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Institute of Bill of Rights Law, William & Mary Law School

JUSTICES SPELL OUT INSIDER TRADING; ANY MISUSE OF CONFIDENTIAL INFORMATION IS ILLEGAL, SUPREME COURT RULES

The Washington Post

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Brett D. Fromson, Washington Post Staff Writer

In the most significant securities fraud case in nearly two decades, the Supreme Court ruled yesterday that the government can bring insider trading cases against people who profit on confidential information even if they are not corporate insiders.

The high court settled 17 years of uncertainty about the legal meaning of insider trading by defining it as intentional buying or selling of securities for personal gain using misappropriated confidential information—no matter where the information comes from.

"This is good news not just for individual investors but also for companies, executives, their families and friends, investment bankers, financial printers, attorneys, accountants and consultants," said Joel Seligman, dean of the University of Arizona College of Law. "Now, if you deceive someone and trade in securities based on inside information, you have a reasonable basis for knowing that you have violated the securities laws."

At a time when more Americans than ever are invested in the stock market, the 6 to 3 ruling was a huge win for the Securities and Exchange Commission, which is responsible for ensuring the fairness of securities markets. There was much apprehension at the agency that an unfavorable ruling could limit its ability to prevent cheating in the stock market.

The government had argued that it could deter insider trading only if the court sustained the SEC's and the Justice Department's legal authority to go after a broad set of people who misuse confidential information.

In the past the SEC relied heavily on an expansive interpretation of securities laws to nab such insider traders as investment banker Dennis B. Levine, arbitrageur Ivan Boesky and banker Martin Siegel in the 1980s. They, in turn, led government attorneys to junk-bond king Michael Milken, who eventually admitted to six counts of false financial filing, securities fraud and conspiracy.

Yesterday's Supreme Court decision overturned a controversial decision last year by the U.S. Court of Appeals for the 8th Circuit. The appellate court had thrown out the 57-count conviction of a Minneapolis lawyer accused of illicitly making $4.3 million by trading Pillsbury stock on inside information about the takeover of that company by British food conglomerate Grand Metropolitan PLC.

The Minneapolis lawyer, James Herman O'Hagan, was convicted on 17 counts of violating Section 10(b) of the Securities Exchange Act of 1934.

The appellate court said the law did not cover O'Hagan because he did not work for Pillsbury or obtain the information from representatives of the company. Thus he had no fiduciary duty to Pillsbury shareholders under Section 10(b), the court ruled.

In reversing the lower court, the Supreme Court said that misappropriating and misusing inside information were sufficient to constitute securities fraud. Section 10(b) makes it a crime to use "any . . . deceptive device in connection with the purchase or sale of any security."

In recent decades, the SEC has used the "misappropriation" theory to bring nearly half of its insider trading cases. In 1985, for example, the commission successfully sued Wall Street Journal reporter R. Foster Winans for insider trading. The SEC contended that Winans had a fiduciary duty to the newspaper and violated that duty by misappropriating information he had gathered in his work about unannounced corporate mergers and acquisitions.

If the Supreme Court had not affirmed the misappropriation theory, the commission would have lost its main enforcement weapon against such trading. In the past decade, nearly half of the 40 to 45 insider trading cases brought by the SEC's enforcement division each year have been based in part on this legal theory.

The majority opinion, delivered by Justice Ruth Bader Ginsburg, said O'Hagan could be convicted of trading on confidential company information because he defrauded his law firm and its client, Grand Metropolitan, when he learned of the planned bid for Pillsbury and traded on that nonpublic information.

Bader said from the bench the intent of Section 10(b) of the Exchange Act was "to ensure honest markets, thereby promoting investor confidence. It would make scant sense to hold a lawyer-turned-trader like O'Hagan a 10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a law firm representing the bidder."

The government must, however, prove that a criminal violation was "willful," she said.

The high court also reinstated criminal convictions based on two other legal theories that had been rejected by the 8th Circuit. In the first, the appellate court said since O'Hagan had no fiduciary duty to Pillsbury shareholders, the SEC overreached in accusing him of violating a prohibition against insider trading on takeovers.

The Supreme Court also reinstated mail fraud convictions, which the appellate court had reversed because it had found no securities violations. The Justice Department had argued that the 20 counts of mail fraud in the O'Hagan case should not be dropped even if the securities-related convictions were.

"This decision reaffirms the SEC's efforts to make the stock market fair to all people, whether you're a Wall Street veteran or Main Street newcomer," SEC Chairman Arthur Levitt Jr. said. "This decision is a reminder to all investors that insider trading is cheating and will be vigorously prosecuted."

There was concern at the SEC that if it lost the O'Hagan case, it would have to go to Congress for legislation defining insider trading more broadly.

That would have been "a nightmare," according to one senior SEC official, who feared that Congress might not give the commission the authority it wanted.

INSIDER TRADING

Among notable cases of those prosecuted for profiting from confidential information about a company they did not work for:

1985: R. Foster Winans, Wall Street Journal reporter, sentenced to 18 months in prison for securities fraud for his arrangement with two brokers at Kidder, Peabody, in which he passed them advance information about the timing and contents of his column on the market.

1986: Ivan Boesky, who built a fortune trading in stocks of takeover targets, sentenced to three years in prison (served just over two) on a single criminal charge related to illegal tips he received from Dennis B. Levine, managing director of Drexel Burnham Lambert; Boesky also agreed to pay $100 million in penalties.

1987: Dennis B. Levine, managing director for Drexel, sentenced to two years in prison and fined $362,000 for using inside information about corporate takeovers to make illegal stock-trading profits.

1992: Robert Willis, psychiatrist, sentenced to five years' probation on criminal charges and fined $150,000 for a stock trade he made based on information he got from one of his patients, the wife of financier Sanford Weill.

TURNING TRADING INSIDE OUT

Ringing Endorsement of the Misappropriation Theory

Sets Stage for Wide-Ranging Prosecution of Insider Trading

Legal Times

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William E. Donnelly and Thomas J. McGonigle

Three weeks ago, the Supreme Court apparently resolved one of the most significant ongoing issues under federal securities law. The question was whether the "misappropriation theory" of insider trading liability provides a valid basis for the imposition of criminal liability under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. In United States v. O'Hagan, 65 U.S.L.W. 4650 (June 25, 1997), a six-justice majority held that the misappropriation theory, properly defined, can support a criminal conviction for insider trading.

Under the misappropriation theory, a person violates Section 10(b) and Rule 10b-5 when he engages in securities trading using confidential information entrusted to him, in breach of a fiduciary duty owed to the source of the information. The misappropriation theory thus differs from the "classical theory" of insider trading liability, which imposes liability on directors, officers, employees, or other agents of a company--i.e., "insiders"--who trade in the company's securities while in possession of material nonpublic information.

The classical theory is premised on the idea that the insider owes a fiduciary duty to the purchasers and sellers of the company's stock either to disclose the material nonpublic information or to refrain from trading. By contrast, the misappropriation theory reaches persons who are not insiders at the company whose securities are traded--who, indeed, may be complete strangers to the company--and thus who cannot be said to have a fiduciary duty to its shareholders.

United States v. O'Hagan concerned the purchase of common stock and call options of the Pillsbury Co. by James O'Hagan prior to the announcement of a tender offer for Pillsbury common stock by Grand Metropolitan, P.C. O'Hagan was a partner at Dorsey & Whitney, a law firm retained by Grand Met in connection with the tender offer. As noted in the Court's opinion, "Both Grand Met and Dorsey & Whitney took precautions to protect the confidentiality of Grand Met's tender offer plans." Following the public announcement of the offer, the price of Pillsbury common stock rose dramatically, and O'Hagan sold his common stock and call options at a profit of more than $4.3 million.

An investigation by the Securities and Exchange Commission into trading in Pillsbury common stock and options prior to Grand Met's tender offer led to a 57-count indictment against O'Hagan, alleging securities fraud, mail fraud, and money laundering. The indictment alleged that O'Hagan had "defrauded his law firm and its client, Grand Met, by using for his own trading purposes material, nonpublic information regarding Grand Met's planned tender offer."

O'Hagan was convicted by a jury on all 57 counts and was sentenced to 41 months in prison. The U.S. Court of Appeals for the 8th Circuit reversed his conviction. The 8th Circuit ruled that the misappropriation theory could not support a finding of violation of Section 10(b) and Rule 10b-5. The court also found that the SEC had exceeded its statutory authority under the Exchange Act in promulgating Rule 14e-3(a), which prohibits trading while in possession of material nonpublic information concerning a tender offer.

The 8th Circuit was the second federal appellate court to find that the misappropriation theory was not a valid basis for imposing insider trading liability. In 1995, the 4th Circuit in United States v. Bryan, 58 F.3d 933, reversed the securities fraud conviction of the former director of the West Virginia lottery. The conviction had been based upon his alleged misappropriation of information, entrusted to him as lottery director, for use in personal securities trading.

Since the 2nd, 7th, and 9th Circuits had all upheld the validity of the misappropriation theory, the effect of the 8th Circuit's decision in O'Hagan and the 4th Circuit's decision in Bryan was to create a significant split among the circuits. That produced the possibility of disparate outcomes in insider trading prosecutions involving fundamentally similar facts.

Risky Business

Under these circumstances, the decision of the SEC and the Department of Justice to seek certiorari in O'Hagan was understandable, although not without risk. For the past 20 years, the Supreme Court has been generally unreceptive to many of the SEC's more expansive, policy-oriented interpretations of the federal securities laws. In particular, the Court has insisted upon confining the scope of Section 10(b) within the narrower limits that the Court concluded were dictated by the language of the statute.

On the other hand, the SEC and the Justice Department may well have concluded that the particularly egregious facts in O'Hagan--millions of dollars in profits derived from the misuse of information entrusted to O'Hagan's law firm by a client--diminished the risk of an adverse decision.

In any event, the wisdom of asking the Court to decide O'Hagan was unquestionably vindicated by the decision, which reversed the 8th Circuit in all material respects. Indeed, it is difficult to imagine how the decision could have been any more favorable for the SEC's insider trading enforcement program.

The majority opinion in O'Hagan--written by Justice Ruth Bader Ginsburg and joined in full by Justices John Paul Stevens, Sandra Day O'Connor, Anthony Kennedy, David Souter, and Stephen Breyer, and in part by Justice Antonin Scalia--analyzed the validity of the misappropriation theory with reference to two essential elements of Section 10(b) liability: (1) the use of a "deceptive device, " (2) "in connection with" the purchase or sale of a security.

The Court found that the element of deception was satisfied because the misappropriator "deceives" the person who has entrusted the material nonpublic information to him by failing to disclose his intention to use that information for personal securities trading--a use inconsistent with his fiduciary duty.

Thus, the Court reasoned, the misappropriation theory is consistent with the Court's prior decision in Santa Fe Industries Inc. v. Green, 430 U.S. 462 (1977). In Santa Fe, the Court held that Section 10(b) does not reach all breaches of fiduciary duty in connection with securities transactions, but rather only those involving manipulation or deception.

Having concluded that misappropriation does encompass deception, the Court then turned to the more difficult question of whether such deception is "in connection with" the purchase or sale of securities. The question was more difficult because, unlike classical insider trading, the operative deception in a misappropriation case is not practiced on the other party to the securities transaction, but rather on the person who has entrusted the material nonpublic information to the misappropriator.

The Court held that " t his element is satisfied because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities."

Misinterpreted Language

In reaching this conclusion, the Court found that the 8th Circuit had misinterpreted language in prior Supreme Court decisions that seemed to suggest that Section 10(b) liability "is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction" (emphasis added). The Court noted that this language from Chiarella v. United States, 445 U.S. 222 (1980), was merely intended to indicate the absence of a "general duty between all participants in market transactions to forgo actions based on material, nonpublic information" and was not intended to suggest that "the only relationship prompting liability for trading on undisclosed information is the relationship between a corporation's insiders and shareholders" (emphasis added).

The Court also sought to clarify language in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994), which the 8th Circuit had relied upon to support its finding that Section 10(b) applies only to misstatements or omissions made to a purchaser or seller of securities. The language from Central Bank referred to liability for misstatements or omissions "on which a purchaser or seller of securities relies." The Court explained that this language "sought only to clarify that secondary actors, although not subject to aiding and abetting liability, remain subject to primary liability under 10(b) and Rule 10b-5 for certain conduct."

Having upheld the validity of the misappropriation theory, the Court also considered whether the SEC had exceeded its statutory authority under Section 14(e) of the Exchange Act in promulgating Rule 14e-3(a). The primary significance of Rule 14e-3(a), which applies only to tender offers, is that the SEC is not required to prove a breach of fiduciary duty in order to establish a violation.

