership Rights

The major failing of a system of inventor ownership is the lack of incentive for supervisors and middle-level managers. Giving the corporation a share of the patent rights might create such an incentive, but only if the size of that share depends upon the degree to which the supervisors and middle-level managers encourage patentable invention. If supervisors and managers know that their own actions will determine how great an interest their corporation will have in patentable inventions produced in their own laboratories, their behavior will reflect that knowledge. Moreover, if corporations always have *some* share in patent rights, corporate investment in industrial research will not be greatly discouraged.

The correct division of ownership in patent rights might thus provide incentives for all the most important actors in the innovative process, if it is based on the proper standard. To provide an incentive for supervisors and middle-level managers, the division of rights should depend on their behavior. But to provide similar motivation for employed inventors, the standard should also take their efforts into account. By what sort of standard should Congress[213] balance the equities and need for incentives for each principal class of actors in the drama of innovation?

The search for a standard might begin with the common law, which identified generally the sort of factors relevant to the division of patent rights. The common-law rules, however, are not refined enough for consistent and effective application in the context of modern technology. Today technical personnel are nearly all "hired to invent" in the sense that they are expected to apply their talents to innovation when the need

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statute would have to restrict his power to refuse to license. Perhaps it could require him to accept a reasonable licensing offer during a certain period after it was filed with the Patent and Trademark Office. The statutory period would be made long enough to give the inventor time to shop around for better offers, and short enough to avoid waning of interest on the part of the offeror, or obsolescence of the technology involved.

213 Setting the standards for the division of rights in employees' inventions is necessarily a job for Congress. Not only does the Constitution vest the responsibility for patent policy in Congress, but the policy judgments required are inherently legislative in character. *See* Finnegan & Pogue, *supra* note 83, at 956-57.

arises.[214] On the other hand, they are seldom assigned to develop a particular device or process because the particular device or process to be developed cannot be specified in advance. Like the two employees in *Dubilier,*[215] technical personnel are often encouraged to select their own projects and to work on things which interest them.

As for expenses, the employer necessarily bears the greater share, if only because the costs of modern research and development are ordinarily well beyond the personal means of most employees. If the division of patent rights were based on capital supplied, the present legal structure, with its palpable lack of incentives, would apply almost universally. Since there is *necessarily* an unequal division of costs, however, it seems both equitable and consistent with the need to provide effective incentives to base the division of ownership not on that inevitable division of costs, but on the extraordinary effort which each of the participants contributes to its part of the process of innovation.

Examination of the various stages in that process shows that the different actors in it bear primary responsibility for different stages. Supervisors and managers ordinarily recognize the need, determine which need to meet, and later make the decisions to provide for production, marketing, and exploitation. The inventor, however, is usually most involved in definition of the problem, conception, production of a working model, and refinement. From the standpoint of both equity and incentive, it seems proper to divide ownership on the basis of the relative contributions of the inventor, on the one hand, and the supervisors and middle management, on the other.[216] To avoid

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214 *See* United States v. Dubilier Condenser Corp., 289 U.S. 178, 217 (1933) (Stone, J., dissenting) ("The inventors were . . . employed to engage in work which unmistakably required them to exercise their inventive genius as occasion arose. . . ."); BUSH STUDY, *supra* note 5, at 2 ("Any research scientist in a laboratory who is worth his salt is making inventions every little while. . .").

215 *See* text accompanying notes 139 to 141 *supra.*

216 Such balancing of relative contributions is not entirely without judicial precedent. Three courts, applying the common law of trade secrets, have noted that, in the absence of an expressed contractual obligation to preserve trade secrets, the relative contributions of employee and employer in developing an alleged trade secret may determine whether the courts will prevent the employee from disclosing or using that alleged secret after his employment has terminated. *See* Structural Dynamics Research

the need for an absolute standard against which to compare these contributions, they should be measured against the contributions expected of each of the parties in the ordinary course of research and development.

Two polar examples will make the proposed division of rights clearer. Suppose first that an employed scientist is assigned the task of developing an improved electronic component. Partly by luck, and partly by virtue of his special skill and experience, he hits upon an idea which might permit production of components with unprecedented properties. He discloses the idea to his superiors, who recognize the worth of the idea and immediately increase his research budget, provide extra support personnel, and allow him to work on the idea full-time. Once the scientist and his group have developed the first crude working model, the employer sends it, along with the scientist's report, to another laboratory, where trained technicians refine it and begin production. In this case the employer clearly should get most of the patent rights. The employer, through its agents, the supervisors and middle-level managers, has shown initiative and alacrity at every step, has changed schedules and incurred administrative costs beyond the ordinary. In short, the employer has responded to the stimulus of the new idea with all possible speed.

In contrast, suppose the scientist with the same idea discloses it to his superiors and hears nothing. He works on the idea, making theoretical calculations and paper studies on his own time or during slack periods at the laboratory. He asks his supervisors for an increased budget and the equipment needed to prove the idea and is refused. He borrows equipment from other groups, works in his spare time and at home, and finally

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Corp. v. Engineering Mechanics Research Corp., 401 F. Supp. 1102, 1110-12 (E.D. Mich. 1975) (although express nondisclosure agreement is enforceable, at common law employee who created subject matter of trade secret on own initiative has interest in subject matter at least equal to employer's interest); Wexler v. Greenberg, 399 Pa. 569, 160 A.2d 430, 434-37 (1960) (absent express agreement, employee who developed alleged trade secrets through his own skill, during routine work and not at employer's specific direction, has no confidential relationship with employer enforceable at law); New Method Die & Cut-Out Co. v. Milton Bradley Co., 289 Mass. 277, 194 N.E. 80, 82-83 (1935) (employer has no exclusive right to alleged trade secrets which resulted from employee's skill and experience where employee was not hired specifically to develop them and where there was no express or implied agreement of confidentiality).

develops a working model. Yet because his immediate supervisors have little faith in him and his idea, they still refuse him additional support. So he writes a proposal in his spare time and presents it to higher management, which finally accepts it. Here the scientist has done substantially more than his job requires. He has risked his supervisor's displeasure and jeopardized his advancement within the company. The employer, however, has done no more than its ordinary business requires: it has provided the employee with a place to work and access to colleagues and whatever materials he could borrow. Here the equities and the need for an incentive both favor the employee.

Obviously, not all cases will be as clear-cut as either of these examples, because research work can generate an infinite number of factual variations. But this potential complexity only proves that patent rights should be divided on the basis of all the facts and circumstances, not on the basis of narrow categories. The essence of invention is not the disembodied new idea, nor the investor's capital contribution, but the initiative and perseverance to develop and prove a conception in the face of human resistance to new ideas — even when the value of that conception is uncertain.[217]

One of the chief constitutional purposes of the patent system is to provide the incentive to face this uncertainty and to overcome this resistance to new ideas. Since this incentive is so important, it should affect *all* the actors involved in the struggle: the supervisors and middle-level managers as well as the inventor. Neither the current system, which deprives employed inventors of virtually all rights in their inventions in advance, nor the old common law, whose rigid categories too often divide ownership on an all-or-nothing basis, is designed to do this fairly and effectively. The law should recognize that the essence of invention is extraordinary effort on the part of all actors in the innovative process in overcoming human resistance to new ideas and should divide the benefits of the patent monopoly accordingly.

At first glance, the standard "extraordinary effort in overcoming human resistance to new ideas" appears incapable of

217 *See* text accompanying notes 29 to 33 *supra.*

precise application. Yet this standard is no more unfathomable than others regularly applied under common and statutory law. For example, what is "negligence" but a lack of the ordinary care which a reasonable and prudent person would exercise in similar circumstances?[218] Without a large body of case law or the help of a jury to draw the line, it would be difficult to tell from a mere verbalization of this standard whether or not particular conduct was negligent. Similarly, patentability of an invention rests upon its "obviousness" to a person of ordinary skill in the art to which its subject matter pertains.[219] Though this standard, too, is apparently difficult to apply, courts have managed to do so for over a hundred years.

The key to all these standards, including the one proposed here, is the factfinder's inherent understanding of what is ordinary and what is not. This understanding is based both upon knowledge of the particular situation at issue and upon a general reservoir of knowledge of similar situations. Deciding whether a group of supervisors and middle-level managers exerted more than ordinary effort in overcoming human resistance to an inventive idea is no more difficult in principle than deciding whether a neurosurgeon exercised ordinary care to avoid severing a patient's optic nerve. As in a determination of negligence in a medical malpractice action, allocation of patent rights under the standard proposed here must be based on a thorough knowledge of all the facts and circumstances, including expert knowledge of the relevant field of science or technology.

Perhaps the standard will be difficult to apply at first, but, as it is applied in an increasing number of cases, particular principles unique to a given class of cases or a given area of science or technology will develop. Indeed, this standard will undoubt-

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218 W. PROSSER, THE LAW OF TORTS 141-80 (4th ed. 1971).

219 *See* 35 U.S.C. § 103 (1976). This standard had its beginnings in Hotchkiss v. Greenwood, 52 U.S. (11 How.) 248, 267 (1851), and was developed judicially for 100 years before being enshrined in statute in 1952, *see* Graham v. John Deere Co., 383 U.S. 1, 10-17 (1966). The difficulty of applying this vague standard at the forefront of technology is what led to Justice Frankfurter's lament that "the training of Anglo-American judges ill fits them to discharge the duties cast upon them by patent legislation." Marconi Wireless Telegraph Co. v. United States, 320 U.S. 1, 60-61 (Frankfurter, J., dissenting in part) (footnote omitted).

edly prove easier to apply than the criterion of "nonobviousness" for patentability. For while "nonobviousness" is in the eye of the beholder, and therefore inherently subjective, the standard proposed here is an objective one, depending in essence upon an assessment of what is ordinary conduct by inventors, supervisors, and middle-level managers in the course of ongoing research and development. Other technical personnel, supervisors, and middle-level managers not involved in the immediate issue can be of aid in this assessment.

4. Division of Patent Ownership Through Private Bargaining and Arbitration

Though the task of applying the standard in an individual case might be delegated to a court or an expert tribunal,[220] private bargaining would be preferable, at least as a first resort. The employer and inventor naturally have the best information both on the economic value of the invention and on the effort which each side put into developing it. Consequently, bargaining between them would be likely to reduce substantially the transaction costs of information transfer and decisionmaking, especially as compared to adjudication in a tribunal with extensive procedural protection of fairness and accuracy.

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220 Previous proposals for dispute resolution have reflected a desire to compromise the goal of informed expertise in order to achieve stability, uniformity, and a measure of adjudicatory authority. For example, the Moss Bill proposed a board of arbitration consisting of three members from the Patent Office, one member chosen by the employees, and one member by the employer. *See* Moss Bill, *supra* note 204, § 437; *Orkin, supra* note 40, at 658-59. Another proposal, for government employees only, would have resolved disputes by administrative proceedings in each agency, with an appeal to the Attorney General and further appeal to the federal appellate courts. *See* Finnegan & Pogue, *supra* note 83, at 965-66.

Neither of these schemes seems to provide enough of the technical expertise necessary to resolve a patent rights dispute quickly and to the parties' satisfaction. The latter system would rely in the end on the very courts whose formidable caseloads, not to mention their lack of technical understanding and impatience with patent matters, are well known, *see* note 221 *infra*. On the other hand, the Moss proposal would sacrifice the federal courts' reputation for fairness and competence for the questionable expertise of the three fixed members of the board, who could in practice dominate decision-making. Since no three people can possibly have training relevant to *all* the technical specialties in which patent rights disputes might arise, the advantages of this tradeoff may be illusory. If the federal courts are to be abandoned despite their prestige and reputation for fairness, the decision-making mechanism replacing them should provide technical expertise directly and narrowly applicable to each dispute. The only way to provide such expertise may be to select an arbitration panel specially for each case.

In addition to reducing the cost of decisionmaking, private bargaining might improve its accuracy, at least compared to that of a lay tribunal's decision. Lay judges considering claims of patent invalidity have long lamented their lack of technical expertise.[221] Yet dividing patent rights according to the standard proposed here would require the same sort of expertise. Instead of evaluating the ingenuity of a new idea against the background of the state of the art to determine whether the idea is "nonobvious,"[222] a tribunal would have to weigh both the employer's and employee's efforts against the state of the art and the difficulty of appreciating and implementing the new idea. In addition, the tribunal would have to compare the efforts of the parties involved in the particular innovation with the customary division of labor between them in order to decide which party made the greater effort beyond the call of duty. Certainly no single body of manageable size could aspire to the same competence in these matters that the parties have inherently by virtue of their experience and prior acquaintance with the particular case.

However attractive division of patent rights by private bargaining may be in terms of its cost-effectiveness and the parties' inherent competence, it cannot serve as a practical alternative to adjudication unless the parties have roughly equal bargaining power. As was discussed above,[223] the cost of development and exploitation of most inventions today is beyond the means of any individual inventor. The inventor has little or no ability to profit from an invention without aid from his employer or a third party. Consequently, any division of ownership which relies upon private bargaining must begin by creating a strong presumption of ownership by the inventor. At

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221 As early as 1912, Judge Learned Hand discerned a need for expert scientific advice in patent matters: "How long we shall continue to blunder along without the aid of unpartisan and authoritative scientific assistance in the administration of justice no one knows; but all fair persons . . . ought, I should think, unite to effect some such advance." Parke-Davis & Co. v. H.K. Mulford Co., 189 F. 95, 115 (C.C.S.D.N.Y. 1911) (L. Hand, J.), *aff'd in part and rev'd in part,* 196 F. 496 (2d Cir. 1912). Later, Judge Frank reaffirmed the need for "the judgment of men who are experts in science." Picard v. United Aircraft Corp., 128 F.2d 632, 639 (2d Cir.) (Frank, J., concurring), *cert. denied,* 317 U.S. 651 (1942).

222 *See* note 219 and accompanying text *supra.*

223 *See* note 198 *supra.*

a minimum, the inventor must not be permitted to sign away his rights before a patent issues,[224] for informed and effective bargaining cannot take place until a particular invention is identified and until it is known whether exclusive rights in it are available at all.

Even if patent ownership is initially given by law to the inventor, subject to later negotiated licensing, the employer may have several natural advantages over competitors in bargaining for an exclusive license. The employer is familiar with the inventor, the process of development, and the field of technology to which the invention relates, so it can better estimate the impact of the innovation and its economic worth and more efficiently develop it. Furthermore, the invention may relate to products in a market dominated by the employer, so the employer may be able to profit more from it than competitors and thus offer the inventor better terms. Indeed, technology is so specialized today that a particular employer may be the only firm which can in practice make use of an invention.

These advantages of the employer, added to the inventor's lack of financial ability to develop the invention on his own, give the employer both the ability and the incentive to bargain effectively for an exclusive license in competition with other firms. Thus, the employer need not fear being denied the use of inventions developed in its own laboratories. If, for whatever reason, the employer can use the invention more efficiently than other firms in the market, it can afford to offer the inventor more than those other firms for exclusive rights. On the other hand, if another firm can use the invention more efficiently, there is no reason why it should not be allowed, and even encouraged, to do so.

In either case, however, the employer should receive a share of the patent rights in order to preserve the incentive for supervisors and middle-level managers. Even if the employer is not the highest bidder for exclusive rights, and some other firm ultimately markets the invention, the employer should never-

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224 This does not mean, however, that the employer cannot be protected against the employee's wrongful disclosure of the innovation before a patent issues or in the event the innovation is unpatentable. *See* note 207 *supra*.

theless receive a share of the royalties paid, based on its effort in the innovative process.

Perhaps in many cases the employer's proper share of the royalties can be worked out by negotiation, but it is probably unrealistic to expect that agreement can be reached in every case. Where disputes develop over the employer's share of the royalties, or over the employee's share of royalty where the employer markets the invention, a backstop to private bargaining is necessary.

Possibly, an expert tribunal could make the decisions in such cases, but there is a more attractive alternative: compulsory arbitration, subject to a statutory standard.[225] Arbitration has had a long and successful history in labor disputes,[226] and it seems well suited to the allocation of patent rights between employer and employee, which, after all, is also a question of labor law. Like other labor disputes, disagreements over application of the proposed standard for division of patent rights will involve the customs and practices of a particular industry, firm, or laboratory. In arbitration, the parties can choose decisionmakers who know these customs and practices well and who can decide, without taking voluminous testimony, on a basis which seems fair to the parties. Just as arbitration creates a "common law of the shop" in labor law,[227] so in patent law it could create a "common law of the research and development laboratory," which both employer and employee would know and respect.

Furthermore, arbitration is preferable to adjudication by an expert tribunal for much the same reasons that private bargaining is preferable at the outset. No single tribunal is likely to possess the expertise necessary to assess technological contributions in fields as diverse as, for example, space exploration and internal medicine. If, however, disputes are subject to ar-

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225 *Cf.* 17 U.S.C.A. § 801-810 (1977) (Copyright Royalty Tribunal).

226 *See, e.g.*, Boys Markets, Inc. v. Retail Clerks Union, Local 770, 398 U.S. 235, 241, 252-54 (1970); United Steelworkers v. Warrior & Gulf Navigation Co., 363 U.S. 574, 577-83 (1960). *See generally* Note, *Prospective Boys Markets Injunctions*, 90 HARV. L. REV. 790, 791-95 (1977).

227 *See* United Steelworkers v. Warrior & Gulf Navigation Co., 363 U.S. 574, 577-83 (1960).

bitration, the parties can choose arbitrators who are familiar both with the field of technology at issue and with the practices of the particular industry.

A system of bargaining and arbitration might work as follows. After making an invention, an employee would apply for a patent in his own name. He would ordinarily fund patent prosecution out of his own pocket, but if the employer took a special interest in the invention, the employer might be allowed to contribute the time of its own attorneys, or fees for outside counsel, subject to the inventor's approval. If the employer were ultimately denied rights in the invention by arbitration, its expenses for patent prosecution would be reimbursed from the inventor's royalties.

Once a patent issued, the employee could begin negotiations with his employer and with other firms for exclusive licensing. Negotiations with the employer would be subject to the statutory standard, as would subsequent arbitration: that ownership should be divided according to the relative effort of the parties, above and beyond the ordinary, in overcoming human resistance to new ideas. There would, however, be a presumption of inventor ownership, so that the employer would be inclined to make reasonable offers for patent rights. Since the inventor would know that the employer's statutory share in the invention could be enforced by arbitration, he would also be reasonable.

In the absence of agreement, either the inventor or the employer could demand compulsory arbitration by a board consisting of three arbitrators, one chosen by each of the two parties and the third chosen by agreement between the first two.[228] The employee could not license the invention to a third party until the conclusion of arbitration.

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228 Arbitration would be necessary only in two situations: 1) where the employer is the only party interested in developing the invention, but the employer and employee cannot agree on the economic value of the invention or the appropriate division of rights and hence cannot negotiate a license; and 2) where the invention is licensed exclusively to a third party and the employer claims a share of the royalties. Since in either situation the interest of some party other than the inventor indicates that the invention is out of the ordinary, arbitration is likely to be used only when an invention has proved its economic merit to some degree. In the case of less promising inventions, the natural reluctance of the parties to incur the costs of arbitration will minimize use of the arbitration process.

The arbitration panel would determine the relative share of rights in the patent according to the statutory standard, subject to the presumption of inventor ownership. If the employer were the only bidder for the invention, the panel would determine reasonable terms for licensing, whether exclusive or nonexclusive, taking into account the statutory standard and estimates of the utility and value of the invention. If the employee had offers from third parties for rights in the invention, the panel would decide whether to allow him to accept any such offer in preference to the employer's best offer. If a license to a third party were allowed, the panel would decide what share of the royalties the employer should receive.

If the first license, whether to the employer or another firm, were nonexclusive, should the inventor have the power to negotiate further nonexclusive licenses? This power seems unwarranted if the inventor's share of patent ownership under the statutory standard is small. However, there are two reasons why it might nevertheless be good policy for the inventor to have this power. First, the employer always has the right to protect itself by paying for an exclusive license.[229] Giving the employer power over further nonexclusive licensing would allow it to pay the lower price for a nonexclusive license and then choose its own competitors. Second, the inventor's motivation in negotiations seems more neutral than the employer's. The inventor simply wants to make money by exploiting the invention, while the employer may have undesirable reasons, such as internal inertia or a desire to protect its market share or obsolete product lines, for refusing to license third parties nonexclusively or for demanding an unreasonably high price for a license.[230] If the employer has legitimate economic reasons for wishing to limit or delay production of an innovation, it should be able to afford an exclusive license. Thus, whenever negotia-

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229 Antitrust law presents no bar to an employer taking an exclusive license in an invention developed in its own laboratories. Even when the employer is a monopolist and the subject matter of the invention is related to that of patents which the employer already holds, the antitrust laws might not condemn the acquisition of exclusive rights to inventions generated internally. *See* 3 P. AREEDA & D. TURNER, *supra* note 189, § 706a, at 127-28.