The Court concluded that Rule 14e-3(a) is within the SEC's rule-making authority under Section 14(e) "as a means reasonably designed to prevent' fraudulent trading on material, nonpublic information in the tender offer context." But the Court declined the government's invitation to interpret the SEC's authority under Section 14(e) as broader than its authority under Section 10(b).

In an opinion joined by Chief Justice William Rehnquist, Justice Clarence Thomas concurred in part and dissented in part from the majority opinion. Thomas' dissent was based largely on the proposition that the misappropriation of confidential information followed by the use of that information in securities trading is not analytically distinguishable from the misappropriation of funds followed by the use of those funds in securities trading. If, as the government conceded at oral argument, the latter situation does not give rise to Section 10(b) liability, then neither should the former.

The majority responded to this contention by asserting that Thomas' dissent missed the point, which was "that a rule suitably applied to the fraudulent use of certain kinds of information would be stretched beyond reason were it applied to the fraudulent use of money."

But the majority was forced to concede that the government had overstated its argument in trying to distinguish misappropriation of funds. The distinction urged by the government was that confidential information of the kind at issue derives its value only from its utility in securities trading, whereas money has utility in many other contexts. The Court corrected the government: "Substitute ordinarily for only and the Government is on the mark."

Easy Case'

The O'Hagan facts, involving information misappropriated from an acquiring company, presented the Court with the "easy case" for the misappropriation theory. As the District Court pointed out 13 years ago in SEC v. Musella, 478 F.Supp. 425 (S.D.N.Y. 1984), absent the misappropriation theory, an individual who obtains nonpublic information regarding a tender offer from the acquiring company, rather than from the target company, is not subject to liability if he capitalizes on this information by trading in the target company's securities. The Musella court found this distinction "troubling, " but "inescapable."

Indeed, the lack of any sound policy reason for this distinction undoubtedly contributed to the Court's willingness to "amend" the government's position in O'Hagan in order to sustain the misappropriation theory.

There is a longstanding debate about whether a legislative solution is preferable to a judicial fix of a statutory anomaly. In the case of Section 10(b), the government has opted for the judicial approach--for now. But O'Hagan may not be the last word.

Of course, the Court's ringing endorsement means that the SEC and criminal authorities can, and undoubtedly will, continue to pursue vigorously cases based upon the misappropriation theory. Just as certain, the cases brought will not be confined to individuals like O'Hagan who obtain information from the acquiring company. The misappropriation theory has already been used to reach a newspaper columnist who traded in advance of his column, a psychiatrist who obtained information from his patient, and sons who received information from fathers. We can expect the SEC to stretch this theory as far as it possibly can to capture any manner of trading that it considers objectionable.

However, as the information at issue in future cases strays further and further from the sort of the information that derives its value "ordinarily" from its utility in securities trading, we may well see the Supreme Court obliged to revisit the misappropriation theory--under circumstances that will make Justice Thomas' dissent seem prescient.

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NONPROFITS GET INTERSTATE TRADE PROTECTION

The New York Times

Tuesday, May 20, 1997

Correction Appended

Linda Greenhouse

In a case watched closely by nonprofit organizations around the country, the Supreme Court ruled today that states offering favorable tax treatment to charities cannot draw distinctions based on whether a charity serves primarily in-state or out-of-state clients.

The Court declared unconstitutional a 40-year-old Maine property tax law that made tax-exempt status generally available to "benevolent and charitable institutions" but withheld it from those "operated principally for the benefit of persons who are not residents of Maine."

By a vote of 5 to 4, the Court said the law amounted to economic protectionism that placed an unconstitutional burden on interstate commerce. The law was challenged by a summer camp operated by the Christian Science church that serves mostly children from outside the state and, as a result, had to pay more than $20,000 a year in local property taxes from which it would have been exempt had most of its campers been from Maine.

Writing for the majority, Justice John Paul Stevens said that a state law making a similar distinction among profit-making businesses would unquestionably violate the Constitution's commerce clause. "We see no reason why the nonprofit character of an enterprise should exclude it" from a similar analysis, Justice Stevens said.

He added that "any categorical distinction" between profit-making and nonprofit organizations was "wholly illusory" given that "entities in both categories are major participants in interstate markets." He noted that the nonprofit sector accounts for approximately 7 percent of the gross national product and, as of 1990, employed 9.3 million people.

Maine's law was evidently the only one of its kind in the country, and the state did not defend it in the Supreme Court. After a state trial court judge declared the law unconstitutional in 1994, the state did not appeal, and the case was carried on by the town of Harrison, about 40 miles northwest of Portland, where the camp that challenged the law, Newfound/Owatonna, is located. The Maine Supreme Judicial Court overturned the earlier decision and upheld the law in a 1995 ruling.

But although, as Justice Stevens observed drily, "the facts of this particular case, viewed in isolation, do not appear to pose any threat to the health of the national economy," the case galvanized an impressive array of nonprofit organizations to make the Justices aware of their concerns.

Groups representing universities, churches, the United Way, the Y.M.C.A. and others warned of the consequences if the Court permitted states to withhold tax exemptions from nonprofits that serve a nationwide audience. The Maine court's decision "poses a substantial threat to the financial welfare of nonprofit institutions generally," a brief from the American Council on Education and other groups told the Court.

Their concern reflected the novelty, and therefore the inherent unpredictability, of the issue. Despite a formidable list of decisions examining, and for the most part disallowing, economic protectionism by the states, the Court had not previously applied these cases in the nonprofit context.

Given the closeness of the vote, the nonprofit groups' concerns proved well founded. The case, argued last October just after the current term began, was the oldest undecided case on the Court's calendar, making it apparent that the Court was engaged in a major battle over the outcome.

The majority opinion, Camps Newfound/Owatonna v. Harrison, No. 94-1988, was joined by Justices Sandra Day O'Connor, Anthony M. Kennedy, David H. Souter and Stephen G. Breyer. Justice Antonin Scalia wrote the principal dissenting opinion, which was signed by the three other dissenters: Chief Justice William H. Rehnquist and Justices Clarence Thomas and Ruth Bader Ginsburg.

Justice Scalia said Maine was not trying to regulate interstate commerce. He said the challenged law "has nothing to do with economic protectionism" but was "designed merely to compensate or subsidize those organizations" that contribute "benefits the state might otherwise provide." As such, the law "survives even our most demanding commerce-clause scrutiny," Justice Scalia said.

Justice Scalia's opinion suggested, without quite saying so directly, that Court precedents protecting interstate commerce should not apply to nonprofit groups.

A separate dissenting opinion by Justice Thomas, which Justice Scalia and Chief Justice Rehnquist joined but that Justice Ginsburg did not, went much further, calling into question the Court's approach to the commerce clause going back to the 19th century.

The clause itself, authorizing Congress to "regulate commerce with foreign nations and among the several states," does not place any explicit limitations on state activity. The Court has interpreted the Constitution as containing an implicit "dormant" or "negative" commerce clause, as the precedents have labeled it, under which states are greatly limited in the way they can act, without Congress's approval, to regulate the national economy.

This entire enterprise has been illegitimate, Justice Thomas said. "The negative commerce clause has no basis in the text of the Constitution, makes little sense and has proved virtually unworkable in application," he said, adding that "we have used the clause to make policy-laden judgments that we are ill-equipped and arguably unauthorized to make."

Justice Thomas said another provision of the Constitution, which prohibits states from taxing imports or exports, should be invoked to prohibit "certain of the more egregious state taxes on interstate commerce." The Court interpreted that provision, in a decision in 1869, as applying only to foreign trade. Justice Thomas, joined in this portion of his opinion only by Justice Scalia, said the 1869 decision should be overruled.

HIGH COURT REJECTS TAX ON NONPROFITS

The Justices Say Maine Can't Discriminate Because an Agency Serves Mostly Out-of-State Residents

Portland Press Herald

Tuesday, May 20, 1997

John Richardson, Staff Writer

The Associated Press contributed to this report.

The U.S. Supreme Court on Monday struck down a 40-year-old Maine tax law that was challenged by a Harrison summer camp and nonprofit agencies around the country.

The law allowed the town of Harrison to with hold tax breaks from a nonprofit lakeside camp because the boys and girls who go there each summer come mostly from outside the state.

Supreme Court justices, in a 5-4 decision, said the Maine law is unconstitutional because it discriminates against nonprofits that serve residents from outside the state. Nonprofits that serve mostly Maine citizens are tax-exempt.

The decision delighted the directors of Camps Newfound/Owatanna in Harrison, and spelled relief for nonprofits nationwide.

Agencies such as the YMCA and United Way urged the court to overturn the law and feared that, if the law were upheld, other states might start collecting from tax-exempt agencies that serve citizens of other states.

William Dale, a Portland lawyer who represents the camp, said the ruling also is good news for a nonprofit camp in Poland that feels it has been taxed unfairly because it serves disabled youths from outside Maine.

Officials from Harrison defended the law, however. Now the town will be deprived of one of its largest taxpayers - representing a $25,000 annual payment.

The decision also could cost town taxpayers $100,000 or more in tax refunds and legal fees. Those costs will now have to be determined by Maine courts.

"That's a significant chunk of change that all the others in town will have to pick up," said Harrison Town Manager Michael Thorne.

Townspeople have argued they shouldn't be forced to subsidize a camp for out-of-state kids. "I expect there will be some hard feelings for some people," Thorne said.

Camps Newfound/Owatonna Inc. runs a 180-acre summer camp for Christian Science children on picturesque Long Lake. Although a nonprofit, the 80-year-old camp paid property taxes under Maine's unusual law because the vast majority of the more than 250 campers who enroll each year were out-of-state residents.

A revaluation in the late 1980s boosted tax bills around Long Lake and prompted the camp to challenge the state law in 1992.

Superior Court Justice Kermit V. Lipez struck down the tax law as unconstitutional, but Harrison appealed and the Maine Supreme Judicial Court unanimously reversed Lipez and upheld the law.

The U.S. Supreme Court in March granted the camps' request to review the ruling from Maine's highest court. The Supreme Court accepts only about one in 75 cases. A Maine case reaches the nine justices about once every five years.

The national focus on Maine's law worried major nonprofits, and many charitable groups supported the Maine camp's challenge. They feared that other states might tax their properties if the law were upheld.

A narrow majority of justices agreed with the camp that the state's double standard is unfair and interferes with interstate commerce.

Justice John Paul Stevens wrote for the court that states cannot favor in-state businesses over companies in other states.

"We see no reason why the nonprofit character of an enterprise should exclude it" from the same constitutional demands, Stevens said.

"To countenance discrimination of the sort that Maine's statute represents would invite significant inroads on our national solidarity," he wrote.

Stevens was joined by Justices Sandra Day O'Connor, Anthony M. Kennedy, David H. Souter and Stephen G. Breyer.

Chief Justice William H. Rehnquist and Justices Antonin Scalia, Clarence Thomas and Ruth Bader Ginsburg dissented.

Writing for the four, Scalia said Maine is justified to only give tax breaks to "property used to relieve the state of its burden of caring for its residents."

When the case was argued in October, Scalia sided with William Plouffe, the Portland lawyer who argued on behalf of Harrison.

"Why should the taxpayers of Maine subsidize a charity for people who live outside of Maine?" Scalia asked.

HIGH COURT RULES AGAINST ASBESTOS SETTLEMENT

The Wall Street Journal

Thursday, June 26, 1997

Edward Felsenthal

In a decision that could increase pressure for a legislative resolution of tobacco claims, the Supreme Court made it harder for massive personal-injury litigation to be resolved through comprehensive court-approved settlements.

The high court's ruling wipes out a $1.3 billion deal designed to settle hundreds of thousands of potential personal-injury claims against a group of former asbestos makers. The question before the court was whether a diverse group of plaintiffs can settle such cases, even if the same group wouldn't be allowed to bring the case to trial as a class action. In class actions, a few plaintiffs sue on behalf of a much larger group, but the cases aren't supposed to be approved for trial unless members of the class have similar injuries or face common legal hurdles.

Even so, some judges in recent years have been approving settlements of such disputes, partly on the theory that the plaintiffs' mutual interest in resolving the case overrides their dissimilarities. But yesterday, in a 6-2 decision, the justices ruled that a common interest in settlement isn't enough.

In an opinion for the court, Justice Ruth Bader Ginsburg said a "sprawling" case such as this one can't be settled as a class action because the claims alleged aren't similar enough and the people involved have too many conflicting interests to be adequately represented by the named plaintiffs.

The decision will make it harder to settle liability claims in a wide variety of areas, including antitrust, breast-implant and consumer-protection cases. It would also make it more difficult to resolve litigation against the tobacco industry if for any reason the proposed legislative settlement of smokers' claims is scuttled. That threat is likely to boost the incentive for the industry and anti-tobacco forces to reach a legislative solution.

The ruling means "there's only one clear channel of resolution, and that's a legislative resolution," said John Coffee, a law professor at Columbia University.

Indeed, several times in the opinion, Justice Ginsburg seemed to invite Congress to intervene and help compensate victims in such cases fairly and efficiently. But she cautioned that judges can't take matters in their own hands.

"Courts must be mindful that the rule as now composed sets the requirements they are bound to enforce," Justice Ginsburg wrote. Judges, she added, "are not free to amend a rule" just to simplify the management of complex liability cases. Class actions are governed under a provision known as Rule 23 of the Federal Rules of Civil Procedure, which lays out a variety of requirements cases must meet in order to be approved by a judge as a class action.

Dubbed "Georgine" after one of the plaintiffs, the case was brought against 20 former asbestos makers, including Amchem Products Inc., Armstrong World Industries Inc., Union Carbide Corp., Pfizer Inc. and U.S. Gypsum Co., a USG Corp. subsidiary. In 1993, the parties reached a settlement that set up a fund for class members who chose to participate in the deal while allowing those who didn't to drop out and sue on their own.

The agreement was supposed to resolve both current and future asbestos-related claims. But the federal appeals court in Philadelphia threw out the deal last year, saying it couldn't "conceive of how any class of this magnitude could be certified."

The Supreme Court's ruling reflects a similar skepticism. Cautioning that the class-action rule must be "applied with the interests of absent class members in close view," the justices said the class-action rule simply "cannot carry the large load" that the parties "heaped upon it."

The Center for Claims Resolution, which represents the former asbestos makers, said it was disappointed with the ruling but would continue trying to work out a deal that can pass legal muster. "The court didn't rule against us on constitutional grounds, so I think there is enough latitude for us to restructure our particular settlement," said Larry Fitzpatrick, the center's president.

Though the decision was a disappointment to companies and plaintiffs' lawyers who endorse such settlements, it may not be the last word on the subject. The rule-making arm of the federal courts has been considering a proposal that would make it clear that judges have the authority to approve class actions for settlement purposes, even if the same class couldn't be certified for trial.

Still, the court's opinion signaled that there may be constitutional or procedural obstacles to an amended rule that gives individual judges too much power to approve nationwide settlements. Among other things, the justices said they weren't certain whether there was any adequate way to notify people whose rights might be affected by a deal that is "so . . amorphous."

Any rule that seeks to "transform a federal court into a junior-varsity Congress" is certain to be rejected by the court, said Harvard Law School professor Laurence Tribe, who represented the plaintiffs challenging the asbestos settlement.

Justices Stephen Breyer and John Paul Stevens dissented from much of the court's ruling, saying "the need for settlement in this mass tort case, with hundreds of thousands of lawsuits, is greater than the court's opinion suggests." Justice Sandra Day O'Connor didn't participate in the case because she owns stock in one of the companies involved. (Amchem Products vs. Windsor)

BANKRUPTCY IN LIEU OF SETTLEMENTS?

'AMCHEM' RULING SPARKS HOT DEBATE ON HARSH ALTERNATIVE

The National Law Journal

Monday, July 28, 1997

Bob Van Voris, National Law Journal Staff Reporter

THE SUPREME COURT's June 25 decision in the Amchem asbestos case has prompted a sharp debate over whether mass-tort class action settlements are dead, dying or doing just fine.

While Amchem Products Inc. v. Windsor, 96-270, casts doubt on whether a company can cap future tort liabilities with the stroke of a settlement pen, lawyers are turning their attention to the Bankruptcy Code as an alternative vehicle for evaluating claims and cutting off liability.

For one thing, a group of nine lawyers, judges and nonlawyer bankruptcy experts are about to recommend changes to the Bankruptcy Code they say will make it easier for bankruptcy courts to deal with mass-tort liability.

This comes at a time when some say the door to mass-tort class actions in the civil courts has been all but losed by the Amchem ruling. In Amchem, the high court affirmed a 3d U.S. Circuit Court of Appeals decision overturning what Justice Ruth Bader Ginsburg called a "sprawling" settlement of current and future asbestos exposure claims against 20 manufacturers. The Supreme Court held that federal courts, when considering settlements, may not relax the requirements of Rule 23 of the Federal Rules of Civil Procedure, which governs class action certification.

Victor E. Schwartz, a defense lawyer with Crowell & Moring L.L.P. in Washington, D.C., is one of those who believes that Amchem demonstrates that Rule 23 is insufficient to carry the weight of most mass-tort class settlements. "If one looks at the letter of Rule 23, there is nothing that says there are different rules for settlement classes," he says.

As a result, he says, companies facing huge numbers of tort claims "are looking once again, as [Johns-]Manville, Dow Corning and A.H. Robins did, to the bankruptcy courts."

Bankruptcy Under Review

The 1994 Bankruptcy Reform Act set up the National Bankruptcy Review Commission, directing it to undertake a sweeping review of the Bankruptcy Code and to report its recommendations to Congress. The full committee report is due in October, although work on many of the proposals, including recommendations dealing with future mass-tort liability, has largely been completed.

The proposal defines "mass future claims" for purposes of Chapter 7 liquidations and Chapter 11 reorganization plans, ensuring that potential future tort claimants are represented and, to the extent possible, compensated for their injuries. This means that the claims may be fully discharged, preventing future claimants from pursuing the company for damages outside of bankruptcy court. In addition, the proposal would recognize future claims in cases where a company has been subject to numerous claims based on pre-bankruptcy acts and is likely to face similar ones in the future. The class that suffered the injury must be reasonably identifiable, and the amount of potential liability must be capable of estimation. This differs from the current law, which is silent on the issue. As Amchem demonstrated, the relationship between Rule 23 and mass torts has always been uneasy. Mass-tort cases often have plaintiffs with various injuries, different histories of exposure to the product and other individual issues.

In addition, courts considering nationwide class actions may have to contend with the tort laws of each of the 50 states. And in cases where people have been exposed to toxic substances, it may take decades for their injuries to appear. Class members with current injuries are motivated to get as much money as possible immediately, while future claimants are best served when a judgment or settlement provides that money will be available years later when they become ill.

Many commentators have faulted settlements like the one ruled on in Amchem for selling out the interests of future claimants. In the typical case, the company wants to cap its liability and move on. And current claimants want the pot for themselves. Future claimants-people who do not even know their interests are at stake-may get shortchanged, critics argue.

Settlement Shortcomings

Members of the National Bankruptcy Review Commission have had to grapple with similar problems. Commission member Judge Edith Hollan Jones of the 5th Circuit is particularly concerned about collusive class action settlements. "Everyone is so concerned with making their money from managing the cases," she says. "Nobody's taking on the ethical responsibility to triage cases."

As a result, she says the commission is trying to ensure the bankruptcy courts do not simply provide an alternative forum for insiders to make deals at the expense of injured people and future claimants.

Judge Jones has been insistent that the mass future claims representative be put on the same footing as any other creditor's representative. After considering proposals that would have partially shielded these representatives from liability, the working group is proposing that they bear full fiduciary responsibility to future plaintiffs.

Even with the proposed changes, few think the Bankruptcy Code is a cure-all for tort cases that do not fit into Rule 23. "You've got to realize that mass-tort bankruptcy is very expensive," says Prof. John C. Coffee Jr., of Columbia University School of Law. "Most of the assets go to the creditors-as normally they should in bankruptcy."

Proposed changes to the Bankruptcy Code, he says, "might make it possible for [bankruptcy] to produce as unfair and impecunious settlements for the injured victims as class actions were doing."

Despite the proposed changes, Judge Jones says bankruptcy law remains a "flawed vehicle" for mass torts. "There must be some better way to run the show." And both plaintiffs' and defendants' lawyers view bankruptcy court -- even a Chapter 11 reorganization -- with some dread.

"There are a host of practical considerations that operate as a disincentive to resorting to bankruptcy court," says Roger Trangsrud, associate dean of George Washington University National Law Center. For one, company managers are not usually eager to give control to a bankruptcy trustee. And the company may not survive the process.

After 'Amchem'

Plaintiffs' lawyer Ronald Motley, of Barnwell, S.C.'s Ness Motley Loadholt Richardson & Poole, is not eager to litigate in bankruptcy court, although he recognizes it may happen more often in the wake of Amchem. Mr. Motley was one of the lawyers who negotiated the settlement that was eventually invalidated by the Amchem decision.

"Bankruptcy court is the modern-day version of Bleak House," he says, referring to Charles Dickens' novel about a nightmarish, protracted lawsuit.

"I find the bankruptcy judges more inclined to protect the debtor," he says. "Second, you're thrown in with banks and other creditors, not [a tort plaintiff's] natural allies. It's an unnatural thing for plaintiffs' lawyers to have to do."

96-1578 PHILLIPS V. WASHINGTON LEGAL FOUNDATION

Use of interest on client trust funds to provide civil legal services to poor litigants--Property interest cognizable under First and Fifth Amendments.

Ruling below (Washington Legal Foundation v. Texas Equal Access to Justice Foundation, CA 5, 94 F.3d 996, 65 LW 2210):

Texas' mandatory Interest on Lawyers' Trust Accounts program constitutes taking in violation of Fifth Amendment of interest earned on trust accounts maintained by lawyers for their clients to extent that clients have not consented to IOLTA program's use of their money; case is remanded to determine whether taking was against will of clients in violation of Fifth Amendment, and compels support of speech that clients find offensive in violation of First Amendment.

Question presented: Is interest earned on client trust funds held by lawyers in IOLTA accounts property interest of client or lawyer, cognizable under First or Fifth Amendment, despite fundamental precept of IOLTA that such funds, absent IOLTA program, could not earn interest for client or lawyer--question on which courts of appeals are in conflict?

Petition for certiorari filed 4/4/97, by H. Robert Powell, Darrell E. Jordan, Brittan L. Buchanan, David J. Schenck, Hughes & Luce LLP, and Nancy Trease, all of Austin, Texas.

HIGH COURT TO REVIEW IOLTA FUNDS

The National Law Journal

Monday, July 14, 1997

Marianne Lavelle

THE SUPREME COURT has agreed to review a ruling that jeopardizes a major source of funding for legal services for the poor-the program that makes use of the interest earned on the small trust accounts that lawyers hold for their clients. Phillips v. Washington Legal Foundation, 96-1578.

In all 50 states, thanks to a program developed by the American Bar Association, the $100 million a year earned on such accounts is collected by state government officials for legal-aid programs. But the Washington Legal Foundation, a conservative public-interest law firm, has long argued that the so-called IOLTA program (Interest on Lawyers' Trust Accounts) violates the Constitution's prohibition on taking of property without just compensation.

In recent years, the 11th and 1st U.S. Circuit Courts of Appeals have considered-and rejected-that argument. But last year, the 5th Circuit cleared the way for the Washington Legal Foundation to launch such a challenge against Texas' law. The 5th Circuit did not reach the constitutional issue, but reversed a district court's dismissal of the case. WLF v. Texas Equal Access to Justice Foundation, 94 F.3d 996.

Members of the Texas Supreme Court, which runs the program, have asked the U.S. Supreme Court to reverse the 5th Circuit ruling. They argue, as proponents of IOLTA have argued for years, that the amount of client funds in such accounts is nominal and held for brief periods of time, typically as escrow in real estate settlements. Because the costs of maintaining such accounts exceeds the interest earned, the deposit of a client's funds acts as an interest-free loan to the bank. IOLTA, they say, is an attempt to transfer this benefit from banks to legal providers for the indigent.

The 5th Circuit questioned the basis of the program. "The traditional rule that interest follows principal must apply because that rule compensates the owners of the principal for the use of their funds," the court said. "If a bank customer chooses, however, to allow the bank to profit in this manner, that decision does not give the state carte blanche to claim that property as its own."

The 5th Circuit said that to win its constitutional argument, the Washington Legal Foundation would have to prove the taking was against the will of the property owner. The same would be necessary for WLF's First Amendment claim, the court said. WLF says the activities of IOLTA-funded activities, such as legal aid to refugees seeking political asylum in the United States and those organizations assisting death-row inmates to challenge their death sentences, force them to support speech they find offensive.

The American Bar Association had urged the Supreme Court to hear the case.

"The ABA is convinced of the constitutionality of IOLTA and is confident the court will uphold this very important funding mechanism for legal services to the poor and for the administration of justice," says Beverly Groudine, counsel to the ABA Commission on IOLTA.