230 *See* text accompanying note 189 *supra*.

tion or arbitration determines that the inventor merits a substantial share of ownership rights in the patent, he should also be given the sole power to negotiate nonexclusive licenses.

A more difficult question is whether the results of arbitration should be reviewable in the courts. Of course, it should always be possible to set aside an arbitral award procured by fraud or corruption, or one which violates the antitrust laws,[231] but whether the law should rely on judicial review to enforce the statutory standard is a more difficult question. If the standard is not enforced somehow, the parties and their arbitration panels might disregard it and apply criteria less likely to produce the desired incentives. On the other hand, judicial review might undermine the purpose of the arbitration system, *i.e.*, prompt resolution of disputes with maximum expertise and minimum cost to the parties and to society. Moreover, the availability of judicial review may give the employer, who normally has far greater financial and legal resources, a tempting opportunity to delay the resolution of disputes and bleed the inventor financially.

For these reasons, judicial review should be limited. An appropriate standard of review might be "clear abuse of discretion." In addition, review might be made contingent on the minority arbitrator certifying under oath that, in his expert opinion, the decision to be reviewed clearly violated the statutory standard for division of rights.

Whatever the standard of review, any exclusive license should be subject to challenge in the courts if the licensee fails to make effective use of the patented invention within a reasonable time.[232] Any interested party, including the inventor, the employer, and any firm or individual with definite plans for making or using the invention, as well as the Commissioner of Patents and Trademarks, should be able to challenge dilatory use of patent rights.[233] If the challenging party can prove that

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231 For example, if an arbitration awarding full rights to the inventor resulted in a third-party monopolist acquiring exclusive rights in an invention technically related to a pre-existing accumulation of patents in the monopolist's hands, there might be a violation of the Sherman Act. *See* 3 P. AREEDA & D. TURNER, *supra* note 189, § 705a, at 118.

232 The Nixon Memorandum has already promulgated a similar policy for government-owned inventions. *See* note 212 *supra*.

233 Similarly, to prevent the inventor from holding out for unreasonable royalties

the licensee has failed to make effective use of the invention, the license should be cancelled, leaving the inventor free to negotiate new licenses with any interested party. In this way a free market in ideas would be ensured by preventing all parties involved from buying the right to suppress an invention for the term of the patent.

Thus the system proposed here for restoring incentives for people to patent law is one of divided ownership, with the inventor's and employer's shares determined by private bargaining, backed by arbitration and limited judicial review. It has the advantage of preserving the incentive effect of patent royalties, which test the faith of the inventor, are naturally proportioned to the value of the innovation, and avoid distortion of the free market system by requiring those who benefit from innovation to pay for incentives. And it also has the advantage of providing a complex of incentives consistent with a realistic model of research and development in modern America.

Unlike present law, the proposed system would produce incentives for inventors by prohibiting advance assignment of patent rights and giving the inventor a share of those rights proportional to his extraordinary effort in overcoming resistance to his new idea. It would not, however, do so at the expense of the corporation, which would retain a share of the patent rights proportional to the extraordinary inventive efforts of its supervisory and management personnel. Thus the proposed system would not appreciably discourage corporate investment in research and development.[234] More importantly,

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from third parties if the employer has no interest in the invention, there ought to be some statutory provision for forcing a licensing agreement. Compulsory arbitration with any third party interested in the invention might be required. Alternatively, any party interested in the invention might be given a right of action to compel reasonable licensing of the invention if the inventor fails to exploit it effectively within a certain period, or an inventor who had never granted a license might be required to accept any reasonable licensing offer after the expiration of a statutory period. These alternatives would, of course, require some procedure to determine what terms were reasonable, and whatever procedure was devised would undoubtedly be time-consuming and expensive.

234 As an additional incentive for research, the employer might be given nonexclusive shop rights whenever its extraordinary contribution to the inventive effort was deemed to be more than 50%, but otherwise no rights beyond those it could negotiate. *Cf.* HAWAII REV. STAT. § 663-31 (1976); COLO. REV. STAT. § 13-21-111 (1973 & Cum. Supp. 1976) (comparative negligence statutes precluding any recovery at all by a plaintiff

by making the corporation's share of patent ownership depend on the behavior of its supervisors and managers, the system would create a powerful incentive for such personnel to foster innovation. They would know that if they dragged their feet in developing a new idea which later proved patentable, their corporation would lose a vital share of the patent rights. On the other hand, they would also know that if they exerted extraordinary effort in overcoming resistance to the new idea, their corporation would get a larger share of the patent rights, and they would get the credit for making that share possible.

Much the same can be said for the inventor, who would know that not only the possibility of obtaining patent rights at all, but also his share of those rights, would depend on his continued efforts in development, refinement, and exploitation of his conception. The proposed system thus would provide both a carrot and a stick during all the stages of the process of innovation and for all the participants in the modern innovative drama, both the inventors, who create the ideas, and their supervisors and middle-level managers, who perform the function of the "investor" in the modern corporate model of innovation.

5. Government Contractors

For the bulk of research work that is now performed under government contract, the system proposed here would represent a striking departure from the present disposition of patent rights. Each corporation performing research and development work for the government is now obligated by contract to grant a nonexclusive license, and often exclusive rights, in its inventions to the government. Thus both the corporation and the inventor are denied *exclusive* rights to the invention.[235] Moreover,

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more than 50% negligent, but otherwise reducing the recovery proportionally to the fraction of negligence for which plaintiff is responsible).

235 Under the policy of the Nixon Memorandum, *see* text accompanying notes 101 to 120 *supra,* the government can award exclusive licenses to certain qualified applicants, including companies other than the one which developed the invention. Nevertheless, the effort, expense, and delay of processing an application for exclusive rights through the government bureaucracy, as well as the chance that an applicant other than the developer will obtain such rights, discourages reliance on the Nixon policy during an invention's developmental stages. Moreover, even if the developing firm obtains exclusive rights, the individual inventor is still barred by the assignment agreement from participating in the firm's gains.

since for many modern inventions the government itself is the principal market, even a nonexclusive license on the government's part may deprive both the corporation and the inventor of significant monetary reward from patent royalties.

Knowing this in advance, the inventors, supervisors, and middle-level managers who work for the government or for government contractors derive little or no incentive from the patent system. Instead, only the ordinary organizational incentives of salary, promotion, and public recognition motivate them, and these incentives are generally ineffective in encouraging innovation.

But should the government pay royalties to its own employees? The argument that the public "pays twice" when it pays royalties for an invention developed through government-sponsored research is stronger when the inventor works in government laboratories than when he works for a corporate contractor. Private contractors necessarily contribute the benefits of their prior experience, existing facilities and organizational structure to contract research, but the government must pay the costs of all this, and royalties, too, if its employees can own patents on inventions made with government aid.

Nevertheless, the record of recent innovation under government auspices is not so good that a proposal for additional incentives can be dismissed out of hand. The cost of most government research and development projects is already so large that an additional tiny percentage of that cost would constitute a sizeable reward for any individual, and even for most corporations. Thus it may be that government patent policy today is misdirected and that the payment of a small percentage of procurement costs in royalties would be well justified by the strong incentives for innovation it would create.

Since inventions developed for the government have no genuine market price, the royalty rate paid by the government need not necessarily be as large as the rate normally paid by industry. Perhaps a payment of as little as one or two percent of procurement costs on patented inventions would create the desired incentive. If the government resolved that such an incentive were worth the cost, then the system of division of

patent ownership proposed above could be adapted to government contractors, and even to government employees, simply by placing the government in the position of the corporate employer.

In the case of government contractors, patent ownership would be split three ways — between the inventor, the corporation, and the government — on the basis of the behavior of the inventor, the corporation's supervisors and middle-level managers, and the government's managers and contract monitors. The behavior of each would be measured against the standard of extraordinary effort in overcoming human resistance to new ideas, and patent rights would be allocated accordingly. In the case of an inventor employed by the government, the patent rights would be split between the inventor and the government by comparing the inventor's behavior with that of the supervisors and middle-level managers in the government laboratory. Where patented products were sold to the government, the government would calculate royalties based on a statutory percentage of the acquisition price but actually would pay only the shares of those royalties corresponding to the inventor's and contractor's ownership of patent rights. Where patented products were sold to third parties, the government's share of the royalties would be paid into the treasury.

In addition to providing an extra incentive for individual inventors and for contractors' personnel, which is now sorely lacking in government-sponsored research and development,[236] this system would have the same beneficial effect on government supervisory and management personnel that it would

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236 One commentator has argued, however, that corporations have plenty of incentive to innovate under government contracts because such contracts allow them to build a base of technical personnel, plant, and expertise at the government's expense. *See Economic Aspects Hearings, supra* note 68, at 132-33 (remarks of Robert Lanzillotti, Chm., Dep't of Economics, Michigan State Univ.).

Certainly the chance to accumulate plant, expert personnel, and experience creates strong motivation to seek out and bid for government contracts. Whether such factors spur better performance under the contract once it is awarded, however, is another matter. A self-interested contractor bound to assign patents to the government would more likely attempt to siphon the better personnel and the more promising new ideas away from contract work. *See* Rines, *A Plea for a Proper Balance of Proprietary Rights,* IEEE SPECTRUM, Apr. 1970, at 43, 45 (over a 5-year period, one company's NASA operations produced four inventions while the corresponding commercial department filed 30 to 50 patent applications *per year*).

have on a corporation's supervisors and middle-level managers. The threat that their behavior would be responsible for a drastic decrease in the government's share of rights in an invention produced with government funds would strongly discourage anti-innovative behavior. Extra effort in fostering innovation, on the other hand, would enhance the government's share of the patent rights. The system would thus provide both a carrot and a stick for all personnel most closely associated with an innovation.

III. CONCLUSION

Our patent system, which controls and guides the development of science and technology, is nearly two hundred years old.[237] It subsists today in essentially its pristine form, despite great changes in the nature and methods of innovation; and it is beset with major problems.[238] The Patent Office is overworked.[239] Courts invalidate nearly 70 percent of patents which reach the appellate level,[240] and the Supreme Court has upheld the validity of only one patent in the last thirty years.[241] Consequently, the confidence of inventors and investors alike in the value of patent protection is declining. Moreover, patent litigation is so expensive that small companies often cannot enforce valid patents, while large companies, merely by threatening an infringement action, can enforce dubious ones.[242] With

237 The first patent act was the Act of April 10, 1790, 1 Stat. 109. The basic structure of the modern patent system was established in 1836. *See Revisions Hearings, supra* note 7, at 186 (floor remarks of Sen. Hart, Chm., on introducing proposed Patent Reform Act of 1973).

238 *See Revision Hearings, supra* note 7, at 186-87.

239 *See id.* at 180 (remarks of Rene Tegtmeyer, Acting Comm'r of Patents) (average time lag from application to issuance of patent is 23 months); *id.* at 186 (floor remarks of Sen. Hart, Chm., on introducing proposed Patent Reform Act of 1973) (2½-year backlog; over 100,000 new applications annually); *id.* at 188-89 (reply of Patent Office to letter of Sen. Hart, Chm.) (less than 1200 examiners for an annual influx of applications which increased from fewer than 91,000 to more than 103,000 between 1968 and 1972).

240 The Patent Office compiled this figure for the years 1968-1972. *See id.* at 196-98 (reply of Patent Office to letter of Sen. Hart, Chm., dated March 19, 1973).

241 *See* Sutton & Williams, *supra* note 26, at 567. The lucky patent was that at issue in United States v. Adams, 383 U.S. 39 (1966). The next most recent finding of validity by the Supreme Court was a per curiam affirmance of an appellate court's decision in Faulkner v. Gibbs, 383 U.S. 267 (1949).

242 *See* note 132 *supra.*

these problems screaming for attention, it is not surprising that, in hearings on the most recent reform bill, several witnesses proposed leaving the problem of employee compensation for another day.[243]

Effective patent reform, however, cannot begin without a clear conception of what the patent laws are intended to accomplish. At the moment, the federal government supports the vast majority of all research and development in the nation. Many of the resulting inventions are produced by government employees and compulsorily assigned to the government. Many others are assigned to the government under research and development contracts with private concerns. And a large fraction of all patented inventions, including those not assigned to the government, are of little use to anyone but government agencies. Does the whole patent system, then, with all its paperwork and its high cost of litigation, serve to shunt rights from one government agency to another?[244] Does it serve merely to encourage large corporations to build large research laboratories which will aid their technical dominance and economic power?

No, the patent system was designed to motivate individuals, by exciting their self interest, to do more in the public interest than they would do otherwise. The progress of technology depends on the contributions of individuals. The more people are motivated to follow their hunches, develop their strange new ideas, and find ingenious solutions to old problems, the

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243 *See* note 204 *supra.*

244 The logical contradictions and practical problems inherent in government ownership of monopoly rights primarily intended for private parties have convinced attorneys general and justices of the Supreme Court that the government cannot own patents. *See* Finnegan & Pogue, *supra* note 83, at 935-40. *But see* 3 CLARK REPORT, *supra* note 5, at 130-31. Although government ownership has been sanctioned by custom and judicial inaction, *see* Finnegan & Pogue, *supra* note 83, at 938, government ownership without exclusive licensing has two disadvantages. It nullifies the economic incentive provided by the right to exclude others from manufacturing and using the invention, and it wastes government funds on patent prosecution and the nonexclusive licensing of private applicants. *Id.* at 942-43.

To the extent that the government grants nonexclusive licenses to all applicants, the hordes of attorneys and mountains of paperwork required to maintain patents in the government's name serve only to encourage disclosure of inventions made by government employees and contractors. This objective could undoubtedly be accomplished more simply.

more rapid progress will be. Innovation is inherently disruptive, and people need a powerful incentive to endure the emotional strain involved in making the commitment to new ideas. Without a goad to endure that strain the nation's technology will drift slowly but perceptibly toward stagnation.

The goad suggested here is a simple one: the return of the constitutional incentive to the individual inventor and the creation of one for the supervisors and middle-level managers, who now perform the role of the "investor" of simpler times. This may be done through a statutory bar of advance assignment of rights in inventions. In order not to destroy the employer's incentive to invest in research, however, the employer must have *some* share of those rights, and this share must be determined by a reasonable standard, and enforced through arbitration or adjudication. The standard suggested here is a broad one: the relative efforts of the employed inventor and the employer's middle management and supervisors, beyond the call of the ordinary, in overcoming human resistance to new ideas. This standard is best implemented by the parties themselves in private bargaining, in which the statutory prohibition of advance assignment and a presumption of the inventor's ownership only barely overcome the employer's great natural advantages. Compulsory arbitration, with limited judicial review, can remedy failure of the bargaining mechanism.

The statutory system proposed here is not the only one which might be designed to resurrect the constitutional incentive. Yet whatever system is eventually enacted must have many of the same properties. It should provide some reward, and the concomitant incentive, to both the inventor and his employer. It should calibrate the reward to the special contribution of each participant in the process of innovation. It should recognize that today the supervisors and middle-level managers in both government and private industry make the resource-allocation decisions once made by private investors. And it should, if possible, avoid the staggering cost and delay of patent litigation in resolving ownership disputes. It is not as important that Congress adopt one scheme or another as it is that the patent laws be reformed to provide once again the incentive which the Founding Fathers so wisely wrote into the Constitution.

Today, restoring the incentive for innovation is not necessary solely for reviving the forgotten purpose of the patent system. It is also vital to the declining health of research and development in America. Progress in technology is not ordinarily made by scientists and engineers who forget their work at five o'clock. Yet with compulsory assignment of inventive ideas nearly universal, the technical employee has little economic incentive to stay after hours.[245] For this reason, if for no other, restoration of the constitutional incentive should be the first, not the last, task of patent reform.

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245 The morale of technical employees in the United States has been particularly low during the past decade due to massive layoffs caused by business cycles and cutbacks in government funding. For example, one observer reports that 100,000 engineering jobs "evaporated" in a period of 18 months due to a decline in government support. *See Innovation Hearings, supra* note 1, at 82 (statement of Robert Kuntz, Past Pres. and Nat'l Dir., Cal. Soc'y of Professional Eng'rs). *See also id.* at 136 (remarks of James Quillin, Pres., Dist. 727, Int'l Ass'n of Machinists and Aerospace Workers) (employment in aerospace industry decreased by 589,000 jobs between 1968 and 1973).

STATUTE

THE MUNICIPAL BOND MARKET: AN ANALYSIS AND SUGGESTED REFORM

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As tax limitation measures disrupt the accumulation of revenues by local governments, municipal bonds become a more important source of funds for needed capital projects. Unfortunately, the most prominent feature of municipal bonds, the exemption from federal income taxation of interest paid to their holders, causes costly and inequitable market imperfections that most severely hurt small and moderate size governments. Yet because the tax exemption remains a valuable subsidy, there is vehement opposition to any proposal to eliminate it.

Messrs. Bagwell, Evans, and Nielsen propose the creation of a national Municipal Development Bank that will allow the retention of the tax exemption but will repair the current inadequacies of the municipal bond market. Their proposal seeks to improve bond opportunities for local governments through a system of guaranteed repayment of financially sound bonds, direct loans to municipalities through the purchase of their bonds, and the dissemination of information regarding financial control techniques to local governments.

Introduction

Most state and local government entities[1] rely on the municipal bond market for a significant portion of the funding required for their capital projects. Currently, 50 percent of such capital financing is raised through long-term borrowing in the

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1 In addition to the 50 states and the territories, there are 3,000 counties, 18,000 municipalities, and 17,000 townships that can issue tax-exempt securities. 1 J. MARLIN & P. ROUSMANIERE, MUNICIPAL SECURITIES REGULATION, A PUBLIC PERSPECTIVE 11 (1977). For ease of reference, the term "state and local governments" is used in this Note to include all of these entities. In addition, this Note uses the conventional terms "municipal securities" and "municipal bonds" to refer to tax-exempt security issues of each of these entities.

municipal market.[2] Recent studies indicate that capital expenditures by these government entities can be expected to increase in the near future, with the bond market remaining as the primary source of funds.[3] Furthermore, there are factors which indicate that future demand for borrowed funds by state and local governments may be even greater than currently predicted.

First, there are clear indications of a general dissatisfaction with current levels of taxation throughout the country. The recent property tax referendum in California[4] and its progeny in other states[5] may be ushering in a period during which states and local governments will be restricted in their access to tax revenues, currently their greatest source of funds. Similarly, there are strong indications that federal grants and revenue sharing money, which make up the second most important source of state and local funding,[6] may be significantly reduced in the near future. President Carter has proposed an "austerity budget"[7] for fiscal year 1979 which not only cuts federal funds for local governments beneath the levels projected in the above-

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2 If confined to expenditures on construction of capital facilities, this figure is 60%. *See* P. HENDERSHOTT & T. KOCH, AN EMPIRICAL ANALYSIS OF THE MARKET FOR TAX-EXEMPT SECURITIES: ESTIMATES AND FORECASTS 43 (1977) (Center for the Study of Financial Institutions, Graduate School of Business Administration, New York U., Monograph Series in Finance and Economics, Monograph No. 4) [hereinafter cited as HENDERSHOTT & KOCH].

3 The studies, conducted in the mid-1970s, attempting to project capital expenditures and sources of revenue for state and local governments, vary in their predictions of the extent to which capital financing will come from borrowed funds. A study conducted by the Brookings Institution estimates this figure at 50%, while a Tax Foundation study estimates 60%. The Brookings study estimates the rate of increase in capital expenditures at 10% per year through 1980. These findings, and those of several other studies, are summarized in J. PETERSEN, CHANGING CONDITIONS IN THE MARKET FOR STATE AND LOCAL GOVERNMENT DEBT, 94th Cong., 2d Sess. 48-51 (Comm. Print 1976) (prepared for Joint Economic Comm.) [hereinafter cited as PETERSEN]. Inflation is expected to account for much of the nominal increase, while the real increases will be due largely to increased commitment to waste treatment and mass transit. B. BOSWORTH, J. DUESENBERRY & A. CARRON, CAPITAL NEEDS IN THE SEVENTIES 34-36 (1975).

4 *California Voters Approve a Plan to Cut Property Tax $7 Billion,* N.Y. Times, June 7, 1978, at A1, col. 4.

5 *13 States Curb Taxes on Spending; A Variety of Other Initiatives Fail,* N.Y. Times, Nov. 9, 1978, at A20, col. 5.

6 Federal grants-in-aid currently constitute 26% of state and local expenditures.

7 Clark, *Putting the President's Budget Together,* NAT'L J., Jan. 27, 1979, at 124. OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSES BUDGET OF THE UNITED STATES FISCAL YEAR 1979, at 184-85 (1979).

mentioned studies,[8] but sets funding at real dollar levels below those of previous years.[9] The decrease in funds from taxes and the federal government, therefore, portends a greater reliance on borrowed funds than even the studies project.

Second, many state and local governments are responding to present financial pressures in a manner likely to create additional needs for future borrowing beyond those taken into account in current capital needs-projections. For example, many cities are facing a general increase in their high service-need populations, which creates a corresponding responsibility to provide more services.[10] While the costs of providing these services are increasing, the major sources of tax revenue which cities rely on to meet these costs are generally drying up.[11] Faced with this dilemma, these cities have reacted by raising taxes or, more often, cutting expenditures; very few are running deficits.[12]

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8 Carter's "austerity" level of aid to state and local government, at $82.9 billion, *id.*, represents an increase in aid since the early 1970s which is in accord with the increases projected by the various capital needs studies referred to in note 3 *supra*. However, the rate of increase in federal aid to state and local government, which has averaged 17% since the early 1960s, falls in this budget to 0.84%. *Id.* For yearly breakdowns on the increases through the 1970s, *see* OFFICE OF MANAGEMENT AND BUDGET, SPECIAL BUDGET ANALYSES FOR THE YEARS 1970-1979 (1979).

The magnitude of the increased borrowing by a particular government entity as a response to the federal cutbacks will depend upon the nature of the projects for which federal funds were to be used and upon the potential recipient's access to the municipal bond marketplace. Lessened availability of federal funds can produce three results: projects can be abandoned; capital expenditures can be financed by borrowing on the bond market; or, financing can be obtained, in whole or part, through alternative sources, such as allocations from general tax revenues. Those projects for which demand is largely contingent upon the availability of federal money or is generated primarily by the incentive of federal funds (*e.g.*, pollution control and mass transit projects), will likely be abandoned if such funds are not forthcoming. However, those projects which are necessary for the maintenance of an acceptable level of community services will probably not be abandoned, and the need for an alternative to federal funding will lead either to increased borrowing or to the use of funds derived from other sources.

9 The Carter austerity budget proposal of $82.9 billion in aid to state and local governments, an increase of only 0.84% over last year's $82.1 billion appropriation, represents a decrease in inflation-corrected dollars. Clark, *supra* note 7, at 124.

10 PETERSEN, *supra* note 3, at 24.

11 While local government costs increased by 25% during 1973 and 1974, the tax base valuation of these governments increased by only 15%. In addition, growing unionization of municipal workers has led to increased costs in the provision of services. *Id.* at 25; *see* Petersen, *Background Paper*, in TWENTIETH CENTURY FUND TASK FORCE ON MUNICIPAL BOND CREDIT RATINGS, THE RATING GAME 26 (1974) [hereinafter cited as RATING GAME].

12 PETERSEN, *supra* note 3, at 26.

While cutbacks are politically appealing in the short run, they can, in many instances, create significant fiscal problems in the future. Those which lead to disinvestment or deferral of investment in capital facilities will ultimately generate significant additional demand for capital funds which otherwise may not have existed. Reduction, postponement, or cancellation of maintenance expenditures on existing capital plants and equipment, for example, is a politically attractive response to increased budgetary pressures[13] which results in capital disinvestment. Such inadequate maintenance hastens the time when capital stock must be replaced, increasing significantly the overall lifetime maintenance and overhaul costs of that stock.

Many cities have also reacted to the recent financial "crunch" by postponing the construction of previously planned capital projects.[14] Assuming that many of these postponed projects are ultimately necessary for the provision of an adequate level of community services, they will have to be constructed at some point in the future. When such construction finally occurs, it will most likely be at a cost much higher than would have been required had the project been undertaken as originally scheduled. Therefore, the need for capital funds, most likely satisfied by borrowing in the municipal market, will also be greater.

It is clear that the financial well-being of state and local governments throughout the country depends greatly on two factors. First, there must be a municipal bond market which functions equitably and efficiently. Second, all municipal issues must possess the ability to sell bonds in this market on a continuous basis at interest rates which are reasonable and genuinely reflective of the risk involved in municipal investment. As the municipal market has undergone dramatic expansion in

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13 Maintenance expenditures for existing capital stock decreased from 29% of local budgets in the mid-1960s to 15% by 1975. Nye, *The Wearing Out of Urban America*, NATION'S CITIES, Oct. 1977, at 8, 10.

14 *See* HENDERSHOTT & KOCH, *supra* note 2, at 38-39. For example, it was estimated that state and local governments would postpone or cancel $600 million to $1 billion in capital expenditures during 1976. JOINT ECONOMIC COMM., 94TH CONG., 1ST SESS., THE CURRENT FISCAL POSITION OF STATE AND LOCAL GOVERNMENTS, 21 (1975).

the past few years,[15] it has become increasingly apparent that neither of these factors exists in the current structure of the municipal bond market. Characterized chiefly by its narrow investor appeal and high degree of volatility,[16] the current market is becoming an increasingly inadequate mechanism for providing capital funds to state and local governments. At the same time, many smaller issuers are finding it increasingly difficult to gain access to this market at reasonable rates because of the lack of reliable information available to investors and a corresponding overreliance on commercial bond ratings of dubious validity.[17]

It is, therefore, becoming more evident that there is a very real need for reassessment and reform of the existing municipal bond market structure. Toward these ends, this Note will provide a brief examination of the municipal market, and, based on this examination, propose a remedy to alleviate the market imperfections that currently hamper the ability of many issuers to attract sufficient investors at reasonable interest costs.

Section I focuses first on the dominant feature of the municipal market — the federal tax-exempt status of municipal bonds — and discusses the inequity, inefficiencies, narrowing effects, and excessive market volatility which result from the fact of tax exemption. The Section then describes and analyzes the current system of grading municipal securities, noting the direct, but apparently unjustified, effect which this system has on the cost of borrowing imposed on municipal issuers. Based on this discussion of the existing market, Section II briefly examines some proposals and recently developed programs, at both the federal and state levels, which have been advanced to deal with some of the existing problems. Section III presents a detailed discussion of the proposal for the creation of a Federal Municipal Development Bank. This proposal, set forth as a

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15 In 1974, $22.824 billion in new state and local government securities were issued, more than double the $10.544 billion issued in 1964. HOUSE COMM. ON WAYS AND MEANS, MUNICIPAL TAXABLE BOND ALTERNATIVE ACT OF 1976, H.R. REP. No. 94-1016, 94th Cong., 2d Sess. 5 (1976) [hereinafter cited as 1976 TBO REPORT].

16 *See* notes 37 to 77 and accompanying text *infra.*

17 *See* notes 88 to 119 and accompanying text *infra.*

Model Statute in Section IV, is designed to be comprehensive enough to deal with all of the problems set forth in the discussion and, at the same time, be politically acceptable to the various interests affected by the municipal market.

I. FUNDAMENTAL CHARACTERISTICS OF THE MUNICIPAL BOND MARKET

The most distinctive characteristic of the existing municipal bond market is that it appeals only to a limited, well-defined segment of the investing public.[18] This narrowness of demand for municipal securities results directly from the fact that the interest paid on these securities is exempt from federal income taxation.[19] While the tax exemption is designed to provide a federal subsidy for part of the cost of borrowing for municipal issuers, the narrow market appeal which it engenders deprives these issuers of the full benefit of the subsidy.

First, it appears that this market narrowness, combined with the increased volume of municipal bonds offered during the past few years,[20] has forced interest rates on municipal securities to increase faster than interest rates on comparably graded corporate securities.[21] The most reasonable explanation is that municipal issuers have been forced to increase their interest rates in order to maintain a large enough market for the growing number of issues. Second, the limited size and nature of the market forces issuers to offer their securities with shorter maturities.[22] Generally, investors prefer shorter maturities

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18 Rosenbloom, *A Review of the Municipal Bond Market,* ECON. REV., Mar./Apr. 1976, at 10 [hereinafter cited as Rosenbloom]. *Contra,* R. FORBES & J. PETERSEN, *Background Paper,* in TWENTIETH CENTURY FUND TASK FORCE ON THE MUNICIPAL BOND MARKET, BUILDING A BROADER MARKET 89 (1976) [hereinafter cited as FORBES & PETERSEN].

19 "Gross income does not include interest on — (1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or the District of Columbia . . . ." I.R.C. § 103(a). This provision is perennially attacked by the Department of the Treasury and by most academicians. *See Hearings on Taxation of Interest on Debt Obligations Issued by State and Local Governments before Senate Comm. on Finance,* 94th Cong., 2d Sess. (1976); Surrey, *Federal Income Taxation of State and Local Government Obligations,* 36 TAX POLICY 3 (1969).

20 *See* note 15 *supra.*

21 R. HUEFNER, TAXABLE ALTERNATIVES TO MUNICIPAL BONDS 39 (1973) (Federal Reserve Bank of Boston Research Report No. 53) [hereinafter cited as HUEFNER].

22 *See* Haar & Lewis, *Where Shall the Money Come From?,* 18 PUB. INTEREST 101, 104-07 (1970).

because of their desire to maintain investment liquidity;[23] whereas issuers prefer longer maturities which more nearly correspond to the life of the capital asset on which the borrowed funds are spent.[24]

In addition to these obvious adverse effects, there are more subtle problems which directly result from the tax exemption and the narrow market appeal it has created for municipal bonds. The following discussion explores these less apparent, but equally harmful, problems — inefficiency and inequity resulting from the use of this mechanism of federal assistance and promotion of a high degree of volatility in the municipal bond market.

A. *The Tax Exemption*

Although arguably of constitutional origin,[25] the tax exemption is now most often justified by proponents on the ground that it makes borrowing less expensive for issuers of municipal securities than would be the case if the interest paid on the

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23 Rosenbloom, *supra* note 18, at 13.

24 Browne & Syron, *Big City Bonds After New York,* NEW ENG. ECON. REV., July/Aug. 1977, at 3. Short maturities compress the repayment of funds used for capital projects into a shorter period of time than the useful life of the project, forcing today's taxpayers to pay the major portion of the cost of assets available to tomorrow's users. *See, e.g.,* L. ECKER-RACZ, THE POLITICS AND ECONOMICS OF STATE-LOCAL FINANCE 121-22 (1970).

25 Proponents of the tax exemption found their analysis on the case of McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819), in which Chief Justice Marshall stated that the "power to tax involves the power to destroy." 17 U.S. (4 Wheat.) at 430-31. Implicit in the constitutional principle of separation of powers is the belief that one government should not weaken or destroy the power of another. Hence, the doctrine of reciprocal immunity was established. Collector v. Day, 78 U.S. (11 Wall.) 113 (1871). In 1895, the Supreme Court ruled that the federal government could not tax the interest derived from state and local governmental securities. Pollock v. Farmers Loan and Trust Co., 157 U.S. 429 (1895). Because the exemption was enacted into law by Congress in 1913, Int. Rev. Code of 1913, § 11B, 38 Stat. 114, 168, the Supreme Court has not reviewed its decision in *Pollock.* Most commentators believe, however, that if the issue were to arise today, the Court would overrule *Pollock,* rejecting the view that the tax exemption is constitutionally mandated. *See* Note, *The Continuing Debate Over the Municipal Exemption: Time for a New Approach by Reformists,* 25 SYRACUSE L. REV. 953-59 (1976) [hereinafter cited as *Continuing Debate*].

The recent Supreme Court decision, Usery v. National League of Cities, 426 U.S. 833 (1976), might breathe new vitality into arguments of constitutional state sovereignty over the costs of operating the government. In *Usery,* the Court held unconstitutional a federal law requiring states and cities to pay their employees the minimum wage and time and one half for overtime. The court based its decision in part upon the impact of increased cost from the regulations on the functioning of the local government.

securities were subject to the federal income tax.[26] The federal subsidization of municipal borrowing through the tax exemption results because investors calculate a bond's yield according to its after-tax rate of return. Since income from municipal securities is not diminished by federal taxes, these bonds attract investors even though they offer an interest rate less than that of a comparably safe, taxable debenture.[27]

This form of subsidy, however, has proven to be problematic since it fails to direct its full benefit to the municipal issuers. In other words, not all of the tax revenue foregone by the United States Treasury is translated into lower interest costs for municipal issuers.[28] In fact, when calculated as a ratio of interest savings to lost tax revenues, the federal tax subsidy has an efficiency of only 0.73.[29]

The twenty-seven cents of every dollar given up by the United States Treasury that does not benefit municipal issuers is known as "spillage," for reasons that become apparent when one examines the nature of this effect. Because municipals pay an interest rate significantly below the going market rate on taxable bonds,[30] only investors that can benefit substantially from their tax-free quality will purchase them. Yet not all taxpayers benefit equally: those in the higher marginal tax brackets have a higher effective after-tax return than those in lower brackets. For example, a 6 percent return for a person in the 28 percent tax bracket is the same as an 8.33 percent after-tax return from a taxable bond. But for the person in the 50 percent tax bracket, a 6 percent return on a nontaxable obligation

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26 *Cf. id.* at 964-66.

27 *See* FORBES & PETERSEN, *supra* note 18, at 77-88. New York City is an exception. During the "credit crunch of 1975," Municipal Acceptance Corporation bonds carried interest rates as high as 11%, a figure which was considered to be astronomical. *See* Weisman, *Interest Rates on M.A.C. Bonds Set at New High,* N.Y. Times, Aug. 15, 1975, at 1, col. 1.

28 PETERSEN, *supra* note 3, at 55-58.

29 *Id.* at 56; FORBES & PETERSEN, *supra* note 18, at 150.

30 Since World War II, the ratio of the exempt interest rate on public offerings to the taxable corporate bond yield has ranged from 64% to 80%. In 1975, municipal borrowers paid 7.05% interest per year, while corporate borrowers were paying 9.46% per year on the same amount, a ratio of 74.5%. 1976 TBO REPORT, *supra* note 15, at 5-6.

is the equivalent of a 12 percent after-tax return from a taxable corporate bond.[31]

If the total amount of bonds issued by municipalities were purchased solely by investors in the highest marginal tax bracket, the spillage problem would not exist. The revenue foregone by the Treasury would equal the amount saved by municipal issuers through the subsidized, lower interest rates. Such a situation, however, does not exist in the current municipal marketplace.[32] In order to attract an adequate number of investors to purchase the growing number of bond issues, municipalities are forced to offer higher interest rates and, thereby, make municipal bonds an appealing investment to taxpayers who are in marginal brackets below the maximum tax rate. As a result, those investors in higher tax brackets receive a greater yield on their municipal investments than would have been possible if they had invested in taxable bonds. This surplus, or spillage, is that part of the tax revenue which is foregone by the Treasury but does not redound to the benefit of municipal issuers. The magnitude of such spillage is quite large: in 1970, the Treasury gave up approximately $4.8 billion as a result of the tax exemption for municipal bonds, but the interest burden of municipal issuers was reduced by only $3.5 billion.[33] The $1.3 billion difference went to the very high bracket taxpayers who received that much more in exempt income than should have been necessary to induce their purchase of municipal bonds.

This inefficiency is just one of the problems created by the interaction of the tax exemption and the structure of the current municipal market. A second major concern is that of inequity in the tax structure resulting from the way in which the incidental and unintentional benefit of this spillage is distributed among taxpayers. The federal income tax system is based on a fundamental principle of progressiveness. Simply stated, this prin-

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31 This example is drawn from Fidelity Municipal Bond Fund, Inc., Application and Prospectus (1977).

32 PETERSEN, *supra* note 3, at 56.

33 *Id.*

ciple dictates that as an individual's income increases, his tax liability should increase at a greater rate.[34] The current treatment of municipal bonds, however, directly conflicts with this progressive principle. Over 50 percent of the interest income from tax-exempt municipal bonds received by individuals is received by those with adjusted gross incomes exceeding $50,000 and subject to marginal tax rates on their nonexempt income ranging between 50 to 70 percent.[35] Yet, this interest income, being exempt, is taxed at a marginal rate of zero. This can hardly be considered progressive, at least with respect to this form of unearned income. In addition, the remaining benefits of the spillage are not distributed equitably among all taxpayers. Instead, they are limited to higher bracket taxpayers, the only individuals for whom municipal securities offer a feasible alternative to investment in corporate securities.[36]

B. *The Problem of Volatility*

The most significant effect of the narrow investor appeal of municipal bonds, caused by their tax-exempt status, is an exceptionally high degree of volatility in the municipal marketplace.[37] Historically, the demand for municipal securities has come almost exclusively from commercial banks, high income households, and fire and casualty insurance companies. Because the behavior of each of these groups has proven to be extremely sensitive to slight changes in the economy or developments in portfolio management techniques, the demand for municipal securities has tended to vary greatly over relatively short periods.[38] This instability and unpredictability is considered to be one of the most serious defects in the current market structure.[39] To show why this is so, the following discussion briefly

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34 HUEFNER, *supra* note 21, at 38-39.

35 PETERSEN, *supra* note 3, at 58.

36 *Id. See also Continuing Debate, supra* note 25, at 961.

37 *See National Domestic Development Act: Hearings on H.R. 8562 et seq. Before the Subcomm. on Economic Stabilization of the House Comm. on Banking, Finance and Urban Affairs,* 95th Cong., 1st Sess. 161 (1977) (statement of Bruce F. Vento).

38 PETERSEN, *supra* note 3, at 33.

39 *Alternatives to Tax-Exempt State and Local Bonds: Hearings Before the House Comm. on Ways and Means,* 94th Cong., 2d Sess. 157 (1976) (statement of Prof. Stanley Surrey, Harvard Law School).

describes the three groups of purchasers, the history of their involvement with municipal bonds, and the way in which the behavior of each group contributes to the volatility of the market.

1. Commercial Banks

Commercial banks currently constitute the largest group of purchasers in the municipal market.[40] This has not always been the case, however. Banks were actively involved in the municipal market during World War II, but they were supplanted by individual investors during the 1950s. Not until the early 1960s did banks return to the market and reestablish themselves as the dominant investor group, a position they have since maintained.[41] During the first five years of the 1970s, however, the percentage of outstanding municipal securities held by commercial banks decreased by 2.3 percent.[42] In addition, during the same period the ratio of municipal securities to total assets declined for most banks,[43] providing further evidence of decreasing interest in municipal bonds on the part of banks. Although there was some indication that banks were returning to the municipal securities market in 1977 and 1978, it is too early to tell whether this represents a long-term resurgence in their interest.[44]

Because the purchase of municipal bonds is not the primary activity of commercial banks, their interest in these securities depends heavily upon the banks' having uncommitted funds remaining for investment after they have satisfied the needs of their clientele.[45] The result is a highly volatile demand which responds primarily to forces completely beyond the control of municipalities. For example, the relatively sustained period of prosperity that the United States enjoyed during the 1960s caused bank deposits to grow faster than demand for bank

40 PETERSEN, *supra* note 3, at 35.
41 Rosenbloom, *supra* note 18, at 13-14.
42 PETERSEN, *supra* note 3, at 35.
43 *Id.*
44 Allan, *The Star of '77: Municipal Bonds,* N.Y. Times, Jan. 1, 1978, § 3, at 1, col. 1; Snyder, *Municipal Bonds: Investors Can't Get Enough of Them,* FORTUNE, Nov. 1977, at 89.
45 *See* PETERSEN, *supra* note 3, at 36.

loans, leaving these institutions with ready cash for investment in municipals.[46] Concurrently, changes in portfolio management techniques freed cash for investment which had previously been tied up in meeting reserve requirements.[47] In addition, the sixties witnessed the introduction of the negotiable certificate of deposit, an instrument by which corporations and others could earn interest on their idle cash. This factor naturally contributed to increased bank deposits.[48] Furthermore, to meet the interest costs of these certificates, banks sought out high-yielding, short-term securities, frequently purchasing low-rated municipals.[49]

By the late 1960s, however, the forces which had given rise to the expansion of bank reserves and residual funds began to disappear. Banks found that they were falling to unacceptably low levels of liquidity and, instead of using their surplus funds to purchase more municipals, they retained their cash to bolster their liquidity positions.[50] More significantly, the primary advantage of municipal bonds to investors — the tax-exempt status of the income — began to lose its comparative appeal for banks as more attractive tax-sheltering devices became available.[51]

While these factors primarily affect the demand for municipals on the part of the larger banks,[52] additional demand-reducing factors affect smaller banks as well. For example, prior to 1975, smaller banks often used municipal securities as collateral to support their public deposits. Accordingly, growth in these deposits brought about a corresponding increase in the demand for municipal bonds. In 1975, however, Congress passed legislation which raised the federal insurance available on public time deposits from $10,000 to $100,000.[53] Since this new level should suffice to cover the majority of these deposits,

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46 *Id.*
47 *Id.*
48 FORBES & PETERSEN, *supra* note 18, at 78.
49 *Id.*
50 PETERSEN, *supra* note 3, at 36-37.
51 Kimball, *Commercial Banks, Tax Avoidance, and the Market for State and Local Debt since 1970,* NEW ENG. ECON. REV., Jan./Feb. 1977, at 20-21.
52 *Id.* at 18.
53 PETERSEN, *supra* note 3, at 37.

the need for municipals as collateral has decreased correspondingly.[54]

Finally, a preliminary warning has been issued with respect to the effect of recently authorized negotiable order of withdrawal (NOW) accounts[55] on the demand for municipal bonds by banks. While banks may be able to offset part of the interest costs of these accounts through increased service charges, to the extent they are unable to do so, these increased costs must be charged against revenue. Thus, as surpluses decrease, it is reasonable to expect that bank demand for municipal securities will also decrease.[56]

The conclusion that must be drawn from this analysis of the behavior of commercial banks in the municipal bond market is that this group of investors is, at best, an undependable source of capital.[57] Even the most recent behavior of these investors — the unexpected return to the market during the past two years[58] — underlines the fact that this segment of the bond market is both volatile and highly sensitive to fluctuations in economic conditions. And, as the following discussion indicates, the other segments of the market, households[59] and insurance companies, do not have the resources or influence to temper the volatility.