At least one member of the Supreme Court will not be listening to the IOLTA arguments for the first time. Before his elevation to the high court, Justice Stephen Breyer was a member of the three-judge 1st Circuit panel that rejected WLF's case unanimously in 1993. WLF v. Massachusetts Bar Foundation, 993 F.2d 962.

LEGAL SERVICES' STEAL FUNDING

ACTIVISTS SKIM INTEREST FROM COURT-RUN ACCOUNTS

Investor's Business Daily

Tuesday, October 15, 1996

David A. Price

Faced with federal cutbacks, legal activists on the left are tapping into a powerful source of support - the legal profession itself.

For more than two decades, say conservatives, the federally funded Legal Services Corp., which gives grants to local poverty law groups, has used tax dollars to promote liberal causes in court.

President Reagan tried to shut it down and failed. The GOP-controlled Congress was more successful at curbing it by cutting funding and restricting its actions.

But the poverty law establishment was ready. It has come up with innovative ways of getting funds without going through legislatures.

These groups have tapped into huge sums of capital that result from civil litigation, the opening of escrow accounts and other legal transactions. Court-ordered programs give these poverty law groups millions of dollars in earnings from some bank accounts and from unclaimed class-action settlements.

And they're using these funds to pursue their own notions of justice and equity in state and federal courts.

Legal Services' typical cases include evictions, foreclosures, divorces and child custody disputes. Of the 1.6 million cases closed by LSC-backed attorneys in 1995, one in every three was a family law case, and a little more than one in every five was a housing case.

But the third-largest category, at 15.7%, was "income maintenance" -welfare and unemployment cases.

These poverty lawyers maintain a docket that is diverse and often controversial. The Washington-based National Legal and Policy Center, a conservative policy group, points to recent lawsuits in which legal services lawyers have:

* Opposed the evictions of drug-dealing residents from public housing in Macon, Ga., Pittsburgh, Philadelphia and New York City.

* Opposed the deportation of aliens in Boston and Atlanta who had been convicted of serious felonies.

* Helped drug addicts and alcoholics receive disability benefits based on their addictions.

* Represented a group of homeless plaintiffs in challenging a Santa Ana, Calif., ordinance that banned camping on public property.

* Fought the adoption of Indian babies by non-Indians in Illinois and Idaho.

* Represented prisoners in civil suits against prison authorities.

* Sued to stop welfare reform in California, New Jersey and Wisconsin, arguing the reforms were unconstitutional or violated federal laws against experimenting on human subjects.

The Republican Congress has been receptive to the criticisms. It cut Legal Services' funding for fiscal 1996 by 30% to $278 million. The fiscal 1997 budget increases slightly to $283 million.

But the new appropriation restricts the activities of grant recipients. Recipients can no longer bring class actions, challenge the legality of welfare reforms or represent prisoners in civil suits. Lobbying limits were also tightened.

These curbs, like past ones, have sent the groups looking for alternatives.

Along with money from states and private fund-raising, a surprising source of nonfederal funds has emerged in the '80s and '90s: the interest on funds that attorneys hold in trust for clients.

Where the amount involved is nominal, or where the money is to be held for only a short time, attorneys in a given state are required to pool money from multiple clients into one bank account - and then the Interest on Lawyers Trust Accounts (IOLTA) is doled out.

Defenders of such practices say they're not taking anyone's money. Because the only trust funds affected are ones that would generate small amounts of interest individually - not enough to offset bank fees for an individual account - the clients do not lose any earnings, in their view.

But trusts scholar Charles Rounds Jr., a law professor at Suffolk University Law School and a critic of IOLTA, disagrees. He said that it "seizes a property right and diverts it."

Rounds added, "If the interest is public property - I don't see how it could be - it belongs in the state treasury to be appropriated."

And Rounds notes banks offer sweep accounts with individual sub-accounts. That means clients could still earn interest from a pooled account.

These programs give the money to legal services groups - a total of $97.6 million in 1993. A 1992 survey found that such interest provided roughly one-fourth of funding for such groups.

And to avoid new restrictions on grant recipients, legal services groups have been spinning off parallel outfits. Under such an arrangement, one group gets federal funds and accepts the strings attached. The other group operates with nonfederal funds, including the trust fund interest, and avoids the strings.

The programs operate in every state but Indiana. Many states began with voluntary programs, but abandoned them when they didn't bring enough money.

In 27 states, handing over the interest is now mandatory. In 19 states and the District of Columbia, lawyers must participate unless they ask to opt out.

Three states - New Mexico, Oklahoma and South Dakota - still have voluntary programs.

In all but a handful of states, the programs were adopted by the courts, not by elected officials.

The Washington Legal Foundation has sued the Texas IOLTA program, which takes in around $5 million a year. The group argues the program is an unconstitutional "taking" of property and that it violates the First Amendment by forcing clients to pay for speech that they oppose.

In Texas, says WLF, IOLTA-funded groups get hundreds of thousands of dollars to represent illegal aliens and death-row prisoners.

The U.S. Court of Appeals for the Fifth Circuit in New Orleans gave the foundation a partial victory last month, rejecting the state's argument that the interest taken by IOLTA never belonged to the clients. The case is now back in federal district court.

Two other appeals courts have upheld the legality of IOLTA.

Another little known source of support has been unclaimed class-action proceeds.

When a defendant loses a class action suit, the company usually has to set up a fund to cover the award or settlement.

But because a class action may have been brought on behalf of thousands or even millions of parties nationwide, who may be unaware of the suit, much of the money goes unclaimed. It is up to the judge to decide where the unclaimed money will go.

Lately, judges have been giving sizable awards to legal services groups.

In May, a federal district judge awarded the Atlanta Legal Aid Society and Georgia Legal Services $1 million each out of a $4.2 million pie left over in a class action brought against airlines for price-fixing. Neither group had been involved in the litigation.

Atlanta Legal Aid executive director Steve Gottlieb says he told the judge an award to legal services would ultimately benefit the class members.

Gottlieb said the judge, Marvin H. Shoob, made the award out of concern for the decline in federal funding. "It clearly was a way of dealing with the national cutbacks," Gottlieb said.

Gottlieb's group is investing its award and plans to use the income to help offset the effects of LSC cuts.

Last December, a judge in Washington state awarded $195,000 of class action funds to the Legal Foundation of Washington and the Legal Aid for Washington Fund, organizations that fund legal services. That case had been brought against Whirlpool Financial Corp. for overcharging on interest.

And since 1994, California law has required that unclaimed class action funds go to legal services unless otherwise assigned.

A fund-raising manual published in August by the American Bar Association for poverty law groups advises that plaintiffs' attorneys "play critical roles in helping a judge decide to whom residual funds should be awarded."

It suggests the groups "work with plaintiffs' attorneys involved in class action litigation to make them aware of the opportunity to direct these funds to support justice for the poor."

WASHINGTON LEGAL FOUNDATION, Plaintiffs-Appellants,

v.

TEXAS EQUAL ACCESS TO JUSTICE FOUNDATION, Appellees.

United States Court of Appeals, Fifth Circuit.

Sept. 12, 1996

. . . WISDOM, Circuit Judge:

The plaintiffs-appellants appeal the district court's denial of their motion for summary judgment and the court's award of summary judgment to the defendants-appellees, in which the district court upheld the constitutionality of the Texas statute, Interest on Lawyers Trust Accounts Program (IOLTA), and found that the defendants are entitled to limited immunity under the Eleventh Amendment. For the reasons that follow, we REVERSE the judgment of the district court in part, VACATE and remand in part, and AFFIRM in part.

I.

Statement of Facts

Clients often give their attorneys money to be held in escrow, such as retainer fees or closing costs for a transaction. In Texas, traditional ethical rules require attorneys to place this money in a trust account that permits withdrawal on demand. The ethical rules also allow attorneys to aggregate all client funds into a single trust account and prohibit attorneys from commingling their own money with the trust fund. Because federal law prohibited banks from paying interest on demand accounts, these accounts formerly amounted to interest-free loans to the banks.

In 1980, new banking regulations allowed negotiable order of withdrawal (NOW) accounts, which operate as interest-bearing checking accounts. NOW accounts created a vehicle for attorneys to pool client funds into an interest- bearing trust account, provided that none of the funds belong to a for-profit corporation. Attorneys, however, may not deduct the costs of maintaining the trust account from the interest earned, because such a practice would constitute an impermissible benefit from the management of the trust account in violation of the ethical rules.

The creation of NOW accounts led to the development of IOLTA programs. The IOLTA concept arises from the premise that there are still situations in which, because of the nominal amount of a client's funds to be held or the brief period for which a client's funds will be held, NOW accounts are not feasible; the costs of maintaining such accounts outweigh the interest that each client would have earned. In these situations, the trust accounts still operated as interest-free loans to the banks. IOLTA is an attempt to switch this benefit from the banks to legal providers for the indigent. Under its statutory power to regulate the state bar, the Texas Supreme Court created its IOLTA program in 1984, which is modeled after IOLTA programs used in other states and which seeks to capitalize on this banking anomaly. The IOLTA program originally permitted attorneys to place client funds that were "nominal in amount" or were "reasonably anticipated to be held for a short period of time" into an unsegregated interest-bearing bank account (IOLTA account), the interest of which is paid to the Texas Equal Access to Justice Foundation (TEAJF), a non-profit corporation created by the Texas Supreme Court. At that time, Texas's IOLTA program was voluntary, meaning that an attorney could choose whether to participate but clients had no choice, other than to select an attorney who did not maintain an IOLTA account.

The TEAJF's purpose is to manage and distribute the interest earned from the IOLTA accounts to non-profit organizations that "have as a primary purpose the delivery of legal services to low income persons",with the exception that no funds may be used to finance class action lawsuits or to lobby on behalf of a political candidate or issue. Nearly all states have similar systems, which were designed to provide much-needed finances to legal providers for the impoverished. States have drastically slashed the budgets for such programs over the years; in 1993, the Texas legislature even refused to enact a modest increase in court filing fees to compensate for temporary IOLTA shortfalls.

Initially, the Texas IOLTA program did not meet expectations. Attorneys were reluctant to deposit their client funds into IOLTA accounts and impoverished Texas citizens still were unable to obtain legal assistance because of a lack of resources. Texas's voluntary IOLTA program yielded only $1 million per year. Following the lead of several other states and the recommendation of the American Bar Association, in 1988, the Texas Supreme Court made attorney participation in the IOLTA program mandatory, requiring that attorneys deposit client funds in IOLTA accounts under certain circumstances. The revised rules, which became effective in 1989, state that

> [a]n attorney ... receiving in the course of the practice of law ... client funds that are nominal in amount or are reasonably anticipated to be held for a short period of time, shall establish and maintain a separate interest-bearing demand account at a financial institution and shall deposit in the account all those client funds.

The rules further guide an attorney's decision as to whether funds are suitable for deposit in an IOLTA account, stating that a client's funds may be deposited in an IOLTA account only if such funds, considered without regard to funds of other clients which may be held by the attorney ..., could not reasonably be expected to earn interest for the client or if the interest which might be earned on such funds is not likely to be sufficient to offset the cost of establishing and maintaining the account, service charges, accounting costs and tax reporting costs which would be incurred in attempting to obtain interest on such funds for the client.

Under the mandatory IOLTA program, Texas realized a dramatic increase in IOLTA revenue, with recent earnings of approximately $10 million per year. The TEAJF distributes these funds to various non-profit organizations who apply to the TEAJF for funding.

Procedural History

The plaintiffs' objections to the activities of some of the IOLTA fund recipients, such as those groups providing legal aid to refugees seeking political asylum in the United States and those organizations assisting death row inmates to challenge their death sentences, prompted them to bring this suit. The plaintiffs allege that the IOLTA program constitutes an impermissible taking of property, in violation of the Fifth Amendment of the United States Constitution, and that the program also forces them to support speech that they find offensive, in violation of the First Amendment. The plaintiffs request compensation for the interest proceeds that the Texas IOLTA program earned from their deposit and an injunction against the further application of the Texas IOLTA program.

The defendants moved to dismiss the case for failure to state a claim. Though the district court denied this motion, it granted the defendants' subsequent motion for summary judgment and denied the plaintiffs' summary judgment motion. The district court, finding the logic of the First and Eleventh Circuits "compelling", reasoned that there was no property interest at stake in the interest proceeds earned on funds deposited in IOLTA accounts. Having made this determination, the district court then dismissed the plaintiffs' First and Fifth Amendment arguments. The district court concluded by holding that the TEAJF is entitled to Eleventh Amendment immunity against all of the plaintiffs' claims and that Newton is subject only to the plaintiffs' claims of injunctive and prospective relief. The plaintiffs now appeal the district court's decision.