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54 *Id.*

55 12 U.S.C. § 1832 (1976). Authorization for NOW accounts was recently extended to financial institutions in New York by the Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-630, § 1301, 92 Stat. 3641 (1978).

The Court of Appeals for the District of Columbia has held that the automatic transfer of funds between savings and checking accounts in commercial banks, a variation of the NOW account, is illegal. American Bankers Association v. Connell — F.2d — (D.C. Cir. 1979).

56 Kimball, *supra* note 51, at 19.

57 Miller, *Storm Signals for Municipal Bonds,* N.Y. Times, Oct. 16, 1977, § 3, at 4, col. 3; *see* Morris, *Tax Exemption for State and Local Bonds,* 42 GEO. WASH. L. REV. 526, 534-36 (1973-74).

58 *See* note 44 *supra.* Preliminary year-end figures indicate that commercial banks bought an unexpectedly large amount of state and city bonds in 1978. Although in previous periods of high interest rates and heavy credit demands, banks were often forced to reduce their tax-exempt portfolio, they did not do so in 1978. Why this occurred has not yet been explained. *See Prices of Tax-Exempts Remain Stable on Surprisingly Heavy Retail Demand,* Wall St. J., Dec. 11, 1978, at 36, col. 3.

59 The term "household" is used interchangeably with the term "individual" in this discussion.

2. Households

Although households are ranked second in importance among municipal security investors, less is known about their behavior than about the behavior of either of the other groups.[60] What has been determined is that this group serves primarily as a "market-clearing" source of funds for municipal issuers. In other words, these issuers attract more than a nominal number of households only when interest rates or municipal securities are raised sufficiently to make these securities competitive with investments in the stock market and corporate bond market.[61] Such levels are reached only when, and to the extent that, municipal issuers are unable to sell the full amount of their new offerings to the other groups in the market.

In the 1960s and the early part of the 1970s, overall household demand for municipal securities exhibited a significant downward trend, declining from 43 percent of total outstanding municipal securities in 1960 to only 26 percent in 1972 and 1973.[62] A recent development, however, may bring about a change in the role of households in the municipal market. This development is the creation of municipal bond funds. Since their inception in 1976, the number of these funds has grown dramatically. Thirty-two were in existence by the end of 1977.[63] Since they are organized as partnerships, interest income earned through investment in the municipals is passed directly to the investors without any federal income tax being imposed. In 1977, an estimated $2.35 billion worth of participations in these municipal funds were sold, slightly less than the $2.64 billion worth sold in 1976.[64]

In spite of these figures, it is not at all clear that the new funds actually represent a stable source of capital for state and local governments. While the hope is that the bond funds will bring in households to replace the commercial banks which are

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60 Rosenbloom, *supra* note 18, at 15.
61 FORBES & PETERSEN, *supra* note 18, at 84.
62 Rosenbloom, *supra* note 18, at 15.
63 Snyder, *Municipal Bonds: Investors Can't Get Enough of Them,* FORTUNE, Nov., 1977, at 90.
64 Allan, *supra* note 44, at 9.

leaving the marketplace,[65] there is ample room for skepticism since the funds are aimed at attracting the investors who have historically shown the least sustained interest in the market.[66] In addition, it must be noted that the new municipal funds have prospered during a period of relatively low stock market prices. Historically, when stock prices rise, the small investor shifts out of the municipal market and into listed stocks. Until stock prices rise once again, it is necessary to withhold judgment as to whether the new funds will bring about any sort of fundamental revival of investor interest in the municipal market.[67] In any event, because these funds currently account for only a very minor percentage of the market, it is doubtful that they can provide the broad, stable source of capital necessary to meet demands at a reasonable rate of interest in the near future.[68]

3. Fire and Casualty Insurance Companies

The third major investor group in the municipal market is composed of fire and casualty insurance companies. For members of this group, demand for municipal securities is directly dependent on current profit levels: insurance companies purchase tax-exempt securities only when, and to the extent that, they need to shelter high profits that would otherwise be taxable at the standard corporate income tax rate.[69] Conversely, when their profit levels drop, this group of investors tends to shift back to higher-yielding taxable securities.[70] In spite of this tendency, however, fire and casualty insurance companies used to be a remarkably stable investor group in the market. Between 1960 and 1970, their holdings remained constant at a figure of 12 percent of outstanding municipal securities.[71] Then, in early 1970, these companies increased their purchases significantly, only to have inflation and in-

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65 *See* Petersen, *Minding the Markets,* GOV'T FIN., Aug., 1977, at 52.
66 *Are the Municipal Bond Funds As Good As They Say?,* FINANCIAL WORLD, Apr. 15, 1977, at 51.
67 *Id.* at 31.
68 *See, e.g., Municipal Bond Funds: White Hope or White Elephant,* THE ECONOMIST, Dec. 18, 1976, at 124.
69 *See* FORBES & PETERSEN, *supra* note 18, at 83.
70 *See* PETERSEN, *supra* note 3, at 38.
71 Rosenbloom, *supra* note 18, at 15.

creased claim levels depress profits — and municipal securities purchases — by 1973.[72] This fluctuating buying pattern has continued throughout the 1970s with the insurance companies returning to the market to purchase an all-time high of $13 billion in municipal securities in 1977, 250 percent more than the previous high of $5.1 billion in 1976.[73]

Although fire and casualty insurance companies are dependable investors in the sense that when they have sufficient profit levels they will invest in municipal bonds, they cannot always be counted on to absorb a given portion of new offerings. Their participation in the market is governed by their profits and those, in turn, are subject to the vagaries of the economy and calamities of nature.[74] Thus, as with commercial banks, the demand of this investor group is determined in large measure by factors which are beyond the control of municipal issuers.

State and local governments will not achieve a measure of stability equal to that of their corporate counterparts until they are able to rely upon a stable group of investors who will purchase and hold municipal securities as a primary investment.[75] As this discussion has shown, the market does not presently provide such a group. Furthermore, it cannot hope to establish one unless it develops an ability to attract capital from all segments of the debt market at reasonable interest rates. As long as the sole mechanism of federal assistance is the tax exemption, the market will not have this necessary attractiveness.

The Municipal Development Bank is designed to supplement the tax exemption with federal guarantee[76] and direct loan programs[77] that will largely eliminate the narrowness and volatility problems which plague the current market. Before turning to a discussion of that proposal, however, it is important to note two additional aspects of the existing market structure which, while not directly linked to the tax exemption, also adversely affect

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72 *Id.* at 16.
73 Allan, *supra* note 44, at 9.
74 Rosenbloom, *supra* note 18, at 15; FORBES & PETERSEN, *supra* note 18, at 83-84.
75 Rosenbloom, *supra* note 18, at 19.
76 *See* notes 159 to 182 and accompanying text *infra;* PROPOSED MUNICIPAL DEVELOPMENT BANK ACT § 8(a) [hereinafter cited as MDBA].
77 *See* notes 183 to 197 and accompanying text *infra;* MDBA § 8(b)-(c).

the operation of the market: (1) the inadequate secondary market structure for municipal securities; and (2) the adverse effect that the current commercial rating system has on the cost of borrowing for municipal issuers.

C. *Inadequate Secondary Market Structure*

The discussion so far has focused on the market for the initial placement of newly issued municipal securities in the hands of investors. In addition, there exists another market, called the secondary market, which involves the resale of municipal securities among investors and which is twice as large, in terms of annual volume of securities traded, as the new issues market.[78] Because purchasers of securities in the new issues market may desire to liquidate their investments prior to maturity through use of the secondary market, accessibility and efficient functioning of that market will significantly affect investors' decisions whether to purchase new issues and, if so, for what price. Accordingly, a brief discussion of that market is now appropriate.

The secondary market is conducted on an over-the-counter basis, which means that it operates primarily through a diffuse network of dealers in municipal securities rather than through a centralized location where brokers for buyers and sellers can meet and trade.[79] Although anchored by a limited number of national firms that cater largely to major institutional clients, the market also contains a crucial segment of small dealers who primarily make markets in the issues of small government entities in their geographical region. These latter issues are generally neglected by the larger dealers who specialize in large trades.[80]

In order for investors to be willing to purchase municipal securities at the highest price, these securities must be highly

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78 Staats, *The Secondary Market for State and Local Government Bonds*, in 3 REAPPRAISAL OF THE FEDERAL RESERVE DISCOUNT MECHANISM 6 (Board of Governors of the Federal Reserve System ed. 1972).

79 *Id.* at 7. *See generally* Vartan, *The Greening of Over-the-Counter*, N.Y. Times, Jan. 29, 1978, § 3, at 1, col. 1.

80 Staats, *supra* note 78, at 8-9.

liquid.[81] In other words, investors must be able to resell the securities in the secondary market quickly, efficiently, and for a price reasonably reflecting the value of the security. Otherwise, they will demand a higher interest rate (lower original price) at the time of original purchase to offset the potential liquidity problems. To ensure the requisite liquidity conditions, the secondary market must exhibit certain characteristics. First, there must be a free interplay between a large number of buyers and sellers with adequate information on the particular securities and general economic conditions. Second, buyers and sellers must be brought together at a minimum cost through efficient institutional structures. Finally, the market must be able to adjust to temporary disturbances in the normal supply and demand relationship with reasonable price continuity.[82]

While the secondary market has a favorable history of providing for the orderly resale of municipals, even in times of severe market stress, its structure causes it to be considerably less liquid than the corresponding secondary market for United States obligations. Consequently, the interest rates on municipals rise faster (and thus price falls faster) than those on the more liquid federal securities.[83] Contributing to the municipals' relative illiquidity are (1) the unavailability of current information on most of the more than 100,000 outstanding issues; (2) the institutional resale structure centering on dealers whose patterns of business contribute to cyclical fluctuations in the market;[84] (3) the reluctance of investors seeking tax-free income to buy bonds at a discount from their face value;[85] and (4) the tendency of commercial banks to liquidate huge amounts of municipal bonds during periods of tight money.[86] As detailed

81 *See* notes 93 to 95 and accompanying text *infra.*

82 Staats, *supra* note 78, at 3.

83 *Id.*

84 Since dealers maintain an inventory of bonds to accommodate purchasers and stand ready to augment this inventory if an investor desires to dispose of a bond, the dealers will either profit or lose from changes in the market value of the inventory. Consequently, dealers will seek to reduce the size of their bond inventories during market price declines and increase their inventories when prices are advancing. These actions, however, accentuate the cyclical market action upon which the dealer is capitalizing. *Id.* at 4.

85 Any appreciation realized on tax-exempt bond, or any excess over purchase price received upon redemption or maturity, is taxable income to the investor. I.R.C. § 1232.

86 Staats, *supra* note 78, at 4.

later in this Note,[87] the activities of the proposed Municipal Development Bank are designed to alleviate the effects of these four factors in the secondary market, thereby increasing investor receptivity to the issuance of municipals in the primary market.

D. *The Rating System: Determining the Cost of Borrowing*

The cost of borrowing is measured by the interest rate which an issuer must pay to the purchasers of its securities.[88] In the case of securities issued by state and local governments, this rate can be subdivided into three fundamental components — the safe rate, the illiquidity rate, and the risk rate.[89]

The safe rate component is the base interest figure for the safest, most liquid securities[90] and is included in the cost of borrowing for all municipal obligations. This figure, determined by the equilibrium between the supply and demand for funds within the bond market,[91] is also affected by competing demand for investment capital in the form of non-municipal securities and other tax shelter opportunities.[92]

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87 *See* accompanying notes 154 to 206 *infra.*

88 *See* P. SAMUELSON, ECONOMICS 599 (10th ed. 1976).

89 *Id.* at 614-15.

90 The safe rate is the largest component of a borrower's interest cost. G. JANTSCHER, THE EFFECTS OF CHANGES IN CREDIT RATING ON MUNICIPAL BORROWING COSTS 36 (1970) (Investment Bankers of Am. Occasional Paper 1) [hereinafter cited as JANTSCHER].

91 This process is outlined in Fortune, *Tax-Exemption of State and Local Interest Payments: an Economic Analysis of the Issues and an Alternative,* NEW ENG. ECON. REV., May/June 1973, at 3, 20 app., 21-31; *see* Rosenbloom, *supra* note 18, at 16-17.

92 Competing tax shelters such as stocks, commercial bank leasing operations, depreciation, and foreign operations siphon off the supply of funds for investment in municipals without being reflected in statistics on the municipal marketplace. *See* note 51 and accompanying text *supra;* R. KIMBALL, COMMERCIAL BANK DEMANDS AND MUNICIPAL BOND YIELDS 160, 167-69 (1977) (Federal Reserve Bank of Boston Report No. 63) [hereinafter cited as KIMBALL]. There is little hard data on the effect in cost terms (as opposed to volume terms) of this competition, but by strengthening the position of the lender vis-a-vis the borrower, it presumably raises the safe rate. *Id.* at 14.

The effect of competing demands for funds within the municipal market is more easily quantifiable. The major competitors are Industrial Pollution Bonds (IPBs). These bonds now hold a 10% share of the market for tax exempt securities, and that share is increasing. FORBES & PETERSEN, *supra* note 18, at 212. There is an expected immediate increase of $4 billion to $6 billion of these issues, with the introduction of each $1 billion of IPBs into the market increasing the safe rate an estimate of 5 to 20 basis points. PETERSEN, *supra* note 3, at 20-21. As a result, state and local governments can expect to pay an extra $150 million in debt service costs per year on their bonds through 1980 because of IPB issues to that date. *Id.* at 21.

The illiquidity component of the interest rate reflects the likelihood of forced sale and the concomitant discount, resulting from adverse market conditions, that such a sale would entail. The amount of this discount is determined by two factors — the degree to which the interest rate has fluctuated for securities of the same grade as the one being offered for sale,[93] and the difficulty which is encountered in attempting to dispose of municipal securities in the secondary market. Because of the high degree of volatility in the municipal market, the informational problems with respect to most municipal issuers[94] and the general inadequacy of the secondary market for municipal securities, the problem of illiquidity for many municipal securities is significant.[95]

The third interest rate component — the risk rate — represents the likelihood of default by the issuer and the resulting loss to the holder of the issuer's securities.[96] Of the three components, the risk rate is determined in the most subjective manner. It is primarily the risk of default perceived by investors, and not the historical performance of the issuer, which appears to determine this component.[97]

Notwithstanding the recent, well-publicized financial difficulties of cities such as New York and Cleveland,[98] the actual risk of default on municipal obligations generally, based on historical performance, is remarkably small. In the period since World War II, state and local securities have proven second only to obligations of the United States government in security of investment.[99] During this period there have been only 431 defaults, of which over two-thirds have been of a temporary or

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93 *See* KIMBALL, *supra* note 92, at 48.

94 RATING GAME, *supra* note 11, at 32.

95 *See* Allan, *Tax-Free Bonds for the Little Guy?*, N.Y. Times, Sept. 25, 1977, § 3, at 2, col. 3; PETERSEN, *supra* note 3, at 53.

96 KIMBALL, *supra* note 92, at 53.

97 *See* JANTSCHER, *supra* note 90, at 14-20.

98 The problems of New York City appear to be fairly unique. New York City's borrowing policy has been *sui generis* since at least 1963, in terms of the proportion of new debt issued to new capital projects undertaken. The enormity of this proportion, relative to other municipalities, indicates New York City's vastly greater tendency to use debt financing imprudently to cover operating expenses. HENDERSHOTT & KOCH, *supra* note 1, at 40-41.

99 Advisory Committee on Intergovernmental Relations, Financial Emergencies in American Cities 22 (draft report 1972).

technical nature.[100] Further, 68 percent of these defaulting issues were held by banks within the immediate geographic locality of the issuer and, therefore, represent instances where standard investor safeguards may not have been observed.[101] Finally, the actual impact of most defaults has been moderated in the past because, even though an issuer might fail to make full payment at the required time, the amount ultimately not paid has generally been far less than the total obligation. Even during the series of defaults accompanying the Great Depression, when $1.35 billion in payments were not made when due, only $200 million of permanent loss was suffered by the holders of municipal obligations. In the period from 1945 to 1969, the dollar volume of defaulted bonds was about $450 million, but permanent losses of principal and interest totalled only $10 million.[102] The import of this evidence, as one observer has noted, is that "where the full faith and credit has been pledged for established public purposes by units of viable size and possessing a modicum of management, there simply has been no record of meaningful risk for forty years."[103]

From these facts it would be reasonable to predict that the risk rate throughout the municipal market generally should be fairly low and uniform for almost all issues. This, however, is not the case. Instead, the existence of a wide spectrum of interest rates[104] indicates that the risk perceived by purchasers of municipal securities is based upon information bearing little relationship to history of performance. To understand fully the functioning and determination of the risk rate, then, it is necessary to examine what this other information is and where it is obtained, since "if valid lines cannot be drawn among the qualities [of different issues], it seems unfair to subject issuers to discriminatory treatment on the grounds that such quality gradations exist."[105]

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100 RATING GAME, *supra* note 11, at 110.

101 G. HEMPEL, MEASURES OF MUNICIPAL BOND QUALITY 27 (1967). Additionally, 96% of the defaulting bonds were held by banks in the issuer's state. *Id.*

102 RATING GAME, *supra* note 11, at 110-11.

103 *Id.* at 117.

104 Kessell, *A Study of the Effects of Competitive in the Tax-Exempt Bond Market*, 79 J. POLITICAL ECON. 706 (1971).

105 RATING GAME, *supra* note 11, at 117.

The large number of issues and issuers of government debt,[106] as well as the wide variety of factors which might conceivably bear upon the ability of an issuer to make good on its obligations, make it virtually impossible for an individual investor to make a complete evaluation of each issue. As a result, most municipal securities investors have come to rely upon ratings assigned to issues by commercial rating services.[107]

There are two major services which give nationally recognized ratings to state and local government bond issues — Moody's Investors Service, Inc. (Moody's) and Standard & Poor's Corporation. Historically, through the efforts of these companies, ratings have been provided for 68 percent of the new municipal issues, representing 92 percent in dollar volume.[108] This very high percentage of issues rated exists despite the fact that, since the late 1960s, both services have required governments to pay a fee in order to have their ratings published. This fact alone indicates how significant these ratings are perceived to be in influencing market demand. Before looking at some other indications, it is helpful to take a brief look at how these ratings services operate.[109]

Both of the services operate in essentially the same manner. After learning of an impending municipal issue through an official notice of sale, the service begins to acquire basic information needed for a credit analysis. If an issuer has had an offering of its bonds rated previously, the service merely has to update that issuer's existing credit file. For a government which has not had a previously rated issue, annual budgets, financial reports, prospectus materials, and answers to various questionnaires must be obtained in order to provide the service with sufficient information for a full evaluation. Thus, the process of information collection must generally begin even before the service receives a contract from the issuer or another party willing to pay the required fee, although such a contract must be

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106 In 1974, there were approximately 120,000 separate municipal bond issues outstanding. These issues, with a total value of $165 billion, represented the borrowings of more than 34,000 entities. *Id.* at 32, 59.

107 *Id.* at 62-64.

108 *Id.* at 41.

109 For a more detailed discussion, *see id.* at 75-83 and sources cited therein.

agreed upon for the service to undertake the evaluation and ultimately publish the rating.[110]

The process of analysis involves several levels of research and review. A staff of analysts, assigned on a geographical basis, undertakes the initial evaluation and develops a recommended rating. The recommendation is then sent to a committee of senior analysts for review. If this group is satisfied with the recommendation, based on its own review of the data, the issue is assigned the final rating. Once a rating is decided upon, the service notifies the issuer, and the rating is released and published, generally about a week before the bond is to be offered.

For both Moody's and Standard & Poor's, the final rating is based on a classification scheme with seven categories, each category designed to represent a different level of risk.[111] The impact of an issue's rating upon the interest rate which the issuer will have to pay is well-documented.[112] Statistics indicate that the cost differential is approximately fifteen basis points (.15 percent) between the two highest grades and that this differential expands between successively lower graded issues.[113] While the existence of this impact on interest rates is clear, the justification for it is not.

Although both services use basic, straightforward criteria which must be considered in arriving at a decision regarding any issuer's creditworthiness,[114] they are very unwilling to release information about the manner in which these, and other,

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110 *Id.*

111 The ratings normally used by the services are as follows:

Quality of Bond	*Moody's*	*Standard & Poor's*
Prime	Aaa	AAA
Excellent	Aa	AA
Upper Medium	A, A-1	A
Lower Medium	Baa, Baa-1	BBB
Marginally Speculative	Ba	BB
Very Speculative	B, Caa	B
Default	Ca, C	D

Source: RATING GAME, *supra* note 11, at 40.

112 *See id.* at 43-46.

113 *See* Kessel, *A Study of the Effects of Competition in the Tax-Exempt Bond Market*, 79 J. POLITICAL ECON. 706 (1971).

114 RATING GAME, *supra* note 11, at 78 suggests the following criteria:

less straightforward or objective factors, are weighed in determining the final rating. The unwillingness of the services to discuss their methods has made it extremely difficult to assess the relevancy or sufficiency of the information and the appropriateness of the standards of evaluation upon which the ratings are based. Compounding this problem of assessment is the fact that so few rated issuers have defaulted in recent years that there has been no real test of the ratings system. Accordingly, it is not unreasonable to assert that significant costs in terms of higher interest rates, resulting from different rating levels, represent an overreaction by investors to the stratification imposed by the ratings system. Because most investors do not have access to significant outside information, they rely on the ratings as the primary indicia of issuer quality.[115]

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1. Current population of the community involved.
2. True — or market — taxable valuations.
3. Gross indebtedness.
4. Net indebtedness — Debt after making deductions for self-sustaining obligations, sinking funds, state assistance, etc.
5. Overall, or combined indebtedness (net debt plus the proportionate share of the indebtedness of any other governmental unit for which the community is liable).
6. The ratio of combined debt to population, expressed on a per capita basis.
7. The ratio of combined debt expressed as a percentage of true or market valuations.
8. The ratio of combined debt expressed as a percentage of per capita income.
9. The community's historical tax collection record including levies, collections, and delinquencies.

115 Although still of secondary importance, outside information — independent of an issue's rating — does have some influence. The amount of this influence is apparent in investors' reactions to the New York City "crisis." Although the publicity surrounding New York City related to specific instances of difficulty in honoring obligations by a specific issuer, investors have reacted with a lowered confidence in state and local government obligations generally. This decline in confidence forced many issuers to increase the interest rates on their obligations in order to attract an adequate number of investors. PETERSEN, *supra* note 3, at 42. These increases cost state and local governments about $150 million per year and will result in a total cost of about $1.5 billion over the life of the obligations. *Id.* at 42. The impact of these increases has varied depending on the region in which the issuer is located, with the fiscally harder-pressed Middle Atlantic states, excluding New York City, paying an average of up to 50 basis points higher, while the North Central region has paid approximately 10 basis points more. In addition, the recent fiscal crises of New York City and other major cities have lessened the attractiveness of municipal securities vis-a-vis corporate issues, with an average of 60 additional basis points now necessary to make a municipal obligation as attractive as a corporate bond with which it would have been traditionally competitive. PETERSEN, *supra* note 3, at 42.

Therefore, taking into account the previously noted fact that historical performance figures suggest municipal ratings generally may be too conservative, market reliance on such ratings may be forcing smaller, lower-rated issuers to pay considerably higher interest rates than are really justified.

It is important to note that high interest rates do not affect large and small governments evenly.[116] Large issuers appear to have more flexibility in the timing of their issues and to exhibit greater sophistication in anticipating and adapting to market fluctuations. Accordingly, they tend to accelerate or delay bond issues depending upon the favorability of the existing interest rate level.[117] Smaller governments, however, are less able to adjust their financing schedules to accommodate changes in market conditions.[118] As a result, they show a tendency to perservere in offerings during periods of high interest rates and then to cancel their proposed construction expenditures if they are unable to sell the offering.[119] Thus, the disadvantage that smaller governments face in the existing market structure is readily apparent: they must either pay the higher costs in times of higher interest rates or forego planned, and maybe even necessary, capital expenditures.

II. Reforming the Municipal Bond Market Structure

As the preceding Section shows, the existing municipal bond market contains several imperfections which needlessly increase the cost of obtaining capital funds for state and local government entities. While there is a general consensus that these imperfections exist and that they pose serious problems for municipal issuers, that consensus does not extend to the discussion of solutions for the problems. Indeed, a wide selection of alternative solutions has been proposed in recent years, but none has garnered the support necessary for widespread adoption. Before proceeding to a discussion of the proposal

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116 *Id.* at 30.
117 *See* Kimball, *supra* note 92, at 5.
118 *Id.* at 8.
119 Petersen, *supra* note 3, at 30.

upon which this Note is based, this Section provides brief summaries of some of the most significant proposed solutions.[120]

A. *Taxable Bond Option*

One widely discussed proposal has been the creation of a taxable bond option (TBO) for municipal issuers.[121] Although the details of TBO proposals have varied significantly,[122] the underlying principle of all TBO proposals is to give state and local governments the choice of issuing their securities as either subject to or exempt from federal taxation. For those issues sold on a taxable basis, the federal government would pay a direct subsidy to the issuer to offset some percentage of the higher interest cost resulting from the issue's taxable status.[123] Accordingly, when deciding whether a given security should be issued as tax-free or taxable, an issuer would presumably adopt the approach offering the lower net interest cost.

Proponents of the TBO method claim that it can alleviate the effects of existing market narrowness by giving municipal issuers the opportunity to attract a wider range of investors without giving up the benefit of federal assistance. In addition, proponents claim that the approach can reduce the perceived inequity which currently results from the fact that only high-income individuals are in a position to take advantage of the tax shelter afforded by the existing municipal market structure.[124]

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120 The discussion of alternatives is not intended to be an exhaustive one, but merely to provide a context within which the proposal accompanying this Note can be more easily evaluated. A more detailed summary of recent proposals for improving the structure and operation of the municipal market can be found in FORBES & PETERSEN, *supra* note 18, at 98-117, and sources cited therein.

121 For a good discussion of how a TBO program operates and of the various benefits and difficulties accompanying the TBO approach, *see* Note, *The Taxable Bond Option: An Elusive Tax Reform Goal*, 27 AM. U.L. REV. 733 (1978).

122 For recent examples of legislative proposals to create a taxable bond option for municipal issuers, *see* STAFF OF JOINT COMM. ON TAXATION, 95TH CONG., 2D SESS., SUMMARY OF THE PRESIDENT'S 1978 TAX REDUCTION AND REFORM PROPOSALS 29 (Comm. Print 1978); S. 261, 95th Cong., 1st Sess. (1977) (introduced by Sen. Kennedy); H.R. 12774, 94th Cong., 2d Sess. (1976).

123 The Kennedy bill, for example, provided for a subsidy rate equal to 40% of the interest yield. S. 261, 95th Cong., 1st Sess. § 3 (1977). The funds for this subsidy would come from revenues collected through taxation of the interest paid on the bonds.

124 *The President's 1978 Tax Reduction and Reform Proposals: Hearings Before the House Comm. on Ways and Means*, 95th Cong., 2d Sess. 66 (1978) (statement of Secretary of the Treasury W. Michael Blumenthal).

Finally, TBO advocates assert that the use of a direct subsidy is more efficient, from the perspective of both the federal government and the municipal issuers, than the implicit subsidy of the tax exemption.[125]

Although the TBO concept has been introduced for congressional consideration on numerous occasions over the past few years,[126] it has never managed to overcome the spirited opposition of most organizations of state and local government officials.[127] In addition to putting forth the constitutional argument against the federal taxability of municipal securities,[128] these groups express the fear that adoption of a TBO program would be the first significant step in the direction of increased federal intrusion into the management of state and local fiscal affairs.[129] At best, it is claimed, administration of the TBO program would involve state and local governments in a tangle of federal red tape or force them to comply with burdensome federal regulations in order to receive the direct subsidy amounts.[130] At worst, the groups fear that the introduction of a TBO program would ultimately result in the complete elimination of the tax exemption for municipal securities.[131] In general,

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125 *See, e.g.*, Note, *The Taxable Bond Option: An Elusive Tax Reform Goal*, 27 AM. U.L. REV. 733, 752-53 (1978).

126 *Id.* at 740 n.45.

127 The following organizations are among those which have gone on record in opposition to the TBO proposal: National Governor's Association; National Association of Counties; National Council of State Legislators; National Association of State Auditors, Comptrollers & Treasurers; and Municipal Finance Officers Association. Interview with Robert Doty, General Counsel, Municipal Finance Officers Association (March 20, 1978). Not all state and local government organizations disapprove of the TBO, however, and those on record as favoring it include the National Conference of Mayors and the National League of Cities. *Id. See also*, Morris, *Tax Exemption for State and Local Bonds*, 42 GEO. WASH. L. REV. 526, 527-29 (1974).

128 *See* note 25 and accompanying text *supra*.

129 *See, e.g.*, Priest, *The Case Against Taxable Municipal Bonds*, GOVERNMENTAL FINANCE, Aug. 1973, at 6.

130 *See, e.g., Taxation & Interest on Debt Obligations Issued by State and Local Governments: Hearing Before the Senate Comm. on Finance*, 94th Cong., 2d Sess. 76-77 (1976) (statement of Grady L. Patterson, Jr.).

131 *See, e.g., The President's 1978 Tax Reduction and Reform Proposals: Hearings Before the House Comm. on Ways and Means*, 95th Cong., 2d Sess. (1978) (prepared statement of Charles L. Davis, Municipal Finance Officers' Association). Although the imposition of conditions on the availability or amount of the interest subsidy might be avoided by returning to the issuance of tax exempt bonds, Mr. Davis suggests that once state and local governments have shifted to taxables and acquired customers for taxables, a large scale shift back to nontaxables would be very difficult. The suggestion

the opposition to this approach reflects the fact that the introduction of taxable bonds would be a fundamental alteration of the existing municipal market structure which could bring about disruptive and unpredictable side effects.[132]

B. *Direct Loan Programs*

In contrast to the fundamental change suggested by TBO proposals, a second alternative has been proposed at the federal level and adopted in a few states. This alternative, which involves direct loans to municipal issuers from state governments or a federal institution, is designed to supplement the demand for municipal securities within the existing market structure.

On the state level, several bond banks have been established during the past decade to reduce the cost of borrowing for the more obscure local governmental units within the state.[133] The programs of these state bond banks vary, but a common procedure is for the bank to make its loans in the form of bond purchases from the local issuers. The bank, in turn, obtains the funds for these purchases by selling its own securities. The advantage of this mechanism is that it shifts investor attention from the smaller issuers, about whom there is little available information and limited investor interest, to the state bank, whose greater prestige and ability to disseminate information on a widespread scale permits it to attract investors more easily and at less costly rates.[134] While these state banks do provide some advantages to smaller local issuers, they still cannot provide the level of advantages available with the direct loan pro-

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that TBO might result in a reorientation of the market mechanism is supported by Secretary of the Treasury Blumenthal's estimate that implementation of a TBO could result in 50% of all new state and local issues being taxable. WEEKLY BOND BUYER, Feb. 6, 1978, at 1.

132 *See, e.g., Alternatives to Tax-Exempt State and Local Bonds: Hearings Before the House Comm. on Ways and Means,* 94th Cong., 2d Sess. 123 (1976) (statement of Grady L. Patterson, Jr., State Treasurer of South Carolina and President of the National Association of State Auditors, Comptrollers, and Treasurers).

133 *See, e.g.,* ALASKA STAT. §§ 44.58.005-.420 (1976 & Supp. 1978); ME. REV. STAT. ANN. tit. 30, §§ 5161-5196 (1978); N.Y. PUB. AUTH. LAW §§ 2430-2454 (McKinney Supp. 1978); N.D. CENT. CODE §§ 6.09.4-01 to .4-21 (1975 replacement vol.); VT. STAT. ANN. tit. 24, §§ 4551-4710 (1975).

134 *National Domestic Development Bank Act: Hearings Before the Subcom. on Economic Stabilization of the House Comm. on Banking, Finance and Urban Affairs,* 95th Cong., 1st Sess. (pt. II), 65 (1977) (statement of Hon. John Rousakis).

gram incorporated in the proposal accompanying this Note.[135] The proposed federal bank can tap greater resources, spread costs more effectively, disseminate information more easily and widely, and generally take greater advantage of the economies involved in the direct loan approach.[136] And, perhaps most significantly, under the accompanying proposal the federal bank has the power to offer taxable securities,[137] an option not currently available to state bond banks. This power gives the federal bank the ability to broaden the national base of investors whose funds ultimately go to municipal issuers.

Some variations on the direct assistance theme have been proposed at the federal level, but none of these has gained acceptance on a general basis. One of the most comprehensive of these schemes was introduced late in the Johnson Administration. Known as the Urban Development Bank (Urbank),[138] this program was one of the first to call for the establishment of a federal institution which would have the power to issue taxable obligations and use the funds to provide direct, low-interest capital development loans to state and local governments.[139] The Urbank proposal has served as the basic model for many subsequent direct assistance plans,[140] including the direct loan portion of the proposal accompanying this Note.[141]

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135 *See* MDBA § 8(b)-(c).

136 *See* notes 183 to 197 and accompanying text *infra*.

137 *See* MDBA § 13.

138 Congressional legislation embodying this proposal appeared in the Senate and House of Representatives in 1969. *See, e.g.*, H.R. 5508, 91st Cong., 1st Sess. (1969); S. 409, 91st Cong., 1st Sess. (1969). For a detailed discussion of the provisions of these bills, *see* Lewis, *The Case for the Urban Development Bank*, in FEDERAL RESERVE BANK OF BOSTON, FINANCING STATE AND LOCAL GOVERNMENTS 173 (1970).

139 This original Urbank proposal is to be distinguished from the more recent National Development Bank proposed by President Carter. The Carter program provides for loans and loan guarantees to businesses in urban areas, not to the local governmental entities, in order to promote private sector economic development in these areas. *See* 14 WEEKLY COMP. OF PRES. DOC. 587-88 (Mar. 27, 1978); Crittenden, *Why Carter Means Business in Helping the Cities*, N.Y. Times, April 2, 1978, § 3, at 1, col. 6.

140 *See, e.g.*, S. 1396, 95th Cong., 1st Sess. (1977) (introduced by Sen. Humphrey); H.R. 7823, 95th Cong., 1st Sess. (1977) (introduced by Rep. Chappell); H.R. 1683, 95th Cong., 1st Sess. (1977) (introduced by Rep. Minish). Among the more significant aspects of the original Urbank proposal which were incorporated in some or all of these subsequent bills are: (1) authorization for the sale of taxable obligations by the bank coupled with a refund from the federal government to the bank in an amount equal to the difference between the interest paid by the bank on its obligations and the interest received by the bank on its loans; (2) use of a "backstop" provision requiring the federal

Proposals for direct loans not restricted in their use have not fared well in congressional debate. Their lack of success can, in large measure, be attributed to the difficulty which has been encountered in attempts to develop acceptable eligibility criteria, administrative standards and procedures, and conditions for the use of loaned funds. In particular, state and local government officials have vigorously opposed these programs because of their fear that heavily conditioned loans may ultimately replace the straight federal grants which they now receive for many projects.[142]

C. *Bond Guarantee Programs*

The third major solution which has been suggested for reducing the high cost of borrowing for municipal issuers would establish bond guarantee programs sponsored by government institutions. As with the other proposals, Congress has had several opportunities to consider legislation establishing a federal corporation to guarantee state and local government securities on a general basis, but it has never adopted a general guarantee proposal.[143] However, several special purpose loan

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government to purchase Urbank obligations whenever necessary to insure the financial integrity of the bank; (3) conferral of "off-budget" status on Urbank transactions, that is, exclusion of outstanding Urbank debt from calculation of the federal budget; and (4) establishment of a cooperative structure in which governments receiving bank loans are required to become members of the bank by purchasing a given amount of Urbank stock.

141 MDBA § 8(b)-(f).

142 *See, e.g., Federal Financing Authority: Hearings Before the House Comm. on Banking, Housing, and Urban Affairs,* 92d Cong., 2d Sess. 291 (1972) (statement of Peter B. Harkins, Nat'l League of Cities and U.S. Conf. of Mayors); *Alternatives to Tax-Exempt State and Local Bonds: Hearings Before the House Comm. on Ways and Means,* 94th Cong., 2d Sess. 123-24 (1976) (statement of Grady L. Patterson, Jr.); AMERICAN ENTERPRISE INSTITUTE, PROPOSED ALTERNATIVES TO TAX-EXEMPT STATE AND LOCAL BONDS 30-32 (1973).

143 One of the earliest such pieces of legislation was introduced by Senator Proxmire in 1969. S. 398, 91st Cong., 1st Sess. (1969). This bill, the Municipal Capital Market Expansion Act of 1969, provided for the establishment of a federal corporation which would report on the financial condition of applicants, guarantee debt service on taxable municipal bonds, and make interest reduction grants to offset the higher interest costs resulting from the taxable status of the guaranteed bonds. Despite its appearance in several other companion or identical bills during the same session, this proposal was never acted upon. Such lack of action has been a common fate of subsequent bills in this area. *See, e.g.,* H.R. 6419, 95th Cong., 1st Sess. (1975); H.R. 10412, 94th Cong., 1st Sess. (1975).

guarantee programs have been created by Congress in recent years.[144] In addition, states have established general guarantee programs for local government securities.[145] Because the guarantee concept is a major component of the accompanying proposal, a full analysis of its theory and operation is provided in the next section.[146]

It is important to note that two private corporations currently exist which provide general municipal bond guarantees on a nationwide basis. These corporations — the American Municipal Bond Assurance Corporation (AMBAC) and the Municipal Bond Insurance Association (MBIA)[147] — issue insurance policies on certain municipal securities,[148] guaranteeing full interest and principal payments for the life of the insured bond. The evidence clearly indicates that the effects of AMBAC and MBIA guarantees are an increase in the rating of a bond[149] and a reduction in interest cost to the issuer.[150]

The experience of these private insurers demonstrates the beneficial effects that credible guarantees can have in lowering borrowing costs. At this time, however, the private insurers do

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144 *See, e.g.,* 7 U.S.C. § 936 (1976) (Rural Electrification Administration loan guarantees); 33 U.S.C.A. § 1281 hist. note (Supp. 1978) (Environmental Protection Agency guarantees of Environmental Finance Agency guarantees of Environmental Finance Agency purchase of bonds for the construction of pollution control facilities); 42 U.S.C. § 4514 (1976) (Department of Housing and Urban Development guarantees of loans to finance the development of "new communities").

145 *See* notes 171 to 179 and accompanying text *infra.*

146 *See* notes 159 to 182 and accompanying text *infra.*

147 AMBAC, a subsidiary of MGIC Investment Corporation, was formed in 1971. MBIA, formed in 1974, is a joint venture of four major insurance companies — Aetna Casualty and Surety Company; St. Paul Fire and Marine Insurance Company; Aetna Insurance Company; and United States Fire Insurance Company. FINANCIAL WORLD, Oct. 1, 1976, at 19. For a general discussion of the role of private guarantors in the municipal bond market, *see* Minge, *Guarantying Municipal Bonds,* 1974 WISC. L. REV. 89 (1974).

148 Both AMBAC and MBIA restrict their guarantees to municipal bonds rated BBB or higher by Standard & Poor's.

149 With an AMBAC guarantee, Standard & Poor's automatically grants a rating of AA to the security. Because of the greater level of assets behind MBIA, issuers insured by this corporation automatically receive an AAA rating from Standard & Poor's. *A Boost For Municipals,* BUS. WK., Mar. 24, 1975, at 126. Moody's does not rate insured issuers as a matter of policy. FINANCIAL WORLD, Oct. 1, 1976, at 19.