II.

It has been suggested that the IOLTA program represents a successful, modern-day attempt at alchemy. While legends abound concerning the ancient, self-professed alchemists who worked tirelessly towards their goal of changing ordinary metal into precious gold, modern society generally scoffs at this attempt to create "something from nothing". The defendants in this case denounce such skepticism, declaring that they have unlocked the magic that eluded the alchemists. The alchemists failed because the necessary ingredients for their magic did not exist in historical times: the combination of attorney's client funds and anomalies in modern banking regulations. According to the defendants' theory, the interest proceeds generated by Texas's IOLTA accounts exist solely because of an anomaly in banking regulations and, until the creation of the IOLTA program, that interest belonged to no one. The defendants then contend that Texas used the IOLTA program to stake a legitimate claim to these funds and that the plaintiffs cannot now seek to repossess the fruits of this magic as their own. We, however, view the IOLTA interest proceeds not as the fruit of alchemy, but as the fruit of the clients' principal deposits.

State law defines "property" and the United States Constitution protects private property from government encroachment. Texas observes the traditional rule that "interest follows principal", which recognizes that interest earned on a deposit of principal belongs to the owner of the principal. In the light of this rule, it seems obvious that the interest earned in the IOLTA accounts is the property of the clients whose money is held in those accounts; nevertheless, the district court adopted the theory espoused by the First and Eleventh Circuits, which circumvents this rule. The district court concluded that the plaintiffs cannot "have a [cognizable] property interest in interest proceeds that, but for the IOLTA Program, would have never been generated". This reasoning, though, does not give proper weight to Supreme Court precedent.

In Webb's Fabulous Pharmacies v. Beckwith, the Supreme Court addressed a similar situation. The case arose when the purchase of Webb's Fabulous Pharmacies faltered because, at the closing, the purchaser learned that Webb's had substantial debt that was not previously revealed. The purchaser then filed a complaint of interpleader in Florida state court and tendered the $1.8 million purchase price to the clerk of court. Florida law required the clerk to place the interpleaded funds into an interest-bearing account, to retain the interest earned for the court, and to deduct statutorily-defined fees for maintaining the funds. During the following year while the matter was being resolved, the interpleaded funds earned over $100,000 in interest. The court then appointed a receiver for Webb's, who promptly demanded that the clerk deliver the funds to him. The clerk surrendered the funds, but withheld approximately $10,000 for administrative fees and the $100,000 in interest that had accrued. The creditors then filed suit in state court to recover the interest. Ultimately, the Florida Supreme Court ruled against the creditors, holding that there was no unconstitutional taking because money deposited with the clerk was public money, interest earned on public money was not private property, and the statute only took that which it created. This decision prompted the creditors to appeal to the United States Supreme Court.

The Supreme Court began by noting that the principal deposited with the clerk clearly constituted private property under Florida law. The Court then determined that because the principal was "held only for the ultimate benefit of Webb's creditors, not for the benefit of the court" and eventually would be distributed to them, state law gave the creditors a property interest proportional to their share of the principal.

Having decided the ownership of the principal, the Court turned to the interest on the principal, "the fruit of the fund's use" Reaching the opposite conclusion from that of the Florida Supreme Court, the Webb's Court held that simply because the state ordered the placement of interpleaded funds into an interest-bearing account does not mean that the state can assert ownership of that interest. Recognizing that "[t]he usual and general rule [under Florida law] is that any interest on an interpleaded and deposited fund follows the principal and is to be allocated to those who are ultimately to be the owners of that principal", the Court ruled that "earnings of a fund are incidents of ownership of the fund itself and are property just as the fund itself is property". The Court then concluded that the Florida law perpetrated an unconstitutional taking of the interest, which is the property of the creditors who own the principal.

After Webb's, numerous state courts debated the constitutionality of IOLTA programs. With the exception of the Indiana Supreme Court, these courts agreed that Webb's was inapposite because of the difference in size between the deposit in Webb's and the funds eligible for deposit in IOLTA accounts.

In 1987, the Eleventh Circuit considered the IOLTA issue in a suit challenging Florida's version of the IOLTA program. The Eleventh Circuit distinguished Webb's on the basis that Webb's involved the ownership of over $100,000 in accrued interest, an amount that clearly exceeded any fees that were assessed. In contrast, the Florida IOLTA program only concerned deposits that were so small or short-term that the administrative costs of maintaining an interest-bearing NOW account for that deposit would exceed any interest earned. Relying on this factual distinction, the Eleventh Circuit concluded that Florida's IOLTA program does not commit an unconstitutional taking, reasoning that the owner of principal has no legitimate expectation of earning interest on money deposited into a Florida IOLTA account because "the use of [the client's] money had no net value, therefore there could be no property interest for the state to appropriate". According to the Eleventh Circuit, the use of the money had no net value because the IOLTA program only takes the interest from those deposits that do not produce interest in excess of the administrative expenses incurred.

Although the Eleventh Circuit explicitly says otherwise, inherent in its Cone analysis is the notion that the value of the alleged property involved determines whether there is a cognizable property interest. Under Cone, " 'property' is [erroneously] redefined as an interest that must necessarily benefit its owner". The Webb's decision, however, creates a rule that is independent of the amount or value of interest at issue, holding that a property interest existed in the accrued interest simply because "[t]he earnings of a fund are incidents of ownership of the fund itself and are property just as the fund itself is property". We see no reason why this rule does not apply to the instant case.

The Cone court also failed to consider the precise events of the transaction, concluding that the only protectable property interest in interest proceeds attaches to the amount of interest that remains after a bank deducts its charges from the interest earned, because the owner of the principal only has a legitimate expectation of receiving those interest proceeds. It appears, however, that a bank pays interest on the account and then deducts fees. It is a two-part process. As a result, a property interest attaches the moment that the interest accrues, from which the bank then deducts its charges from the depositor's account. Furthermore, the Webb's Court noted that Florida was under no obligation to place the interpleaded funds into an interest-bearing account, but once it did so, then any interest earned belongs to the depositor. The same rule applies to IOLTA accounts. Ethical rules historically demanded that attorneys hold their clients' funds in trust accounts, choosing the type of account in accordance with the best interests of the client. If attorneys still had this latitude, clients could not complain that a taking occurred when the attorney placed their funds in a non-interest bearing account, because until the interest accrues, the clients have no cognizable property right in the interest. The Texas IOLTA program, however, requires attorneys to place certain client funds into an IOLTA account and then takes the interest that accrues for itself. In such a case, the plain rule is that the interest proceeds, once they have accrued, belong to The Cone Court was correct to note that the value of the property involved does not effect the determination of whether a property interest exists; indeed, the Supreme Court rejected this position in Loretto v. Teleprompter Manhattan CATV Corp., in which the Court held that "constitutional protection for the rights of private property cannot be made to depend on the size of the area permanently occupied." the owner of the principal.

The defendants additionally argue that finding a property interest in the IOLTA interest overlooks the fact that, for practical banking reasons, the interest earned in trust accounts could never accrue to the clients. This argument ignores one of the critical driving forces of IOLTA: IOLTA programs became possible only with the announcement of Internal Revenue Service ruling 81-209. In this ruling, the I.R.S. agreed that clients would not be taxed on the interest earned on their deposits in IOLTA accounts provided that they had no choice but to participate in the program. By the terms of this ruling, if clients have any control over the interest generated from their nominal and short-term deposits into IOLTA accounts, then the interest generated is taxable income. To prevent this situation, Texas gave itself an IOLTA monopoly, reserving all the IOLTA interest proceeds for itself and requiring all of its attorneys to participate in the program. If private charities were to establish private IOLTA programs and clients could choose the program to which their funds went, then clients suddenly would have taxable income. Applying the defendants' arguments to such a scenario, the IOLTA funds would be too minimal to return to the clients, therefore falling outside of the Cone definition of property, yet clients still would have to pay income tax on the interest earned, interest which Cone would say was not their property. This situation flies in the face of reason.

We are also hesitant to declare that such interest is not property lest we incite a new gold rush, encouraging government agencies to dissect banking regulations to discover other anomalies that lead to "unclaimed" interest. One possible source is the interest earned by banks during the float time of checks. Consider a customer who deposits a check drawn on a payor bank with a depositary bank. "In a simple case, where the Federal Reserve Bank is the only intermediary, the depositary bank will present that check to the Fed and receive a [provisional] credit in its reserve account." The Fed then presents the check to the payor bank, whose account is debited and the payor bank must send notice of dishonor within the defined period or be liable for the amount. Typically, this process takes one to two days, during which time the depositary bank has a provisional credit from the Federal Reserve in the amount of the check. Until recently, depositary banks were not required to pay interest to their customers during the time between the deposit of funds and the payor banks' deadline to send the notice of dishonor, effectively giving the depositary banks an interest-free loan on the deposited funds during that time because the depositary banks could treat the provisional credit like cash reserves. This interest-free loan appears very similar to the one that the Texas Supreme Court sought to exploit with the IOLTA program and the interest earned on some checking accounts conceivably could fall below any benefits received, creating an IOLTA-like situation. While depositary banks now must pay interest on deposits from the time that they receive provisional credit from the Fed, credit unions are exempt from this requirement and still receive the benefit of these "interest-free loans".

This is only one example of another "anomaly" in the banking industry and we cannot believe that such anomalies each create funds that belong to nobody. The traditional rule that interest follows principal must apply because that rule compensates the owners of the principal for the use of their funds. If a bank customer chooses, however, to allow the bank to profit in this manner, that decision does not give the state carte blanche to claim that property as its own. As technology continues to advance, the speed with which such transactions can occur will continue to increase, providing greater opportunities for states to try to collect the fractions of pennies that could be earned as interest during the float time of all these activities. Indeed, the faster the funds move, the more and more difficult it will be for individuals to make a practical claim to such funds. Nevertheless, the rule remains the same: any interest that accrues belongs to the owner of the principal, unless they agree otherwise.

III.

The district court's decision on the merits is wholly premised on the notion that clients do not have a valid property interest in the interest proceeds earned on funds in IOLTA accounts. Having rejected this premise, we vacate the district court's award of summary judgment to the defendants and denial of summary judgment to the plaintiffs. We remand this case for reconsideration in the light of the principles explained in this decision and for further factual development of the record, such as the clarification of the types of account pooling permitted by the TEAJF rules.

With respect to the merits of the plaintiffs' claims, we note that to prevail on their taking claim, the plaintiffs must demonstrate that the taking was against the will of the property owner. That or a similar showing would also likely be necessary to prevail on their First Amendment claim. We express no opinion as to whether such a showing has been, or can be, made in the context of this case. We leave these and such other issues as may surface to be addressed in the first instance by the district court on remand.

IV.

Finally, the district court also granted the defendants' request for immunity under the Eleventh Amendment with respect to the plaintiffs' claim for monetary restitution. The parties now only dispute whether the district court erred by declaring the defendants immune to the plaintiffs' restitution claim. The parties do not seriously challenge this portion of the district court's ruling; the defendants concede that they are subject to the plaintiffs' prospective injunction claims and the plaintiffs admit that their "principal concern all along has been in obtaining prospective injunctive relief". We suggest another reason for the parties' lackadaisical approach to this part of the decision: they realize that the district court is correct.

The Eleventh Amendment shields states and their agencies from suits in federal court without the states' consent. Initially, we note that the Texas Supreme Court is entitled to Eleventh Amendment immunity. This immunity extends to the TEAJF because the Texas Supreme Court created the TEAJF pursuant to its rule-making authority and the TEAJF acts on behalf of the Texas Supreme Court to carry out its role, which the Texas Supreme Court defined. Similarly, defendant Newton is entitled to immunity because he is being sued in his official capacity as chairman of the TEAJF, and therefore is also a state actor. The immunity that applies, as held by the district court, is limited and protects the defendants only from the plaintiffs' claims for reimbursement because the Eleventh Amendment does not protect the state from federal suits seeking injunctive relief. Accordingly, we hold that the district court did not err on this issue.

V.

For the foregoing reasons, we find that the district court erred by holding that the clients do not have a cognizable property interest in the interest proceeds that are earned on their deposit in IOLTA accounts. We VACATE the district court's award of summary judgment for the defendants and denial of summary judgment for the plaintiffs and REMAND for further consideration. Finally, we AFFIRM the limited immunity that the district court granted to the defendants.