150 One MBIA official, for example, has estimated that the average rate of interest savings for an issuer is about 0.50%. *A Boost for Municipals,* BUS. WK., Mar. 24, 1975. Still, even though MBIA-insured bonds are given automatic AAA ratings, unguaranteed AAA bonds sell at higher prices and lower interest rates. *Belt & Suspenders,* BARRON'S, Nov. 29, 1976, at 14-15.

not have sufficient resources to provide coverage for a very large segment of the market. Because the ratio of total assets to liability exposure is the key to the credibility of these private guarantee programs,[151] both AMBAC and MBIA are limited in the amount of debt they can cover and are very selective in the quality of bonds they will insure.[152] As a result, private guarantors cannot be expected[153] to provide the broad coverage that could be obtained through a federally established public guarantee program.

III. THE MUNICIPAL DEVELOPMENT BANK ACT

The proposed Municipal Development Bank Act[154] (the Act) establishes a federally chartered Municipal Development Bank (the Bank), which is charged with three functions. First, it is authorized to guarantee eligible securities issued by participating state and local governments.[155] Second, the Bank is empowered to make direct loans to participating governments under certain specified circumstances and to raise the funds for these loans through the sale of the Bank's own taxable bonds.[156] Finally, the Act directs the Bank to create and administer an Office of Technical Assistance (OTA), whose primary duty is to provide assistance to participating governments in the area of state and local fiscal management techniques.[157]

The proposed Act represents an effort to synthesize the positive attributes of the various alternatives summarized above into one comprehensive program.[158] The goal of the pro-

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151 Standard & Poor's rating treatment is based, in part, on strength of the insuring company's reserves, cautious selection of risks, and quality of issuers selected for insurance.

152 MBIA currently turns down about half of the applicants for its insurance. Further, while it will accept BBB-rated issues, 80% of its policyholders, in fact, held A ratings prior to obtaining the guarantee. *Belt & Suspenders,* BARRON'S, Nov. 29, 1976, at 14.

153 In fact, AMBAC is limited in the overall amount of isurance it may write on any single issuer to $20 million. *Id.* at 11.

154 A full text of the proposed Municipal Development Bank Act (MDBA) appears at pp. xxx-xxx, *infra.*

155 MDBA § 8(a).

156 MDBA § 8(b)-(g), 9.

157 MDBA § 7.

158 *See* notes 120 to 153 and accompanying text *supra.*

posal is to establish a mechanism which is administratively simple and economically efficient in its targeting of federal assistance to municipal issuers, and which has the flexibility provided by the tandem use of guarantee and direct loan programs. At the same time, the Act is designed to cause the least amount of disruption possible with respect to the private market and to guard against excessive federal intrusion into state and local processes.

A. *The Guarantee Program*

The guarantee program which the Bank is authorized to administer makes up the heart of the Act. This program is designed to alleviate the most serious problems facing individual municipal borrowers: misperception of the amount and differences of risk associated with most municipal securities; scarcity of information about many issuers, especially the smaller ones which rely most heavily on the municipal market for their capital funds; and illiquidity problems arising from the inadequate secondary market structure. The guarantee program accomplishes these goals by shifting investor attention away from the individual municipal issuers and toward the Bank, a more secure institution about which information is readily available. The result, as indicated by the experience of private guarantee programs, should be a significant lowering of interest rates.

The Bank is specifically authorized "to guarantee timely payment of principal and interest on obligations issued by State and local governments."[159] The guarantee extends to all general obligation and revenue bonds. Nevertheless, to insure that the Bank's limited resources provide maximum benefit to the municipal market as a whole, the Act contains specific eligibility criteria which limit the availability of guarantees to those issues and issuers who are sufficiently responsible, on the one hand, and sufficiently in need of Bank assistance, on the other.

The first criterion relates to the capital project for which the funds raised through the guaranteed issue will be used. Specifically, the Act requires "that the project to be assisted by

159 MDBA § 8(a).

such guarantee is consistent with Community Development Plans formulated . . . by the unit of local government with general jurisdiction over the area in which the project assisted by the guarantee will be located."[160] The Secretary of Housing and Urban Development, responsible for the administration of the Community Block Grant Program, can easily provide the information necessary for the Bank to determine if a given project complies with this requirement. However, if a community has not filed a community development plan encompassing the proposed project, no guarantee can be granted unless the OTA certifies, in accordance with regulations it is directed to promulgate, that the assisted project will be consistent with the economic development of the local community.[161]

The project eligibility criteria ensures that the benefits accruing from the federal Bank guarantee are available only to those projects which further such federal development policies as orderly community growth and responsible fiscal management. The goal of the Act is to achieve this result while minimizing administrative costs and permitting as much local discretion as possible in the use of funds raised with guaranteed bonds. Thus, mindful of the sensitivity of state and local officials in this area, the Act contains a proviso expressly stating that the project

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160 MDBA § 8(a)(1). The Community Development Program can be found at 42 U.S.C.A. § 5301 *et seq.* (1977 & Supp. 1979), and the regulations adopted pursuant thereto, 24 C.F.R. § 570.1 *et seq.* (1978). The relevant planning requirements are contained in 42 U.S.C.A. § 5304 (1977 & Supp. 1979) and 24 C.F.R. §§ 570.300-.303 (1978).

The list of construction projects eligible under the Community Development Block Grant Program provides some indication of the types of projects which are likely to be eligible for Bank guarantees:

> [T]he acquisition, construction, reconstruction or installation of public works, facilities, and site or other improvements — including neighborhood facilities, centers for the handicapped, senior centers, historic properties, utilities, streets, street lights, water and sewer facilities, foundations and platforms for air rights sites, pedestrian malls and walkways, and parks, playgrounds, and recreation facilities, flood and drainage facilities in cases where assistance for such facilities under other Federal laws or programs is determined to be unavailable, and parking facilities, solid waste disposal facilities, and fire protection services and facilities which are located in or which serve designated community development areas . . . .

42 U.S.C.A. § 5305(a)(2) (1977). While this list is useful as a general guide, restricting assistance to these enumerated projects by an express provision may unduly inhibit Bank flexibility and local discretion. Developmental consistency criterion should serve to target the use of the guarantee function without undue restriction.

161 MDBA § 8(a)(1).

eligibility criteria "shall not be construed as requiring guaranteed projects to meet strictly the eligibility criteria applicable to the Community Development Block Grant Program."[162] Furthermore, in recognition of the fear of federal intrusion which state and local officials often express when confronted with proposals in this area, the Act expressly prohibits the Bank from adding to the substantive eligibility requirements specified by the Act.[163] These provisions are intended to prevent the imposition of conditions which, although representing positive federal policies, are basically extrinsic to the purposes of the Act. Examples of such criteria would be requirements of prevailing wage or affirmative action in the construction of the project.

The other eligibility criterion relates to the financial condition of the issuer seeking a guarantee. Broadly speaking, the Act limits the availability of Bank guarantees to bonds issued by governments that are unable to obtain sufficient funds at an interest rate less than a "reasonable differential" above the average rate in the municipal market without a Bank guarantee, but that are also sufficiently credit worthy to justify a determination that the amount of the bond to be guaranteed does not exceed the repayment capacity of the issuer.[164] The Act directs the Bank to formulate regulations setting forth the procedures to be used to conduct the fiscal evaluation necessary to make this determination.[165] By restricting Bank assistance to those cities whose interest costs exceed the market average by a predetermined differential, for example .5 percent,[166] cities enjoying high ratings by the private rating services will be excluded from this program since that segment of the market is

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162 *Id.*
163 MDBA § 8(a).
164 MDBA § 8(a)(2).
165 MDBA §§ 7(b), 8(a).
166 In December, 1977, Aa-rated bonds paid an average interest rate of 5.23%. 1 MOODY'S MUNICIPAL AND GOVERNMENTAL MANUAL a10 (1978). Accordingly, during that period an interest rate below 5.73% would have been considered within a reasonable differential.

Since the reasonableness of an interest rate depends on the balancing of a wide variety of complex factors, determination of the appropriate differential is left to the informed discretion of the Bank's board of directors as exercised in the promulgation of appropriate regulations.

already functioning efficiently and their interest costs are at the lowest range of municipal interest costs. Conversely, those cities suffering significant fiscal difficulties will also be denied participation because their involvement would undermine investor confidence in the Bank. Moreover, the extension of guarantees to debtors of questionable soundness would commute the Bank from an institution designed to improve market efficiency to a federal subsidy for infirm municipalities. The cities that remain eligible are those which must pay interest rates above the market level because they are too small to receive a private rating[167] or to be traded through the larger dealers on a national basis[168] or, because of the mechanics of the private rating systems, receive very low ratings that do not reflect their actual ability to repay their debt.[169]

By restricting the guarantee to issuers who are unable to attract sufficient investment demand without the benefit of the guarantee, the Act avoids interference with that segment of the municipal market which is currently functioning adequately. In addition, this restriction essentially eliminates the potential for competition between the Bank and the existing private insurance corporations. As noted previously,[170] the private guarantors limit their coverage to a small, highly rated segment of the market, while the Bank guarantee is intended to benefit the larger segment of smaller, medium rated and unrated issuers.

While the threshold criterion of need insures that Bank assistance is available only to those who require it most, the Act also protects the financial integrity of the Bank by requiring that it reject guarantee applications from especially risky issuers. In addition, this threshold criterion of financial condition gives the Bank some leverage to use for encouraging improved fiscal management on the local government level.

Existing state guarantee programs and federal guarantee proposals vary in the restrictiveness of their eligibility criteria. With respect to project scrutiny, most state programs are

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167 *See* notes 115 to 119 and accompanying text *supra.*
168 *See* note 80 and accompanying text *supra.*
169 *See* notes 110 to 115 and accompanying text *supra.*
170 *See* notes 151 to 153 and accompanying text *supra.*

limited to guarantying bonds used for construction of specific types of projects, such as school buildings,[171] pollution control systems,[172] or health care facilities.[173] In contrast, the Minnesota guarantee program[174] and several of the federal proposals,[175] place only minor restrictions, if any, on the purposes for which funds raised from the sale of guaranteed bonds may be used.[176] In the area of issuer scrutiny, one program requires a showing of inability to market the bonds at a reasonable rate without a guarantee;[177] several programs require a showing of fiscal soundness similar to the Act's requirement that the amount of the bond not exceed the debt paying capacity of the issuer,[178] and, one of the federal proposals contains threshold showings at both ends of the risk spectrum[179] in the same manner as proposed by the Act.

Should an issuer default on payments with respect to a guaranteed bond, the Bank is directed to meet the issuer's

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171 N.H. REV. STAT. ANN. § 195-C:1-:5 (1978). This statute contains the additional requirement that the state School Building Authority determine that the project for which a guarantee is sought "will be of public use and benefit." § 195-C:1(II).

172 N.H. REV. STAT. ANN. § 149:5 (1978).

173 CAL. CONST. art. 13, § 21, cl. 5; CAL. HEALTH & SAFETY CODE § 436.8(c) (West 1973).

174 MINN. STAT. §§ 475 A.01-.06 (1976 & Supp. 1977).

175 H.R. 10405, 94th Cong., 1st Sess. (1975); H.R. 7517, 94th Cong., 1st Sess. (1975).

176 H.R. 10412, 94th Cong., 1st Sess. § 1(a)(2) (1975) (obligations must be for public workers projects); S. 398, 91st Cong., 1st Sess. § 202(b)(2), (b)(3)(B) (1970) (interest from the bonds must be subject to tax and the assisted projects must be economically sound").

177 H.R. 10412, 94th Cong., 1st Sess. § 14(a) (1975) (guarantees may be made "when [applicants] present evidence, they are unable to obtain funds on terms which the [guaranteeing entity] considers reasonable").

178 N.H. REV. ST. ANN. § 195-C:1(II) (1978) (before issuing a guarantee, the Authority must find that "the amount of the authorized borrowing appears to be within the financial means and available resources of the [issuers]"); H.R. 6419, 95th Cong., 1st Sess. § 104(b)(1) (1977) (issuer must be found, by the guaranteeing agency, to be "able to meet its fiscal responsibilities"); S. 398, 91st Cong., 1st Sess. § 202(b)(3)(A) (1970) (guaranteeing agency must determine that the amount and repayment terms of the guaranteed bond are "not in excess of the debt paying capacity of the borrower").

179 H.R. 10405, 94th Cong., 1st Sess. (1975). Respecting inability to market obligations absent a guarantee, this bill provides that the issuer show that it is "unable to obtain credit in the private market and that the failure to obtain such credit will cause the assisted municipality or State agency to default on their outstanding obligations." § 4(1). With respect to fiscal soundness, the terms of the bill require that the assisted municipality submit a plan for balancing its budget, § 4(2); and that the state in which the municipality is located demonstrate an ability to control the fiscal affairs of the municipality, § 4(3), agree to repay the guaranteeing agency upon default, § 4(4), and make certain grants to the municipality, § 4(7).

obligations within ten working days.[180] The ten-day grace period is designed to avoid the administrative costs attendant to payment and reimbursement in the case of temporary or short-term, technical defaults. Once the Bank actually fulfills any issuer's payment obligations, it acquires a lien on the tax collections of the issuer, taking the same priority under applicable statutes as a federal lien,[181] in the amount which it was required to pay out.[182]

B. *The Direct Loan Program*

The second major Bank program authorized by the Act is the provision of direct loans to eligible participating governments in the event of a "temporary shortfall of capital for municipal borrowing at acceptable interest rates."[183] The direct loans, which take the form of Bank purchases from the recipient governments of a series of municipal securities with a pro rata share maturing annually, are intended to alleviate acute, short-term problems of the municipal bond market in general, which result from the narrowness and high volatility.[184] By contrast, the guarantee program will offset market imperfections that unreasonably hamper the ability of particular government entities to raise capital, because of the unavailability to investors of current information concerning most municipalities.

Under the direct loan provisions, the Bank must make a determination that the demand for municipal securities among private investors generally has decreased to such a level that a significant number of municipal issuers are unable to market their bonds, even with guarantees, at an "acceptable" interest rate. The term "acceptable" is used in this portion of the Act to distinguish this determination of a general market condition from the determination of a "reasonable" interest rate differential, as used in other provisions to determine individual issuer eligibility for Bank guarantees.[185]

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180 MDBA § 8(a).

181 *E.g.*, for priority of claims when debtor is insolvent, *see* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 507, 92 Stat. 2549 (1978) (to be codified at 11 U.S.C. 507).

182 MDBA § 8(a).

183 MDBA § 8(b)(1).

184 *See* notes 18 to 77 and accompanying text *supra*.

185 *Cf.* MDBA § 8(a)(2).

The Bank board of directors is charged with promulgating regulations "setting forth the circumstances in which the direct loan program will be activated."[186] In drafting this proposal, consideration was given to including within the Act more specific standards for when the loan program should be "triggered," but the complexity and variableness of the relevant factors makes this an area which is best left up to the expertise of the Bank. Among the factors that must be taken into account when the Bank formulates its regulations are the appropriate range of interest rate differential between taxable and tax-exempt bonds, the impact of impending activation of the loan program upon prevailing interest rates, the effect activation will have on the incidence of municipalities falling outside the "reasonable interest rate differential" under the guarantee program, and the optimal duration of the loan program once activated. The consolidated approach which the authors most seriously considered for inclusion in the provisions of the Act called for activation of the loan program when the differential between the average yield on tax-exempt municipal securities and the average yield on taxable corporate bonds, or, alternatively, on United States Treasury bonds, falls below a specified percentage. The use of such a ratio, rather than an absolute numerical differential, would allow the program to adjust automatically to the normal increases and decreases of the general market interest rate which can be expected to vary the spread between municipal and taxable bond interest rates without altering their proportional relationship. Additionally, measuring their relationship by use of a percentage directly reflects investor decisions during times of an orderly and competitive market when they will equilibrate the after-tax return on taxable and tax-exempt bonds.

Once the loan program is triggered, the Act authorizes the Bank to issue its own taxable securities to raise funds for the purchase of securities of qualifying governments.[187] The amount of state and local obligations which may be purchased

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186 MDBA § 8(b)(2).
187 MDBA § 9(a).

by the Bank is limited to $2 billion in any one fiscal year.[188] This limit prevents the Bank from engaging in unrestrained borrowing, which could create undue competition with Treasury bonds and draw investor capital away from municipal issuers. At the same time, however, the limit should be high enough to allow the Bank to deal with a serious shortfall in the municipal market. The taxable status of the Bank's securities, its prestige as a national financial institution, and the ready availability of information regarding the Bank's operations should combine to make these securities attractive to investors who are not currently interested in the municipal market, such as tax-exempt pension funds and individuals or institutions facing relatively low marginal tax rates. As a result, the loan program operates to broaden the investment base ultimately supplying capital funds to municipal issuers.

After raising the necessary amount of funds through the sale of its obligations, the Bank is authorized to purchase securities from the smaller, less well-known municipal issuers who are the first to be denied reasonable access to the market during periods of tight credit. Because the role of the Bank is limited to that of a supplemental source of capital, the loan program should not disrupt normal investment patterns or crowd out private investors. The Act expressly states that the Bank is to "encourage and supplement, and not compete with, the investment of private capital in state and municipal obligations."[189] Accordingly, the Act emphasizes the guarantee program and excludes from direct loan eligibility those issuers who are able to borrow at reasonable rates without Bank assistance or with a Bank guarantee.[190] Finally, the Act ensures that assistance through the direct loan program is only feasible for most issuers as a last resort. This is accomplished by the requirement that the interest rate on securities purchased by the Bank may not be less than two-thirds of the current average market yield on the outstanding obligations of the Bank. Assuming that the taxable Bank obligations provide a yield similar to that of "high-

188 MDBA § 8(b)(1).
189 MDBA § 8(g).
190 MDBA § 8(c)(2).

medium" (Aa-rated) taxable bonds, an interest structure such as the following (based on figures from December, 1977) would exist:

Average market yield on Bank obligations	8.24%
Minimum yield on securities purchased by the Bank	5.43%

For the same period, average yields on municipal obligations were as follows:

Aaa-rated	5.07%
Aa-rated	5.23%
AA-rated	5.46%
Baa-rated	5.79%
Overall average	5.39%

Thus, an issuer would not have found direct loan assistance economical during the period unless the interest rate it was forced to offer in the private market was substantially higher than average.[191]

For the direct loan program to work efficiently, the Bank obligations must offer an interest rate high enough to permit competition with other taxable issues. At the same time, the interest rates on the tax-exempt municipal securities the Bank purchases will be lower. Accordingly, the Bank faces a differential between the amount it pays out and the amount it receives in operating the loan program, which differential is limited by the two-thirds requirement.[192] The amount of this differential will be returned to the Bank in the form of an annual payment from the United States Treasury. In large part, this payment represents the additional revenue collected by the federal government through taxation of the interest on the Bank obligations issued in lieu of the direct sale to the public of tax-exempt bonds.[193]

The eligibility criteria applying to the guarantee program also apply to applicants for direct loans.[194] The Act contains additional project scrutiny requirements assuring that direct loan applicants have exhausted alternative sources of funds and will

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191 Figures from 1 MOODY'S MUNICIPAL AND GOVERNMENTAL MANUAL a10 (1978); 1 MOODY'S INDUSTRIAL MANUAL a37 (1978).

192 MDBA § 8(d).

193 *See* notes 32 to 33 and accompanying text *supra.*

194 MDBA § 8(c)(1)-(c)(2). *See* notes 160 to 169 and accompanying text *supra.*

use the proceeds economically. First, the Bank must receive assurances from the issuer that it has already applied for all other forms of federal assistance for which the project is eligible.[195] Second, the applicant must certify that construction of the project will be by competitive bid.[196] These additional requirements will stretch Bank resources so that they provide maximum benefit to municipalities with no reasonable alternative source of capital funds.[197]

C. *The Office of Technical Assistance*

The third function of the Municipal Development Bank is the administration of an Office of Technical Assistance (OTA).[198] The OTA will operate from a national office and twelve regional offices, staffed by full-time civil servants under the direction of an Administrator appointed by the president of the Bank.[199]

The duties of the OTA can be divided into two broad categories. The first category includes those duties previously discussed,[200] which relate to the operation of the guarantee and loan programs of the Bank. In this area, the OTA is directed to consult with the Secretary of Housing and Urban Development and then to promulgate regulations regarding the procedures for determining eligibility for Bank guarantees.[201] In addition, the OTA is charged with formulating regulations which set forth the bidding procedures for capital projects to which municipal issues seeking loan assistance from the Bank must conform.[202] All regulations established by the OTA must be formulated in accordance with the rulemaking provisions of the Administrative Procedure Act[203] and must be approved by the board of directors of the Bank.[204]

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195 MDBA § 8(c)(3)(A).
196 MDBA § 8(c)(3)(B).
197 This requirement may also serve as an incentive to smaller communities to seek the advice and assistance of the Office of Technical Assistance in order to improve their grantsmanship.
198 MDBA § 7.
199 MDBA §§ 6-7.
200 *See* notes 161, 165, 186, and 196 and accompanying text *supra*.
201 MDBA § 7(b).
202 MDBA § 8(c)(3)(B).
203 5 U.S.C. § 553 (1976).
204 MDBA § 8(b).

The second category of OTA functions include research and analysis of municipal finance and capital development problems and assistance to participating governments in areas such as finance, fiscal management, and drafting of project proposals.[205] While this category of functions is essentially independent of the other programs administered by the Bank, the information generated by the OTA in performing these duties can be used to revise the procedures and criteria utilized by the other Bank programs. The primary purpose of the OTA, however, is to improve the fiscal condition and operating procedures of the Bank's clients by serving as an information clearinghouse, gathering and dispensing data and expertise to the many smaller governments which lack the resources necessary to support an adequate technical staff. The OTA is designed to function in an advisory capacity, and no preconditions exist before a requesting government may receive its services. In addition, no fees shall be charged for use of these services, funding for which is to come from Congressional appropriations.[206]

An Act to Establish the Municipal Development Bank

Table of Contents

205 MDBA § 8(a).
206 MDBA § 10(b).

Section 1. *Title*

Be it enacted by the Senate and House of Representatives of the United States of America in Congress Assembled, that this Act may be known and shall be cited as the Municipal Development Bank Act of 1979.

Section 2. *Legislative Findings and Purposes*

(a) The Congress hereby finds and declares that some of the nation's most precious resources and greatest hopes for a prosperous future are its communities and urban areas. It notes that their continued vitality requires the adequate and timely provision of a wide variety of public works and community facilities, such as housing, streets, water, sewers, schools, hospitals, libraries, airports, facilities for liquid and solid waste disposal, mass transit, and recreation.

The Congress finds that the capital infrastructures of many communities are deteriorating because the sources of funds needed to finance their renewal and upkeep are severely strained.

The Congress further finds that meeting the anticipated financial needs of our communities requires a coordinated effort to encourage public investment in our nation's communities, which, when efficiently planned and implemented, will add to the wealth of individual communities as well as to that of the Nation.

(b) It is the purpose of this Act to establish a Municipal Development Bank to guarantee the obligations of and to make long-term development loans to state and local governments and their agencies to help them meet needs for public works and community facilities, including the acquisition of land necessary thereto.

Section 3. *Definitions*

In this Act the following words have the meanings indicated:

(a) "Bank" means the Municipal Development Bank created by Section 4 of this Act.

(b) "Local government" means any county, municipality, or other political subdivision of a State, or agency or instrumentality thereof, or any school or other special district created by or pursuant to State law.

(c) "Obligation" means any bond, note, debenture, or other instrument evidencing debt.

(d) "State" means the States of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, and the Trust Territory of the Pacific Islands, or any agency or instrumentality of a State.

Section 4. *Municipal Development Bank*

There is hereby created a corporate body known as the Municipal Development Bank. The Bank, which shall not be an agency of the United States Government, shall operate and conduct its business under the provisions, powers, and limitations of this Act.

COMMENT: The Bank is created and governed by this Congressional legislation yet is not established as an agency of the Federal government for two reasons: (1) to emphasize the cooperative federal and local nature of the Bank's operations, and (2) to prevent inclusion of the amount of the Bank guarantees in the federal debt. Guarantees by the United States government and its agencies are included in the federal debt during the entire time they are outstanding, whether recourse is made to them or not.[207] Since only the Bank and not the federal treasury shall be liable for the Bank issued debts and guarantees, it is inappropriate and unnecessary for the Bank's commitments to appear on the national accounts.[208]

Section 5. *Board of Directors and President*

(a) The Bank shall be governed by a board of directors consisting of six persons who shall be responsible for formulating the policies of the Bank. The Secretary of the Treasury and the Chairman of the Federal Reserve Board or their designees shall each be directors of the Bank. The remaining four directors shall be appointed by the President of the United States with the advice and consent of the Senate and shall be drawn from among the ranks of state and local government officials. Each shall serve for a four year term, except as described in subsection (b) below, at the con-

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207 *See* 2 HOUSE SUBCOMM. ON DOMESTIC FINANCE, COMM. ON BANKING AND CURRENCY, 88TH CONG., 1ST SESS., A STUDY OF FEDERAL CREDIT PROGRAMS 882 (1964); D.J. OTT, FEDERAL BUDGET POLICY 15, n.10 (1965).

208 *See* MDBA § 9(a).

clusion of which their appointment may be renewed. Any seat on the Board which becomes vacant may be filled by the President for the unexpired portion of the term.

(b) The four appointed members of the initial board of directors shall be designated to serve terms as follows: one member for a one year term; one member for a two year term; one member for a three year term; and one member for a four year term.

(c) The President of the United States, with the advice and consent of the Senate, shall appoint a president of the Bank, who shall serve at the pleasure of the President. The president shall be chairman of the board of directors, and shall be responsible for the management of the Bank as its chief executive officer, subject to the general policies of the board.

(d) The board of directors shall meet at the call of its chairman, who shall require it to meet not less than once each month.

COMMENT: The board of directors of the Bank, which is identical in size to the Board of Governors of the Federal Reserve Board, is designed to be a small, manageable policy-making body, responsive to both federal and local concerns. The federal government's perspective will carry significant weight because of the presence of representatives of the Federal Reserve Board and Treasury Departments, the President's appointment authority, and the President's power to remove the head of the Bank. Extensive federal influence is necessary in light of the national scope of the Bank's operations, the relationship between Bank operations and other federal credit mechanisms, and the allocation of federal dollars which Bank operations may entail. It was determined that the need for accountability and responsiveness to national fiscal policy outweighs the need for independent decision-making, and, therefore, unlike the Chairman of the Federal Reserve Board, the president of the Bank may be removed by the President of the United States.

Sensitivity to the needs of state and local governments, which are the Bank's clients, is assured by the fact that a majority of the members of the board of directors shall be drawn from the ranks of state and local governmental officials. Vacancies among these directorships shall be created and filled on a rotating basis, thus assuring continuity in the policymaking body.

Section 6. *Offices*

The Bank shall establish twelve regional districts, coterminous with those of the Federal Reserve Board. The Bank's headquarters shall be located in Washington, D.C. and a regional Bank office shall be located in each district to service the state and local governments therein. Each office shall be authorized to process loans and guarantees, provide technical assistance in accordance with Section 7, and conduct other business necessary to the service of Bank members and efficient functioning of the Bank. The Bank may establish additional offices as necessary for the efficient conduct of its business.

Section 7. *Office of Technical Assistance*

(a) The Bank shall have an Office of Technical Assistance, operated under the direction of an Administrator appointed by the president of the Bank, who shall serve at the pleasure of the president, to assist State and local governments in the areas of finance, fiscal management, capital development, formulation of specific project proposals under this Act, and related areas. The Office of Technical Assistance may also undertake research and information gathering, and facilitate the exchange of advanced concepts and techniques relating to municipal finance and fiscal management among state and local governments.

(b) The Office of Technical Assistance shall develop standards for reviewing loan guarantee and direct loan applications and for evaluating adherence to the criteria established by Sections 8(a) and 8(c) of this Act. Any such standards must be formulated in accordance with the rulemaking provisions of the Administrative Procedure Act, and must be approved by a majority of the directors of the Bank.

COMMENT: The Office of Technical Assistance shall be the administrative arm of the Bank, drafting regulations, gathering information, and evaluating applications for assistance. It shall also serve as a national clearinghouse for information, advice, and assistance in matters of municipal finance. There is currently no organization providing this service. The OTA shall function through the twelve regional branches as well as the national office in order to promote efficient delivery of Bank services and to facilitate familiarity with particular regional concerns and characteristics.

Section 8. *Guarantee and Loan Programs*

(a) The Bank is authorized, subject to the provisions of this section, to guarantee timely payment of principal and interest on obligations issued by State and local governments. If timely payment is not made, the Bank shall meet the due payment within ten working days, retaining a lien for the amount thereof on the tax collections of the guaranteed state or local government. The lien shall have the same priority under applicable statutes as a federal tax lien. No guarantees shall be made unless the Bank makes the following determinations:

(1) the project to be assisted by such guarantee is consistent with community development plans formulated, in accordance with 42 U.S.C. § 5302(a) and regulations adopted pursuant thereto, by the unit of local government with general jurisdiction over the area in which the project assisted by the guarantee will be located. With respect to projects which will be located in areas for which there is no such community development plan, the Office of Technical Assistance must certify, in accordance with regulations it shall adopt after consultation with the Secretary of Housing and Urban Development, that the project to be assisted is consistent with the comprehensive economic development of the community. *Provided,* that this subsection shall not be construed as requiring guaranteed projects to meet strictly the eligibility criteria applicable to the Community Development Block Grant Program;

(2) the State or local government is unable to obtain sufficient credit to finance its actual needs at a rate of interest less than a reasonable differential above the then current average market municipal bond interest rate, and that the total debt load of the State or local government, including the issue for which the guarantee is requested, does not exceed the repayment capacity of such issuer. The Bank may not establish additional eligibility criteria for guarantees other than by administrative interpretations of this subsection, unless authorized by congressional amendment of this Section.

COMMENT: The Act establishes three eligibility requirements for a Bank guarantee. The first, conformance with local community development plans, assures that the federally assisted project will advance the general policy goal of orderly development, without impinging on local discretion through detailed federal review of their projects. If no such local development plan exists, the OTA is required to investigate, in accordance with Bank regulations, whether the project comports with the com-

munity's present and future development. The second, inability to obtain capital funds at less than an interest rate above a reasonable differential from the average municipal bond interest rate, limits Bank guarantees to those communities most in need of assistance and prevents the Bank from intervening in that segment of the market where commercial guaranties and high-grade ratings are available.[209] The size of the interest rate differential is to be set forth in regulations by the Bank. The third, sufficient debt paying capacity of the guarantee recipient, acknowledges the practical necessities to maintain investor confidence in the Bank's financial stability and to preserve Bank resources. While excluding those cities with chronic fiscal difficulties, this requirement facilitates the Bank's serving the middle sector of the bond market: those communities that are basically sound yet are burdened with excessive interest costs because of market imperfections.[210]

The prohibition on the imposition of additional eligibility requirements is intended to assuage many communities that have opposed previous federal assistance programs as impinging upon local budgetary discretion.

> **(b)(1) If the board of directors of the Bank determines that there is a temporary shortfall of capital for municipal borrowing at acceptable interest rates, the directors may activate the direct loan program described in this section. The volume of direct lending under this program may not exceed the amount of the capital shortfall, and in no case shall exceed $2,000,000,000 in any fiscal year.**
>
> **(2) The board of directors of the Bank shall issue regulations setting forth the circumstances in which the direct loan program shall be activated.**

COMMENT: The operation of the direct loan program supplements the primary guarantee function of the Bank. It allows the Bank to intervene directly in the bond market by issuing taxable bonds when conditions in the tax-exempt market in general prevent the market from adequately serving the needs of municipal borrowers at an "acceptable" interest rate. Ex-

209 *See* notes 108 to 115 and 151 to 152 and accompanying text *supra.*
210 *See* notes 99 to 107 and accompanying text *supra.*

amples of incidents that can precipitate such conditions are well publicized financial difficulties of a major city or changes in federal tax laws that cause a diversion of funds from the tax-exempt market.[211] The complexity of analyzing the specific set of circumstances which shall constitute a "shortfall of capital" sufficient to activate the direct loan program militates in favor of leaving the drafting of a specific definition to the Bank.[212]

(c) When the direct loan program is activated in accordance with the provisions of subsection (b) above, the Bank is authorized subject to the provisions of this section to purchase, on terms and conditions determined by the Bank, any general revenue obligation of a State or local government. No purchase shall be made unless the Bank determines:

(1) that the project to be assisted by such loan is consistent with community development plans formulated, in accordance with 42 U.S.C. § 5304(a), and regulations adopted pursuant thereto, by the unit of local government with general jurisdiction over the area in which the project assisted by the loan will be located. With respect to projects which will be located in areas for which there is no such community development plan, the Office of Technical Assistance must certify, in accordance with regulations it shall adopt after consultation with the Secretary of Housing and Urban Development, that the project to be assisted is consistent with the comprehensive economic development of the community. *Provided,* that this subsection shall not be construed as requiring loan projects to strictly meet the eligibility criteria applicable to the Community Development Block Grant Program;

(2) that the State or local government is unable to obtain sufficient credit to finance its needs at a reasonable rate of interest without a Bank loan, and that the total debt load of the State or local government, including the requested loan, does not exceed the repayment capacity of such issuer.

(3)(A) that application has been made for all other federal assistance for the project for which the loan is sought is eligible, and

(B) that the project will be constructed in accordance with regulations pertaining to competitive bidding which the Office of Technical Assistance is hereby directed to promulgate.

COMMENT: Direct loans are subject to the same requirements

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211 *See* notes 27, 31, and 98 and accompanying text *supra.*

212 *See* text following note 186 *supra.*

that apply to guarantees, as well as to two additional limitations which are necessary in light of the greater commitment of Bank resources attendant to the making of a loan instead of a guarantee. The first additional restriction, that the borrower has sought all other applicable federal assistance for its project, makes clear that loans are a source of federal assistance to be used only as a last resort. Additionally, this requirement is designed to prevent State and local governments from using a direct loan to circumvent the imposition of restrictions that attach to other federal programs for which the project may be eligible. The second requirement, that the contractors for the project be selected by competitive bidding, will ensure the least expensive construction, thereby preserving Bank resources for assistance to other communities.

(d) Any loan made pursuant to this section shall be in an amount not exceeding the total capital cost of the project to be financed with the loan; shall be repaid in the form of equal periodic payments of principal and interest (*i.e.*, a series of bonds with a pro rata portion coming due annually); shall be secured in such manner and totally repaid in such period, not exceeding forty years, as may be determined by the Bank; and shall bear interest at a rate determined by the Bank, taking into consideration the current average market yields on municipal bonds. The average interest rate on a loan (*i.e.*, a series of bonds purchased) shall not be less than two-thirds of the current average yield on outstanding obligations of the Bank as of the last day of the month preceding the date on which the loan is made. Bank may sell, upon such terms and conditions and at such price or prices as it shall determine, any of the obligations acquired by it under this subsection.

COMMENT: In addition to technical provisions relative to the terms and conditions of Bank loans, this subsection places a floor on the interest rates of the obligations that the Bank can purchase. The floor fluctuates with the prevailing general market interest rate as reflected by the Bank's own outstanding obligations. The two-thirds differential approximates the historical differential observed during orderly market periods and restricts the federal interest subsidy to about the amount the Treasury will recoup through the issuance of taxable bonds

by the Bank.[213] Provision is also made for the Bank to sell the State and local obligations it holds when general market conditions improve. The Act does not place limitations on the resale price. The Bank may not engage in any substantial program of buying at a high price (low interest rate) and selling the same obligations on the market at a low price (high interest rate), however, because this Act forbids authorization for payments from the Secretary of the Treasury to subsidize such activities.[214]

(e) The Bank is authorized to charge fees for its loans and guarantees to cover defaults. Such fees shall be accumulated in a special reserve account.[215]

(f) No guarantee or direct loan shall be issued under this section unless the State or local government has not been in default on any obligation, nor had any obligation to the Bank on account of a default or a bond issued under subsection (a) or a loan issued under subsection (c), during the two years preceding a request for a guarantee under subsection (a) or a loan under subsection (c).

COMMENT: This restriction adds to the Bank's power to reject particularly bad risks, and more importantly, gives the Bank a mechanism with which to induce State and local governments to comply with the terms of their Bank assistance.

(g) It is the policy of Congress that, to the fullest extent possible consistent with the purposes of this Act, the Bank, in the exercise of its functions under this section, should encourage and supplement, and not compete with, the investment of private capital in State and municipal obligations.

Section 9. *Bank Obligations*

(a) The Bank is authorized, with the approval of the Secretary of the Treasury, to issue obligations with such maturities and bearing such rate or rates of interest as may be determined by the Bank. Such obligations may be redeemable at the option of the Bank before maturity in such manner as may be stipulated therein.

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213 *See* notes 28, 29, and 191 and accompanying text *supra.*

214 *See* MDBA § 10(b).

215 For a discussion of the use of Bank fees, *see* MDBA § 10 and comment thereto *infra.*

The Bank shall insert appropriate language in all of its obligations issued under this subsection clearly indicating that such obligations, together with the interest thereon, are not guaranteed by the United States and do not constitute a debt or obligation of the United States or of any agency or instrumentality thereof other than the Bank. The Bank is authorized to purchase in the open market any of its outstanding obligations.

(b) In addition to the obligations of the Bank authorized to be outstanding in subsection (a) of this section, the Bank is authorized to issue obligations to the Secretary of the Treasury. The Secretary is authorized to purchase any such obligations in order to further the purposes and augment the financial resources of the Bank. To finance such purchases, the Secretary of the Treasury is authorized to use the proceeds of the sale of any securities hereafter issued under the Second Liberty Bond Act, as now or hereafter in force.

COMMENT: This section authorizes the Bank to issue obligations to the public and to the Treasury department in order to finance the direct loan program. The absence of a federal guarantee behind the Bank's bonds is to prevent the Bank's lending and guarantee programs from being included in the national debt accounts.[216]

Section 10. *Authorization for Payments from the Treasury*

(a) The Secretary of the Treasury is directed to make annual payments to the Bank in the amount by which the interest paid by the Bank on account of its obligations exceeds the interest received by the Bank on account of loans made by it pursuant to Section 8(c).[217]

(b) There are hereby authorized to be appropriated to the Bank such sums as may be necessary to carry out the provisions of the Act, including such sums as may be necessary to cover operating expenses of the Bank. *Provided,* no sums shall be appropriated on account of any deficit incurred by reason of the Bank reselling any obligation issued by and purchased from a State or local government.

Section 11. *Powers*

The Bank shall have the following powers:

(a) to sue and be sued and complain and defend, in its corporate name and through its own counsel;

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216 *See* comment following MDBA § 4 *supra.*

217 For a discussion of the payment, *see* MDBA § 13.

(b) to adopt, alter, and use its corporate seal;
(c) to adopt, amend, and repeal by its board of directors its bylaws, rules, and regulations as may be necessary for the conduct of its business;
(d) to conduct its business, carry on its operations, have offices, and exercise the powers granted by this Act in any State without regard to any business qualification statute;
(e) to lease, purchase, or otherwise acquire, own, hold, improve, use, or otherwise deal in and with any real, personal, or mixed property or any interest therein, wherever situated;
(f) to accept gifts or donations of services, or of any tangible or intangible property in aid of any of the purposes of the Bank;
(g) to sell, convey, mortgage, pledge, lease, exchange, and otherwise dispose of and encumber its property and assets;
(h) to appoint such officers, attorneys, employees and agents as may be required, determine their qualifications and their duties, fix their salaries, require bonds for them and fix the amount thereof; and
(i) to enter into contracts, execute instruments, incur liabilities, and do all things necessary or incidental to the proper management of its affairs and conduct of its business.

COMMENT: Since the Bank is not chartered under or empowered by any state incorporation statute, these powers must be explicitly conferred in order for it to engage in its normal operation.

Section 12. *Annual Audit*

(a) The financial transactions of the Bank shall be audited annually at the close of the fiscal year by the General Accounting Office in accordance with the principles and procedures applicable to commercial corporate transactions and under such rules and regulations as may be prescribed by the Comptroller General of the United States. The audit shall be conducted at the place or places where the accounts are normally kept. The representatives of the General Accounting Office shall have access to all books, accounts and financial records of the Bank and necessary to facilitate the audit, and they shall be afforded full facilities for verifying transactions with the balances or securities held by depositaries, fiscal agents, and custodians.
(b) The expenses of any audit performed under this section shall be borne out of appropriations to the General Accounting Office, and appropriations in such sums as may be necessary are authorized. A report of each such audit shall be made by the Comptroller General to the President and to the Congress not later than six

months following the close of the fiscal year. The report shall set forth the scope of the audit and shall include statements of assets and liabilities, capital and surplus or deficit, income and expenses, sources and applications of funds, and such other comments and information as may be deemed necessary to keep Congress informed of the operations and financial condition of the Bank. The report shall contain recommendations deemed advisable by the Comptroller General with respect to the operations and financial condition of the Bank, including a description of any impairment of capital or lack of sufficient capital noted in the audit. A copy of the report will be furnished to the Secretary of Housing and Urban Development, the Secretary of the Treasury, and to the Bank.

Section 13. *Taxation of the Bank and its Obligations*

(a) The Bank, its property, its franchise, capital, reserves, surplus, security holdings, and other funds, and its income shall be exempt from all taxation now or hereafter imposed by the United States or by any State or local taxing authority, except that any and all obligations issued by the Bank shall be subject as to principal and interest to federal taxation to the same extent as the obligations of private corporations, and may be taxed by State and local governments.