96-871 STATE OIL CO. V. KHAN

Ruling below (CA 7, 93 F.3d 1358, 65 LW 2142):

Contract requiring retailer to rebate to wholesaler any profits derived from setting retail price higher than wholesaler's suggested price is maximum price fixing that is per se illegal under Section 1 of Sherman Act; district court abused its discretion when it excluded retailer's expert evidence, which was study by qualified economist of same retail operation over five-month period during which it was operated by receiver, without claiming that study's methodology failed to satisfy professional norms; in absence of any evidence by wholesaler, inference from retailer's study that retailer had been hurt by maximum price provision was sufficiently plausible to defeat summary judgment for wholesaler on issue of injury.

Questions presented: (1) Did court below err in holding that gasoline dealer, who was limited to margin of 3.25 cents per gallon, was entitled to recover damages under Section 4 of Clayton Act, for losses he claimed from his inability to increase his profit by increasing his price to consumers? (2) Did court below err in holding that agreement between supplier, who was also landlord of property on which business was conducted, and dealer, under which dealer's margin or markup was limited was per se violation of Sherman Act?

COURT TO JUDGE PRICE-FIXING ARRANGEMENTS

The Associated Press

Tuesday, February 18, 1997

Richard Carelli

WASHINGTON (AP) - The Supreme Court said Tuesday it will decide whether wholesalers always violate federal antitrust law by limiting the prices retailers can charge consumers for a product.

The justices said they will hear the appeal of an oil company being sued by an Illinois gas station owner who wants to charge more per gallon than the oil company will allow.

Barkat Khan runs a DuPage County service station where he sells gasoline and related products supplied by State Oil Co. A contract between Khan and State Oil bars him from pricing the gasoline, sold under the name Union '76, at more than a suggested retail price.

State Oil, which owns the station and the land it's on, sells the gasoline to Khan at 3.25 cents a gallon under the suggested retail price.

Their contract requires Khan to rebate all profits he realizes from raising the price without State Oil's permission above the suggested retail price, which changes from time to time.

Khan sued State Oil, contending that the contractual arrangement amounted to illegal price fixing - a violation of a key antitrust law, the Sherman Act.

A federal trial judge threw out Khan's lawsuit but the 7th U.S. Circuit Court of Appeals reinstated it in August.

The appeals court relied heavily on a 1968 Supreme Court decision in which the justices ruled that a newspaper publisher violated federal antitrust law when it fixed a ceiling at which its distributors could resell the newspaper to the public.

The high court said then that such price fixing was illegal automatically, or "per se."

In the appeal acted on Tuesday, lawyers for State Oil urged the justices to reconsider the 1968 ruling.

The appeal argued that a "rule of reason" rather than a "per se" rule should be used in judging whether such arrangements are anti-competitive and illegal.

The case is State Oil Co. vs. Khan, 96-871.

COURT TO CONSIDER RESALE PRICING CEILINGS, FLOORS

THE HIGH COURT COULD OVERTURN 'PER SE' LAW AGAINST MAXIMUM RESALE PRICE MAINTENANCE.

The National Law Journal

Monday, March 31, 1997

Richard M. Steuer

RESALE PRICE MAINTENANCE-in which a manufacturer and a dealer agree on the price at which the dealer will resell a product-includes both minimums and maximums. Recently, two matters have focused attention on minimum resale price maintenance, in which the manufacturer sets a floor for resale prices, and maximum resale price maintenance, in which the manufacturer sets a ceiling.

These matters, American Cyanamid and State Oil v. Khan, foretell much about the direction the law will be taking in this area.

On Jan. 30, the Federal Trade Commission entered into a proposed consent agreement with American Cyanamid Co. outlawing rebates that serve to impose minimum resale price maintenance.

American Cyanamid sold agricultural chemicals to dealers at wholesale prices that were exactly the same as the prices it recommended to the dealers as suggested retail prices. If the dealer resold the products at or above the suggested retail prices, it qualified for a substantial rebate which, in effect, became its profit margin. If, on the other hand, the dealer resold at less than the suggested retail price, it necessarily lost money on the sale and was disqualified from receiving the rebate.

The FTC charged that this amounted to an agreement to fix resale prices-the agreement being embodied in the rebate contract and the price-fixing inherent in the fact that the rebate was an offer the dealer really could not refuse. American Cyanamid, which already had abandoned this program, decided to settle rather than litigate. The proposed consent agreement would prohibit American Cyanamid from conditioning any rebate or other incentive on the price at which a dealer resells or offers to resell its goods.

This matter presents a good example of how "law" is being made in this area today without traditional case law. Commissioner Roscoe B. Starek III dissented from the commission's decision to accept the consent agreement on the ground that evidence of a dealer's conformity to a suggested resale price is insufficient to establish an agreement to charge that price, and therefore, that the challenged practice should not be treated as illegal per se. This prompted three commissioners-Chairman Robert Pitofsky and commissioners Janet D. Steiger and Christine A. Varney-to issue a responsive statement describing the basis of their decision to accept the consent agreement. Because this matter was concluded with a consent agreement, there were no hearing, no findings of fact and no administrative law judge decision.

Commissioner Mary L. Azcuenaga filed a separate statement urging the commission to include its commentary in the consent order itself or not at all.

The majority relied on the 7th U.S. Circuit Court of Appeals decision in Khan v. State Oil Co. for the proposition that, if a manufacturer enters into an agreement confiscating all of a dealer's profit margin in the event that the dealer departs from suggested resale prices, such an arrangement amounts to a resale price maintenance agreement and is illegal per se.

Khan involved maximum resale price maintenance, while American Cyanamid involved minimum resale price maintenance, but the commission concluded that the same principle apply. As described below, the U.S. Supreme Court subsequently granted certiorari in Khan.

The majority rejected Commissioner Starek's contention that there had been no agreement, emphasizing that "American Cyanamid entered into written agreements which offered financial incentives for adherence to a minimum price schedule."

Practical Effect

The practical effect of this proceeding is to reaffirm that although a manufacturer still may refuse to continue dealing with discounters under the Colgate doctrine, it may not take the easier path of continuing to deal with discounters while trying to discipline them with some lesser punishment.

In this respect, American Cyanamid is consistent with recent government resale price maintenance cases against such companies as New Balance, Reebok, Keds and Playmobil, all of which also ended in consent decrees.

American Cyanamid extends that line of cases to rebate forfeiture in particular, chipping away further at the Colgate defense. It is interesting to note that Chairman Pitofsky led an unsuccessful effort to overturn Colgate completely in the 1980s, when he served a term as an FTC commissioner.

The bottom line is this: Suggested resale prices are not "suggested" when accompanied by an agreement under which the dealers cannot deviate from those prices without forfeiting their entire profit. The proposed consent order has been placed on the public record and is subject to a 60-day public comment period before it can become final.

Certiorari in the 'Khan' Case

On Feb. 18, the Supreme Court granted certiorari in State Oil Co. v. Khan, which involves resale price ceilings. The outcome is likely to be the overturn of the per se rule against maximum resale price maintenance and, just possibly-though much less likely-the end of the per se rule against all resale price maintenance.

In Khan, a petroleum supplier sold gasoline to a dealer at a wholesale price determined by subtracting 3.25 cents from the suggested retail price that the supplier set. Theoretically, the dealer was free to resell the gasoline at any price it chose, but if it sold at a price higher than the suggested retail price, it was required to rebate the excess to the supplier. Because the dealer's volume presumably would decrease at the higher price (assuming the validity of the laws of supply and demand) and the dealer would not be allowed to keep the increased margin per gallon anyway, it would make no sense to exceed the suggested retail price.

The 7th Circuit, in an opinion written by Judge Richard A. Posner, determined that the supplier had, in effect, engaged in maximum resale price maintenance, a practice that had been declared per se unlawful by the Supreme Court in Albrecht v. Herald Co.

Judge Posner did not stop there, however. Calling Albrecht "wobbly" and "moth-eaten" at its foundations, he wrote that the decision "was unsound when decided, and is inconsistent with later decisions by the Supreme Court. It should be overruled. Someday, we expect, it will be."

In all likelihood, that day is coming soon because, as Judge Posner pointed out, Albrecht is inconsistent with the spirit, if not the letter, of the Supreme Court's later decision in Atlantic Richfield Co. v. USA Petroleum Co. This case held that a competitor of a dealer that is subject to a price ceiling stands to suffer no antitrust injury as a result of having to compete against the lower prices that the ceiling imposes on the market.

But Judge Posner was not through. He seized the occasion to point out that, although the Supreme Court reconfirmed the per se rule against minimum resale rice maintenance as recently as 1988, in Business Electronics Corp. v. Sharp Electronics Corp., in his view, that position is "not one that is easy to defend in terms of economic theory or antitrust policy."

As Judge Posner put it, under modern economic theory, "resale price maintenance does not impair any interest that the antitrust laws...could be thought intended to protect." He added, "The Court must think that preventing intrabrand price competition harms an interest protected by the antitrust laws even if the restriction increases competition...and even if a restriction that had similar effects but was not an explicit regulation of price would be lawful."

Those "fightin' words" are as close to a formal invitation as the Supreme Court is likely to get to overrule the per se rule against all resale price maintenance. If the court accepts the invitation, it may use Khan as an opportunity to revisit the entire law of resale price maintenance, both maximum and minimum, but the betting is against it.

Justice Breyer's Dilemma?

Two last points about Khan: Although most maximum resale price maintenance cases decided after Albrecht found some way to distinguish that case, the most prominent reaffirmation of Albrecht came in a 1st Circuit opinion written by then-Judge (now Justice) Stephen G. Breyer, Caribe BMW Inc. v. Bayerische Motoren Werke Aktiengesellschaft. It will be interesting to see whether Justice Breyer adheres to the same position or attributes it to stare decisis and takes a fresh look at the issue. It would not be inconsistent for him to reaffirm Caribe's recognition of the anti-competitive effects of maximum resale price maintenance but conclude that these effects more appropriately should be dealt with under the rule of reason.

The other point about Khan is that, because it provided the foundation for the FTC's opinion in American Cyanamid-at least with respect to the definition of "agreement"-the Supreme Court's resolution of Khan could have an impact on the precedential value of that opinion.

Khan promises to be a notable decision no matter how it turns out. If the Supreme Court does nothing more than overturn the per se rule against maximum resale price maintenance, the result will be to permit manufacturers to cap the resale prices that their dealers may charge, and this will have important implications for many companies across America. If the court goes further, the decision could be a certifiable bombshell.

The lesson to be drawn from these developments is that manufacturers desiring to influence resale prices soon may be able to install ceilings but should not expect to put in floors. This will afford manufacturers the ability to prevent price gouging by their dealers, but not to prohibit discounting. The results should be in by the end of the year.

Mr. Steuer is a partner and co-chair of the antitrust group at New York's Kaye, Scholer, Fierman, Hays & Handler L.L.P. and the author of a book and numerous articles on antitrust topics.

Barkat U. Khan and KHAN & Associates, Inc. Plaintiffs-Appellants

v.

STATE OIL COMPANY, Defendant-Appellee

United States Court of Appeals, Seventh Circuit

93 F.3d 1358

Decided Aug. 29, 1996

. . POSNER, Chief Judge.

The plaintiffs operated a gas station in DuPage County, Illinois, under a contract with State Oil Company, a distributor of gasoline and related products. The contract provided for the lease of the station (which State Oil owned), and the supply of gasoline and ancillary products for resale, to Khan. Mr. Khan was the actual signatory of the contract, rather than his corporation, which operated the station, so it does not appear that he is complaining about a merely derivative injury to himself, in which event he would not be a proper party.

State Oil terminated the contract because Khan failed to pay the agreed-upon rent for the station. The termination precipitated this suit, which, so far as relevant to the appeal, charges price fixing in violation of section 1 of the Sherman Act, and breach of contract under the common law of Illinois. The district judge granted summary judgment for the defendant on both claims. He ruled that the legality under the Sherman Act of the alleged price fixing was to be tested by the rule of reason rather than by the per se rule, that the plaintiff had presented no evidence on essential elements of a rule of reason case (such as market power), that the study conducted by the plaintiffs' economic expert was inadmissible, and that without the study the plaintiffs could not even prove injury.

The contract between State Oil and Khan provided that State Oil would establish a suggested retail price for the gasoline (which was sold under the brand name "Union 76") and would sell the gasoline to Khan for 3.25 cents less than that price. If Khan believed the price was too high he could ask State Oil to lower it and if State Oil complied Khan would be entitled to purchase the gasoline from State Oil at the same margin, that is, at the new price minus 3.25 cents. If State Oil refused to reduce the suggested retail price Khan could still charge a lower price, but his margin would be smaller because he would not be getting a lower price from State Oil. If Khan believed the suggested retail price was too low he could ask State Oil to raise it, thus preserving his margin; but if State Oil refused and Khan went ahead and raised his price anyway, the contract required Khan to rebate the difference between his new price and the suggested price times the number of gallons sold at the new price. The contract thus required Khan to rebate the entire profit from raising his price without his supplier's permission above the retail price suggested by the supplier.

The provision concerning the charging by Khan of a price below the suggested retail price neither is price fixing nor is germane to the price-fixing charge. A supplier is under no obligation to lower his price to his customer just because the customer wants to resell the supplier's product for less than the supplier has suggested without sacrificing any of his profit margin. The contract in this case merely disclaims any such unusual obligation, and since the obligation has no basis in antitrust law the disclaimer has no antitrust significance either.

State Oil also denies that the provision in the contract pertaining to Khan's charging a price above the suggested retail price is a form of price fixing. It points out that Khan was free to charge as high a price as he wishes. This is true in the sense that it would not have been a breach of contract for Khan to raise his price. But the contract made it worthless for him to do so; and, realistically, this was just an alternative sanction to termination, and probably an equally effective one. Generally when a seller raises his price, his volume falls; and if his profit on each unit sold is frozen, the effect of his raising his price will be that he loses revenue: he will sell fewer units, at the same profit per unit. The contract, incidentally, required Khan to buy all his gasoline from State Oil so he could not merely switch to another brand if he wanted to charge a higher price.

Practices that have the same effect are not always treated the same in law. More precisely, two practices that have one effect in common may differ in their other effects. A merger between competitors and a price-fixing agreement between competitors has the same effect in extinguishing price competition between the parties, but the merger is more likely to produce offsetting cost savings and it is therefore treated more leniently by the antitrust laws. So the fact that State Oil's rebate scheme was as effective in deterring Khan from raising his price as a threat to terminate his lease would have been does not dictate that the two practices be treated identically under the antitrust laws. But State Oil has not identified any other relevant difference between the two methods of preventing a dealer from charging more than the suggested retail price. The purely formal character of the distinction that it urges can be seen by imagining that the contract had forbidden Khan to exceed the suggested retail price and had provided that if he violated the prohibition the sanction would be for him to remit any resulting profit to State Oil. There is no practical difference between that form of words and permitting Khan to sell at a higher price but providing that if he does so the profit belongs to State Oil.

So State Oil engaged in maximum price fixing; the next question is whether this practice is illegal per se, meaning that all the plaintiff need prove to prevail is that the defendant engaged in the practice; investigation of its actual economic effects is pretermitted. Challenged practices that do not fall within any of the per se categories are subject to the broader-ranging inquiry into effect and motives that goes by the name of the "rule of reason" and that requires the plaintiff to prove that the defendant's conduct actually (or with a high likelihood) reduced competition. Price fixing has long been illegal per se. In its usual and most pernicious form, the term refers to an agreement or conspiracy between competing firms to fix a minimum price for their product. By a modest extension it refers also to an agreement between competitors to fix either a minimum or a maximum price for the resale of their product by their dealers. Why might competitors fix a minimum resale price? In order to make it more difficult for any of them to engage in undetected violations of their agreement to fix their own (that is, the wholesale) prices; a supplier who observed that he was losing sales because his competitor's dealers were selling the competitor's product at a low price would know that the competitor was failing to enforce the price-fixing agreement. Why might competitors fix a maximum resale price? The difference between what a supplier charges his dealer and what the dealer charges the ultimate customer is, functionally, compensation to the dealer for performing the resale service; so by agreeing on the resale prices of their goods competing sellers can reduce their dealers' margin below the competitive price for the dealers' service. This is a form of monopsony pricing, which is analytically the same as monopoly or cartel pricing and so treated by the law.

The questionable next step in the evolution of antitrust law was to affix the per se label to contracts in which a single supplier, not acting in concert with any of its competitors, fixed its dealers' retail prices. Here the economic difference between fixing a minimum resale price and fixing a maximum resale price becomes more pronounced. A supplier acting unilaterally might fix a minimum resale price in order to induce his dealers to furnish valuable point-of-sale services (trained salesmen, clean restrooms-- whatever) to customers, which they could not afford to do without a guaranteed margin to cover the costs of the services, because the customers would use the services provided by the full-service dealers but then purchase the product from a competing dealer who could sell the product at a discount because he had not borne the expense of providing the services.

As for maximum resale price fixing, unless the supplier is a monopsonist he cannot squeeze his dealers' margins below a competitive level; the attempt to do so would just drive the dealers into the arms of a competing supplier. A supplier might, however, fix a maximum resale price in order to prevent his dealers from exploiting a monopoly position. We do not know anything about the competitive environment in which Khan and State Oil operate--which is why the district judge was right to conclude that if the rule of reason is applicable, Khan loses. But suppose that State Oil, perhaps to encourage the dealer services that we mentioned, has spaced its dealers sufficiently far apart to limit competition among them (or even given each of them an exclusive territory); and suppose further that Union 76 is a sufficiently distinctive and popular brand to give the dealers in it at least a modicum of monopoly power. Then State Oil might want to place a ceiling on the dealers' resale prices in order to prevent them from exploiting that monopoly power fully. It would do this not out of disinterested malice, but in its commercial self-interest. The higher the price at which gasoline is resold, the smaller the volume sold, and so the lower the profit to the supplier if the higher profit per gallon at the higher price is being snared by the dealer.

Despite these points, the Supreme Court has thus far refused to reexamine the cases in which it has held that resale price fixing is illegal per se regardless of the competitive position of the price fixer or whether the price fixed is a floor or a ceiling. The key precedent so far as the present case is concerned is Albrecht v. Herald Company, a damages suit like this where the Court held over a vigorous dissent that the action of a newspaper publisher in fixing a ceiling at which its distributors could resell the newspaper to the public was illegal per se. State Oil seeks to distinguish Albrecht by pointing out that the initiative for the newspaper to take action against the plaintiff distributor had come from another distributor, giving the scheme a "horizontal" flavor. True, but this was not a factor on which the Court relied. It stated its holding broadly: maximum price fixing is illegal per se even if entirely "vertical," that is, even if the only parties in the picture are a single supplier and a single dealer, as in this case. The Court explicitly rejected the view that "contracts between a single supplier and his many dealers to fix maximum resale prices would not violate the Sherman Act." The only use the Court made of the involvement of the other distributor was to show that it was not a case in which the supplier, had merely cut off a dealer for failing to adhere to a suggested price. It is not cricket to distinguish a precedent by pointing to a fact mentioned by the court in the previous opinion but clearly given no weight by it. Otherwise no precedents would have any force, for no two cases are exactly alike.

State Oil points out that a supplier has the right to suggest a retail price and terminate a dealer who does not adhere to it. True, but irrelevant. In such a case there is no agreement between the parties and so no basis for invoking section 1 of the Sherman Act, which is limited to contracts, combinations, and conspiracies, all of which involve an element of agreement. There was an explicit agreement that Khan could not make money if he sold above the suggested retail price. Had he raised its price above that level, State Oil would have had a contractual right to a rebate.

State Oil's main argument is that Albrecht is no longer the view of the Supreme Court. State Oil relies on a line of cases decided after Albrecht in which the Court established the concept of "antitrust injury." There is no right to maintain a suit under the antitrust laws unless the defendant's conduct has impaired the kind of interest that the antitrust laws were intended to protect. And there is no such interest in the maintenance of a monopoly price. If typically and here a resale price ceiling imposed by a seller merely prevents his dealers from reaping monopoly profits, the injury to the dealers from the ceiling--the loss, that is, of monopoly profits--will not support an antitrust suit. The requirement of proving antitrust injury is not waived in per se cases. In Atlantic Richfield Co. v. USA Petroleum Co., the Supreme Court held that a competitor of dealers prevented by their suppliers from raising their prices could not complain that the restriction was preventing him from raising his own prices.

We have considerable sympathy with the argument that Albrecht is inconsistent with the cases that establish the requirement of proving antitrust injury. In fact, we think the argument is right and that it may well portend the doom of Albrecht. In Jack Walters & Sons Corp. v. Morton Building, Inc., we said we regarded the continued validity of Albrecht as an open question, albeit for a different reason: that after Albrecht the Supreme Court had (reversing its previous position) recognized that exclusive dealer territories may be procompetitive. As we pointed out earlier in this opinion, and as one of the dissenting opinions in Albrecht had pointed out as well, a price ceiling is a natural and procompetitive incident to a scheme of territorial exclusivity. The majority opinion in Albrecht had rejected this argument on the ground that price fixing cannot be "justified because it blunts the pernicious consequences of another distribution practice," namely exclusive territories. We now know that the consequences of that other practice are not pernicious.

Yet despite all its infirmities, its increasingly wobbly, moth-eaten foundations, Albrecht has not been expressly overruled. And the Supreme Court has told the lower federal courts, in increasingly emphatic, even strident, terms, not to anticipate an overruling of a decision by the Court; we are to leave the overruling to the Court itself. Albrecht was unsound when decided, and is inconsistent with later decisions by the Supreme Court. It should be overruled. Someday, we expect, it will be.

But all this is an aside. We have been told by our judicial superiors not to read the sibylline leaves of the U.S. Reports for prophetic clues to overruling. It is not our place to overrule Albrecht; and Albrecht cannot fairly be distinguished from this case.

It might be distinguishable if there were a class of cases in which maximum price fixing, though wholly vertical, wholly unilateral, did cause antitrust injury, even if Albrecht and the present case were not members of that class. Then, while Albrecht itself might be decided differently today, its principle that such price fixing is illegal per se would have some domain of application. In that event affirmance here would construe Albrecht narrowly but not abrogate it. But State Oil is not able to identify any cases, real or hypothetical, in which the practice condemned in Albrecht could cause an injury to the interests protected by antitrust law. If proof of antitrust injury is required in cases involving the sort of price fixing involved in Albrecht, no such case could be brought, whether by a private plaintiff or by the Department of Justice or the Federal Trade Commission.

More to the point, the Supreme Court's conception of antitrust injury may be broader than State Oil's. The Court has never retreated from the proposition that vertical minimum price fixing (resale price maintenance) is illegal per se. Yet, under the dealer-service theory that we sketched, and other theories that have the support of antitrust economists, resale price maintenance does not impair any interest that the antitrust laws interpreted in light of modern economics could be thought intended to protect. It increases rather than reduces competition--as the Court recognized in the Sylvania decision, dealing with the closely related area of territorial and other nonprice restrictions placed by suppliers on competition among their dealers. Yet Sylvania itself reaffirms the per se rule against vertical price restrictions. The Court must think that preventing intrabrand price competition harms an interest protected by the antitrust laws even if the restriction increases competition viewed as a process for maximizing consumer welfare and even if a restriction that had similar effects but was not an explicit regulation of price would be lawful. If this is what the Court believes--and it does appear to be the Court's current position, though not one that is easy to defend in terms of economic theory or antitrust policy--the Court may also think that interfering with the freedom of a dealer to raise prices may cause antitrust injury. We suspect not, but we cannot have sufficient confidence in our view to declare a decision of the Supreme Court that has not been expressly overruled nevertheless defunct, as we would have to do in order to agree with the district court's ruling that the maximum price provision in the contract between State Oil and Khan was not illegal per se. In Atlantic Richfield, despite the Court's evident skepticism about the continued soundness of Albrecht, the Court distinguished it on the ground that the dealers subject to a price ceiling imposed by their supplier, as distinct from their competitors, were the intended beneficiaries of Albrecht. The implication is that the injury to a dealer like Khan from not being able to raise his price because of a restriction imposed by his supplier is antitrust injury.

But even if Khan, as we believe, is not ruled out of court by the concept of antitrust injury, he had to prove injury in fact to be able to maintain the suit. The only evidence of injury was in the report of his economic expert, so if the judge did not abuse his discretion in excluding the report we must affirm the dismissal of the antitrust count even though we think he was wrong to think that Albrecht made it impossible for Khan to prove antitrust injury. But we think it was an abuse of discretion.

The judge's ground for the exclusion was that "the report turns entirely on the experience of one receiver who operated one gas station over a five-month period." Before Khan was terminated, State Oil issued a notice of termination and, on the ground that Khan was selling inventory in which State Oil retained a security interest without reimbursing State Oil, obtained from a state court an order appointing a receiver to operate the station. He did so for five months. The plaintiffs' expert obtained the receiver's financial records and determined from the cost and revenue figures in them that the receiver must have disregarded the price ceiling in the agreement with State Oil. The figures showed that the receiver had realized a margin on his sales of gasoline in excess of 3.25 cents. The only way he could have done this was by charging a price in excess of the suggested retail price and not rebating the higher margin generated by the higher price. The expert inferred that had Khan been allowed to raise his price above the suggested retail price, he would have had a higher income, enabling him to pay his rent and therefore avert termination.