COMMENT: This section establishes that the Bank bonds used to finance the direct loan program shall be taxable rather than tax-exempt.

Section 14. *Securities Laws Exemption*

All obligations issued by the Bank pursuant to this Act shall be deemed to be exempt securities within the meaning of laws administered by the Securities and Exchange Commission to the same extent as securities which are direct obligations of or obligations guaranteed by the United States.[218]

Section 15. *Certificates*

In order to furnish certification representing obligations of the Bank, the Secretary of the Treasury is authorized to prepare such certificates in a form as the board of directors of the Bank may approve, and these certificates shall be held in the Treasury subject to delivery upon order to the Bank. The engraved plates, dies, bed pieces, and so forth, executed in connection with the printing of

218 15 U.S.C. § 77(c)(2) (1976).

such certificates, shall remain in the custody of the Secretary of the Treasury.

COMMENT: This section contains technical provisions necessary to conform this statute with other laws governing federal financial institutions.

Section 16. *Independent Status*

The United States shall not be liable for any debts, defaults, acts, or omissions of the Bank.

Section 17. *Annual Report*

The Bank shall transmit to the President and the Congress an annual report of its operations and activities as soon as practicable after the end of each fiscal year.

Section 18. *Bankruptcy Exemption*

Payments due to be made to the Bank by State and local governments pursuant to direct loans and guarantees made under Section 8 of this Act shall be exempt from discharge in bankruptcy under federal bankruptcy statutes.

Section 19. *Miscellaneous*

(a) The sixth sentence of the seventh paragraph of Section 5136 of the Revised Statutes, as amended (12 U.S.C. § 24), is amended by inserting "or obligations of the Municipal Development Bank," immediately after "or obligations participations, or other instruments of or issued by the Federal National Association or the Government National Mortgage Association."

(b) Section 5200 of the Revised Statutes, as amended (12 U.S.C. § 84), is amended by adding at the end thereof the following new paragraph:

> **"(15) Obligations of the Municipal Development Bank shall not be subject to any limitation based upon such capital and surplus."**

(c) The first paragraph of section 5(c) of the Home Owner's Loan Act of 1933, as amended (12 U.S.C. § 1464(c)), is amended by inserting "or in obligations of the Municipal Development Bank;" in the second proviso immediately after "any political subdivision thereof;"

(d) Paragraph (2) of section 14(b) of the Federal Reserve Act (12 U.S.C. § 355), is amended by inserting, "or any obligation of the

Municipal Development Bank" immediately before the period at the end thereof.

COMMENT: Subsection (a) authorizes national banks to deal in, underwrite, and purchase on their own account Municipal Development Bank bonds. Subsection (b) exempts the Bank's obligations from the statutory limitation which prevents national banks from holding obligations totalling more than 10 percent of their outstanding capital stock. Subsection (c) authorizes federal savings and loan associations to invest their funds, without limit, in Municipal Development Bank obligations. Subsection (d) authorizes Federal Reserve banks to purchase Municipal Development Bank securities.

BOOK REVIEW

IN THE MATTER OF COLOR: RACE & THE AMERICAN LEGAL PROCESS, THE COLONIAL PERIOD. By *Judge A. Leon Higginbotham, Jr.* New York: Oxford University Press, 1978. Pp. 389, appendix, bibliography, notes, index. $15.00.

*Review by William P. LaPiana**

In the Matter of Color by Judge A. Leon Higginbotham, Jr. is an unusual work. Serious historical scholarship is seldom undertaken by those outside traditional academic settings. Such specialization is an unfortunate product of the professionalization of scholarship. In practical terms, few men and women who must earn their livelihood in one profession have time to pursue another. Judge Higginbotham's book, however, is the product of hours stolen from the scant leisure of an appellate judge and devoted to a passionate exposition of the "poisonous legacy of legalized oppression based upon the matter of color . . ." (p. 391). Many of the book's strengths come from its creation outside the history departments. At a time when much professional history inhabits an inaccessible land of mathematical models and statistical analyses, this amateur historian has summoned from his deep personal involvement with the subject a book which can be read profitably by all educated men and women.

Judge Higginbotham's history generally benefits from his nonprofessional status. The work is not without faults related to historical methodology; indeed the historical analysis is sometimes inadequate and incomplete. However, one can recognize that to a great extent the most interesting aspect of the work lies outside the technical historical treatment. For an observer of contemporary American law and politics, *In the Matter of Color* is most enlightening not for its abundant information about the place of blacks in the legal systems of the British North American colonies but rather for what it says about an appellate judge's view of law and the legal process.

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As an example of historical technique, *In the Matter of Color* is an old-fashioned book. Judge Higginbotham makes his story a compendium of printed sources. We learn much about the laws passed by the legislatures and the disputes settled by the courts. Such limitation to printed sources is often criticized for ignoring the broader context in which laws are passed and disputes settled. Today much effort is spent in finding out who legislators, judges, lawyers, and parties were and how they fit into the structure of their society. Behind this inquiry into the details of social life is a widely held belief that traditional sources do not necessarily reflect accurately the structure and workings of society.

Judge Higginbotham nonetheless rests his effort on the widely held belief that law is uniquely important to the American history of slavery and racial prejudice. Early in his work, he acknowledges that "a view of slavery from the perspective of the law does not make a complete picture" (p. 7). Despite his concession, Judge Higginbotham goes on to draw too much from individual pieces of evidence. On the basis of a 1659 Virginia statute reducing import duties on slaves he asserts that the composition of the labor force was changing (p. 34). The statute, however, is not necessarily related in any specific way to the actual composition of the work force. Nor can one know without further investigation whether this statute fostered an increase in the slave trade. Such investigation would require an examination of sources such as census and tax returns to shed light on the racial composition of the population. This Judge Higginbotham — as a lay historian — understandably does not do.

Similar investigation would be necessary to support the statement on page 147 that in 1785 in New York the willingness to allow slavery to continue "was most prevalent among [the state's] white working-class population . . . ." His discussion of the 1785 bill for gradual emancipation does not mention anything about the "working class." The very meaning of the term as applied to eighteenth-century society is not self-evident. Even if one accepts a rough definition by excluding professionals and wealthy merchants, one is left with people whose contribution to the written record is not always abundant. The

only evidence for the subsequent assertion that working class people were victimized by a system in which "several jobs were closed to them" (p. 147) is a 1686 New York City ordinance, cited as "representative," which made race a qualification for certain occupations (p. 118). The ordinance limits one occupation to blacks but denies them another. Thus it is not unambiguously a blow to the white working class. In addition the effect of the ordinance and of others like it is an open question which can only be answered by more detailed research into the reality of daily life in seventeenth- and eighteenth- century New York.

Research along these lines would illustrate the possibilities of writing history "from the bottom up" — a term which at its broadest includes the use of non-traditional sources in the attempt to provide a more complete picture of all society. More extensive research would probably do little, however, to alter the general picture presented by Judge Higginbotham. It would simply make parts of the story more accurate historically and perhaps accentuate the human side of a complex institutional arrangement.

Such research would, however, bring into sharp focus the role of people — parties, judges, legislators, and lawyers — in the legal process. Often one is left with the impression that Judge Higginbotham sees the legal system as a group of institutions carrying out a set of ideas or concepts coinciding with justice and morality. Such a view can lead one to ignore the role played by the individuals involved, an especially crucial role since Judge Higginbotham is dealing with a society in which legal professionalism was not at all well established. The judges and legislators of the colonies of which the Judge writes were most likely local magnates whose legal tasks were only one small part of their exercise of social leadership. Their view of justice and right must have been at least as much an expression of their general beliefs as it was the result of contemplation of the strictly legal. This is not to claim that law has no independent ideological life; rather, such independent life is far easier to sustain when society contains a group whose social function is dependent solely on its relationship to the legal system.

Attention to the role of individuals may mitigate the danger

of ignoring the substance of decisions by concentrating on process. Judge Higginbotham writes:

> The fairness of any legal system can be measured by the availability of adequate remedies to protect one's rights. Thus, the essential question is, does one have free access to a court or legislative body to obtain vindication where a human right has been infringed? (p. 155).

Yet access is useless if the outcome is rigged. Post-Revolutionary War debtors, late nineteenth- and early twentieth-century industrial workers, and twentieth-century blacks must at one time or another have felt that once in the courtroom or the legislative hearing the result was foreordained — their kind always lost because the people making the decisions wanted it that way.

Such a crude realist approach to the workings of the legal system is not an ideal explanatory device. It can, however, point out the assumptions underlying Judge Higginbotham's didactic purpose. Throughout his book Judge Higginbotham contrasts the injustices worked against blacks in colonial America with a vision of a legal process which enforces human rights, which, in the end, should have made slavery impossible because it was incompatible with justice. Such a view, I believe, is possible only because in mid-twentieth-century America the triumph of legal professionalism has given great strength to the idea of the rule of law as something which can control and discipline the rule of self-interested men. Such a development is good — but it has not swept all history before it.

American history is replete with instances of attacks on judges and lawyers as representatives of one interest or class. Even early criticisms of the case method written by teachers of the old school castigated the innovators for ignoring the political and economic biases of the judges who wrote the opinions so avidly analyzed in the search for principles. In short, a realist approach may be the basic American perspective on law and the legal process. If that is so, then Judge Higginbotham's careful and painstaking presentation of the outrages perpetrated by the seventeenth- and eighteenth-century legal process may fail to shock as many as it should. The powerful always work their will on the weak. There are, perhaps, good

and disinterested men like Lord Mansfield who attack oppression, but they are few and far between.

The historical relationship between law and American society is complex. It has changed over time, perhaps in the general direction of enhancing the independent image of law and thus its ability to mold social practices. Certainly race relations have been profoundly affected by legal pronouncements of the last twenty-five years. But the power of the legal process should not be confused with broad agreement on what is just. In our pluralistic society there may be many views of justice — but only one version of the law can be allowed if anarchy is to be avoided. The law may coincide with one or another idea of justice, but it most clearly reflects the beliefs of the men and women who have the power to decide what it shall be.

RECENT PUBLICATIONS

A VOLUNTARY TAX: NEW PERSPECTIVES ON SOPHISTICATED ESTATE TAX AVOIDANCE. By *George Cooper*. Washington, D.C.: The Brookings Institution, 1979. Pp. 111, index. $7.95, cloth; $2.95, paper.

In *A Voluntary Tax: New Perspectives on Sophisticated Tax Avoidance,* George Cooper, a law professor at Columbia University and a member of the Brookings Institution associate staff, suggests that a massive reconsideration of the estate tax is in order. According to Cooper, "the estate and gift tax is not striking terror into the hearts of the very wealthy, nor is it even seriously burdening most persons who devote effort to avoidance." (p. 79). Nor, says Cooper, does the Tax Reform Act of 1976 provide much relief. Conceding some reforms, Cooper argues that "the changes are unlikely to have much effect in increasing tax liabilities" (p. 82) with little — if any — impact on traditional avoidance mechanisms.

To combat these problems, Cooper offers several alternatives and debunks several others. He argues against the elimination of the corporate double tax as simply encouraging the creation of personal holding companies. Further, he maintains that a capital gains tax at death is "more likely to be a negative than a positive factor in the estate tax avoidance front" by undercutting the stepped-up basis reward for holding property (p. 82).

What he does recommend, however, is better enforcement of existing law, such as stricter valuation of common stock interests and deferred valuation. Cooper suggests that the United States could advisably "attack certain transactions, such as the transfer of property to a holding company, as shams that ought to be ignored for tax purposes" (p. 87).

In the long run, however, Cooper believes only statutory changes are likely to improve the massive tax avoidance available in the estate and gift tax area. Any such congressional initiative, says Cooper, must at the very least include the taxation of "lost value to the donor's wealth holdings, rather than any reduced value artificially generated by the donor's actions

in dividing his property" (p. 93). He suggests a limitation of the front-end trusts, generation skipping and generation jumping transfer, and the charitable deduction. He also proposes cutting back the number of possible tax exemptions for wealth, prohibiting estate freezing, and imposing a periodic wealth tax.

Cooper does not deny the practiacl political problems likely to arise from such drastic suggestions. He does fail to mention valid policy arguments to be raised by opponents of his estate tax scheme. Nonetheless, the book offers a provocative — if not at times provoking — new perspective on ways to handle problems in the estate tax field.

THE MILITARY EQUATION IN NORTHEAST ASIA. By *Stuart E. Johnson* with *Joseph A. Yager.* Washington, D.C.: The Brookings Institution, 1979. Pp. xi, 87. $2.95, paper.

In the face of volatile events such as those in the Middle East and Indochina, foreign policy analysis offers only a partial perspective. At its best, it represents a recommendation and conclusion on changing situations for which — in truth — there can be no conclusions. One example of the imponderables of foreign policy and the dilemma of policy analysis is a recent publication by the Brookings Institution, *The Military Equation in Northeast Asia.* In only a matter of months since publication, the underlying factual assumptions of the book have been undermined "worst-case" situations would the "reduction in U.S. . . . strength . . . [be seen] as evidence of declining U.S. interest in the area . . . [and diminished] will and ability of the United States to honor its security commitments and to prevent an expansion of Soviet influence" (p. 83). But in light of U.S. promises to, among others, Taiwan and Korea any such withdrawal is likely to meet with more than a little complaint.

The book also fails to place enough emphasis on the strategic problems which reduced capacity may prompt. For example, the authors suggest the withdrawal of Second Division ground forces in Korea "will not affect greatly the balance of ground forces" (p. 79) so long as some enhancement of the South's fire

power occurs. What it fails to emphasize — indeed offers in nothing but a parenthetical.

It is when policy is discussed, however, that the book seems less than satisfactory. Calling the U.S. forces "wasteful" (p. 87), the authors demand the withdrawal of all permanent combat forces in Northeast Asia and maintenance of one carrier group in the Pacific. While their premise of waste may be in part correct, one cannot easily believe that such a massive policy change will meet with congressional approval. Such incredulity is in part a response to the authors' unrealistic assessment of political obstacles. The authors assume that only in unlikely or transposed.

To its credit, the work provides a succinct overview of the massive changes over the last seven years in the U.S. defense posture in Northeast Asia. Focusing on the Nixon trip to China in 1972 and improving Sino-Soviet relations, it outlines the economic emergence of Japan, the split between the People's Republic of China and the Soviets, and the emerging importance of the Russians in Indochina is that the force improvement plan is already two years behind schedule and therefore scarcely adequate for the Korean defense purposes in the near future.

In the light of these potential political and strategic problems, the book's recommendations must be taken with a grain of salt. One can only assume that the limited perspective is due to forgivable unpredictability of foreign events and the isolation of defense analysts from "real world" politics.

THE NATIONAL PURPOSE RECONSIDERED. Edited by *Donna Baron.* New York: Columbia University Press, 1978. Pp. xiv, 139. $12.50.

Five prominent Americans reexamine America's goals and values in *The National Purpose Reconsidered.* Capped with a separate historical prologue, the five essays grow out of a series of symposia sponsored by Columbia University as a part of America's bicentennial celebration. Although they were initially delivered in 1976, the essays appear in print here for the first

time. Their messages remain timely and provocative.

George Ball, Martin Marty, Barry Commoner, Gunnar Myrdal, and John Doar explore the forces shaping American society in their respective professional areas. Columbia historian Richard Morris' prologue sets the tone by articulating the major factors that have affected the national purpose since the nation's creation. His conclusion, that "a moral imperative has continually motivated America and its people" (p. 7), expresses a theme that runs throughout the separate essays. Thus John Doar, describing the disintegration in the 1950s and 1960s of the country's legal system of racial segregation and disfranchisement, sees in America's renewed commitment to equal rights for blacks the triumph of the ideals of both democracy and equality. Martin Marty's discussion of the changing role of religion in American society likewise traces the importance Americans have historically placed upon religious concerns. He sees in the contemporary trends toward immediacy and toward the particular in religion a "creative protest against technology or politics when these diminish the human and the local" (p. 47). Yet he sees these trends by themselves as inadequate for the affirmation and transmission of values for society. Instead, he calls for more activities by local groups or "subcommunities" in an effort to discover networks "within which to connect and discern common symbols" (p. 50).

Ball's essay echoes the theme of national moral purpose in the area of foreign relations. Rejecting post-Vietnam calls for American withdrawal from international affairs, Ball asserts that "the relevant question can no longer be whether we should lead but rather how . . . we should seek to exercise our leadership" (p. 13). According to Ball, American foreign policy cannot be based upon concerns of pure power politics, realpolitik, for such a policy cannot attract public support over long periods. Rather, there must be a congruence between foreign policy and America's ideals and aspirations.

Examining the impact of the energy crisis, Commoner's essay considers American values in an "era of constraints" and proposes that social concerns be made a part of the process of governing the system of production. Gunnar Myrdal reflects upon the social and economic changes in American society since

the publication of his *An American Dilemma* and concludes that the "ideals in the national purpose are given more than lip service and that in the longer run they have determined the trend of development in America" (p. 95). But Myrdal's essay points out that in many areas, for many of America's citizens, those ideals are far from being fully realized.

And that, indeed, is the general thrust of *The National Purpose Reconsidered.* America's ideals remain noble and they continue strong, but they also remain only imperfectly and incompletely applied in American life.

BOOKS RECEIVED

AGE OF SEGREGATION: RACE RELATIONS IN THE SOUTH, 1890-1945. By *Robert Haws.* Jackson, Miss.: University Press of Mississippi. Pp. ix. 156. $8.95, cloth; $3.95, paper.

AMERICAN POLITICS AND PUBLIC POLICY. By *Walter Dean Burnham & Martha Wagner Weinberg,* eds. Cambridge, Ma.: The MIT Press, 1978. Pp. xi, 402, index, $14.95.

CHILD ADVOCACY WITHIN THE SYSTEM. By *James L. Paul,* et al. New York: Syracuse University Press, 1977. Pp. xii, 162, index. $9.95.

THE CONSTITUTION BETWEEN FRIENDS: CONGRESS, THE PRESIDENT, AND THE LAW. By *Louis Fisher.* New York: St. Martin's Press, 1978. Pp. xii, 253, indices. $12.95.

CREATING JOBS: PUBLIC EMPLOYMENT PROGRAMS AND WAGE SUBSIDIES. By *John Palmer,* ed. Washington, D.C.: The Brookings Institution, Studies in Social Economics, 1978. Pp. 370, index. $14.95, cloth; $5.95, paper.

THE DECLINING SIGNIFICANCE OF RACE. By *William Julius Wilson.* Chicago: The University of Chicago Press, 1978. Pp. xii, 154, notes, bibliography, index. $12.50.

ESTATE AND GIFT TAX CHANGES UNDER REVENUE ACT OF 1978. By CCH Editorial Staff. Chicago: Commerce Clearing House, Inc., 1978. Pp. 70, index. $2.50, paper.

GOVERMENT AND THE MIND. By *Joseph Tussman.* New York: Oxford University Press, 1977. Pp. 133, notes. $8.95.

IDEOLOGICAL COALITIONS IN CONGRESS. By *Jerrold E. Schneider.* Westport, Conn.: Greenwood Press, 1979. Pp. xvi, 270, tables. $22.50.

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THE KLAN. By *Patsy Sims.* New York: Stein and Day, 1978. Pp. x, 345, index. $12.50.

THE LAST HALF-CENTURY. By *Morris Janowitz.* Chicago: The University of Chicago Press, 1978. Pp. xiii, 557, index. $25.00.

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PAT HARRISON: THE NEW DEAL YEARS. By *Martha Swain.* Jackson, Miss.: University Press of Mississippi, 1978. Pp. 301, bibliography, index. $15.00.

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POOR PEOPLE'S MOVEMENTS: WHY THEY SUCCEED, HOW THEY FAIL. By *Frances Fox Piven & Richard A. Cloward.* New York: Vintage Books, 1979. Pp. 361, index. $4.95, paper.

PROTEST AT SELMA: MARTIN LUTHER KING, JR. AND THE VOTING RIGHTS ACT OF 1965. *David J. Garrow.* New Haven: Yale University Press, 1978. Pp. xiii, 236, notes, index. $15.00.

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TELEVISION AND HUMAN BEHAVIOR. By *George Cornstock, Steven Chaffee, Nathan Katzman, Maxwell McCombs & Donald Roberts.* New York: Columbia University Press, 1978. Pp. xviii, 510, references, index. $16.95, cloth; $9.95, paper.

A VOLUNTARY TAX? By *George Cooper.* Washington, D.C.: The Brookings Institution, 1979. Pp. viii, 111, index. $7.95, cloth; $2.95, paper.

WHAT WAS FREEDOM'S PRICE? By *David Sansing,* ed. Jackson, Miss.: University Press of Mississippi, 1978. Pp. xiii, 126. $7.95, cloth; $3.95, paper.