Of course competitive conditions may have changed during the time the receiver was operating the station. A dealer's ability to raise his price depends on the demand for his product; the demand for gasoline in general, or for Union 76 relative to other brands, may have increased after the receiver took over. If so, his ability to maintain a price higher than the suggested retail price would not prove that Khan had had a similar ability. And if Khan could not have maintained a price above the suggested retail price, simply because competition would not have permitted him to do so, then he wasn't hurt by the contractual provision of which he complains. There would be a violation of the antitrust laws, but no injury.

But this is just to say that the evidence presented by the expert was not conclusive on the subject of injury--was, indeed, very far from being conclusive. That did not make it either inadmissible or devoid of probative value. The inference regarding the receiver's profit margin, drawn from the station's cost and revenue data, was straightforward, and, so far as appears, was made in just the way that an economist interested in a firm's profit margins for reasons unrelated to litigation would make it; and likewise the inference that if Khan had enjoyed the freedom that the receiver evidently thought he had he would have charged a higher price, and made more money, than he did.

The antitrust claim should not have been dismissed. We turn to the breach of contract claim. Although Khan's primary complaint is that he was prevented from raising his price, he also complains that there were times when he wanted to lower his price on nonpremium gasoline. As we said at the outset, this claim has no standing as an antitrust claim. But State Oil concedes that its contract implicitly obligated it to suggest retail prices that were realistic in light of competitive conditions facing Khan. The only evidence Khan presented concerning those competitive conditions was evidence that on sixteen occasions during his operation of the station he had called other dealers and been told that their retail prices were lower than the suggested retail prices fixed by State Oil. This evidence falls far short of establishing a genuine issue of material fact concerning a breach of the contract. There is no evidence that the dealers were actual competitors of Khan or that the prices charged by those dealers were prices for the same grades of gasoline sold by Khan, which, remember, sold a gasoline that has a well-recognized brand name. The evidence is perfectly consistent with an assumption that State Oil's suggested retail prices were competitively realistic.

So the contract claim was rightly dismissed as a matter of contract law, but we note the absence from the record of any indication of why the district judge, having dismissed the federal claims before trial, retained rather than, as is the norm in such situations, relinquished jurisdiction over the supplemental state law claim. The presumption in favor of relinquishment when all federal claims fall out before trial is rebuttable, but it should not be lightly abandoned, as it is based on a legitimate and substantial concern with minimizing federal intrusion into areas of purely state law. Since the absence of merit of the supplemental claim in this case is clear as a matter of elementary contractual interpretation, so that the retention of jurisdiction for purposes of dismissing the claim did not require the district judge to speculate about the meaning of state law, we think the judge was right to retain jurisdiction rather than visit upon the parties and the state courts the burden of further litigation. As we said in Brazinski, citing a slew of earlier cases, if the correct disposition of the supplemental claim is so clear as a matter of state law that it can be determined without a trial and without entanglement in difficult issues of state law, considerations of judicial economy counsel retention and prompt decision, rather than remission to the state court. But we remind the district courts of the presumption against retaining jurisdiction of supplemental state-law claims when the federal claims are dismissed before trial, and of the concomitant importance of stating the ground on which the court believes in a particular case that the presumption has been rebutted.

The judgment of the district court is affirmed in part and reversed in part, as explained in the opinion, and the case is remanded for further proceedings consistent with the opinion.

AFFIRMED IN PART, REVERSED IN PART AND REMANDED.

RIPPLE, Circuit Judge, concurring: [OMITTED]

96-847 AT&T FAMILY FEDERAL CREDIT UNION V. FIRST NATIONAL BANK AND TRUST CO.

First ruling below (First National Bank and Trust Co. v. National Credit Union Administration, CA DC, 988 F.2d 1272, 61 LW 2597):

Banks have competitive interest in ensuring that credit unions comply with federal regulatory limits and thus have standing to sue to prevent violations of Federal Credit Union Act requirement that credit union membership be confined to groups having common bond of occupation or association.

Second ruling below (First National Bank and Trust Co. v. National Credit Union Administration, CA DC, 90 F.3d 525, 65 LW 2106): Federal Credit Union Act's limitation of credit union membership to "groups having a common bond of occupation" does not permit National Credit Union Administration's interpretation allowing credit union members to be drawn from multiple unrelated groups, each with its own common bond.

Questions presented: (1) Did court below err in conferring prudential standing under its "suitable challenger" test on banks to challenge NCUA's interpretation of FCUA, after acknowledging that interests Congress intended to protect in statute were antithetical to interests of banks, contrary to Fourth Circuit's holding that banks did not have such standing because they were not within "zone of interest" Congress intended to protect? (2) Did court below err in invalidating NCUA's 1982 interpretation of FCUA's "common bond" provision, which permits federal credit unions to consist of multiple unrelated employer groups?

96-843 NATIONAL CREDIT UNION ADMINISTRATION V. FIRST NATIONAL BANK & TRUST CO.

Ruling below (CA DC, 90 F.3d 525, 65 LW 2106):

Federal Credit Union Act's limitation of credit union membership to "groups having a common bond of occupation" does not permit National Credit Union Administration's interpretation allowing credit union members to be drawn from multiple unrelated groups, each with its own common bond; district court's dismissal of suit challenging NCUA interpretation brought by several banks was reversed in earlier ruling on ground that banks' "interests are sufficiently congruent with those of the intended beneficiaries that [they] are not more likely to frustrate than to further the statutory objectives," 988 F.2d at 1275.

Questions presented: (1) Do banks, which court of appeals found not to be among intended beneficiaries of FCUA, nonetheless fall within "zone of interests" of FCUA to have standing to challenge interpretation by NCUA of FCUA's common bond requirement? (2) Has NCUA permissibly interpreted common bond provision to permit membership in federal credit union to consist of multiple groups, so long as each group has its own common bond?

HIGH COURT WILL HEAR CHALLENGE TO CREDIT UNIONS

The Washington Post

Tuesday, February 25, 1997

Joan Biskupic

In a case of great interest to consumers and to the credit unions and banks that hold their money, the Supreme Court agreed yesterday to decide who may join federally chartered credit unions.

Credit unions, which are tax-exempt cooperatives and subject to less regulation than banks, typically offer customers lower fees and better interest rates. And while their membership traditionally encompassed limited groups of people in a workplace or in a community, federal regulators in 1982 allowed them to branch out, diversify their membership and include groups from different employers.

Recent lower court rulings have, however, put new restrictions on credit union membership. The federal government, in urging the high court to take the case, told the justices that the limits "threaten the survival" of the nearly 3,600 credit unions serving 32 million people across the country.

The justices will hear the closely watched case — which will affect the financial services available to millions of workers and the viability of credit unions as a business — in the fall. A decision is likely by the summer of 1998.

In the aftermath of the Great Depression, Congress passed the Federal Credit Union Act in 1934 to help make money available for loans to people of limited means. The act limited membership in a federal credit union to "groups having a common bond of occupation or association or to groups within a well-defined neighborhood, community, or rural district."

In 1982, the National Credit Union Administration, responding to massive company downsizing and a changing financial picture for company credit unions, adopted a policy permitting the establishment of credit unions consisting of "multiple occupational groups."The NCUA construed the statutory phrase "groups having a common bond of occupation or association," to allow more than one group to join together in a single federal credit union as long as a "common bond of occupation or association" existed for all the members of each group.

That enabled weaker credit unions to be merged into healthier ones. But as credit unions came to encompass dozens of unrelated companies, banks felt greater competition.

The case before the court began when the AT&T Family Federal Credit Union in North Carolina began serving customers not employed by AT&T Corp. Four North Carolina banks and the American Bankers Association sued the NCUA.

A federal district court ruled that the NCUA's interpretation of the law was a reasonable reading of an ambiguous statute. But the U.S. Court of Appeals for the D.C. Circuit reversed that, saying the law requires all occupational credit union members to have an occupational bond and forecloses the possibility of employees from an unaffiliated company from joining another company's credit union.

The full effects of the lower court decisions have been postponed because of the government's pending appeal, and the courts have allowed credit unions to continue signing up members from unrelated companies already being served. However, the unions cannot solicit new companies that have no "common bond."

In its appeal, the NCUA asserts that its interpretation of the statute is valid and says that the lower court should have deferred to its view. The federal government also challenged banks' legal standing to sue over the credit union regulation.

Bank lawyers assert that if the NCUA's interpretation is allowed to stand, anyone who has a job with any employer could join the same credit union. The consolidated cases are National Credit Union Administration vs. First National Bank & Trust Co. and AT&T Family Federal Credit Union vs. First National Bank & Trust Co.

CREDIT UNIONS' MEMBERSHIP QUESTIONED
SUPREME COURT TO HEAR BANKING INDUSTRY LAWSUIT AIMED AT LIMITING ENROLLMENT

The Dallas Morning News

Sunday, July 6, 1997

Richard A. Oppel, Jr, Austin Bureau

Like many small-business owners, Pete Mendoza wants to make life a little easier for his employees. One way, he figures, is affiliating with a credit union so his workers have a cheaper option for banking services.

But he fears that might not be possible much longer because the Supreme Court will hear arguments this fall on a banking industry lawsuit that would sharply limit who can join most credit unions.

It's an alarming prospect for many in small business, says Mr. Mendoza, owner of a Dallas ceramic tile firm."They feel like something would be taken away from them."

After years in the making, an epic fight is coming to a head between the nation's banking industry and the credit unions that serve almost 70 million people. For consumers, the outcome may be the most significant development in the banking industry in years, experts say.

At issue are the rules about who can join most credit unions, which have surged in popularity because they offer cheaper loans and more generous savings account interest rates than banks.

But consumer advocates say the court battle, and action in Congress that could follow, may have even broader implications. It could open up the question of whether millions of people who have joined credit unions since 1982 might have to find somewhere else to bank. And, they say, anything that weakens credit unions could reduce competition against banks and hurt all borrowers.

"This case matters not just to those who may have the opportunity to join a credit union, but also to all consumers served by the for-profit institutions as well," said Stephen Brobeck, executive director of the Consumer Federation of America in Washington, D.C.

Bankers argue that it's unfair for credit unions to be allowed to sign up almost anybody as members - as some do now - but still not have to pay federal taxes. Credit unions and consumer advocates contend that banks, despite being very profitable, are simply trying to hobble scrappy competitors and lessen options for consumers.

After action by a number of states, Congress approved legislation in 1934 to create federally chartered credit unions. It permitted groups of people sharing a"common bond" to form tax-exempt credit unions, pooling their money and borrowing against it on favorable terms. They became fixtures at factories, school districts, military bases and other workplaces that employed many people in similar jobs.

But many credit unions found themselves squeezed in the economic downturn of the early 1980s. As large companies laid off thousands of workers at a time, some saw big portions of their memberships thrown out of work, imperiling their solvency. In 1981 alone, 222 federal credit unions failed.

The next year, the federal agency that regulates most credit unions stepped in with a solution: They could merge their memberships. That would allow, say, a credit union at a military base to sign up employees of certain nearby companies. By 1983, the number of credit union failures had dropped to just 40.

Meanwhile, the rule change also gave them leeway to expand rapidly, allowing the most aggressive to take an ever-growing piece of business away from banks.

Growing presence

In some towns, credit unions now have more than 20 percent of all deposits. Their tax-exempt status allows them to undercut banks on loans and pay out more on savings accounts, banking industry officials say, and they have weakened a number of community banks.

"Dadgummit, it's tough," says Ed Lette, president of Security National Bank in San Antonio, a community bank with $165 million in assets.

Ten years ago, 90 percent of the bank's business was consumer loans. Today it's only 9 percent, mostly because of credit union competition, Mr. Lette says.

Small-business owners ought to be concerned about credit unions' increasing clout, he says, because the fierce competition has driven weaker banks to merge and will continue to speed industry consolidation. Over time, that means small-business borrowers will have fewer options.

"I'm not saying that we, as a bank, have suffered, but our community has suffered," Mr. Lette says."If they're going to be like banks and have branches all over the place, they should pay income taxes, or they should go back to their 'common bond.' That's all I ask for."

John Heasley, general counsel of the Texas Bankers Association, acknowledges that many banks are currently quite profitable, many at record levels. But, he says,"If you look at trends of encroachment into the auto loan market, bankers can look down the line and see a potential threat to their viability."

Credit union officials contend the banks are simply being greedy, upset that a small portion of their overall business has been taken away.

"We think banks would like to eliminate credit unions as competition," says Kenneth Sorrels, president of Dallas Teachers Credit Union."Credit unions have typically been more consumer-friendly. We don't have stockholders who demand we make as much profit as we possibly can."

Jack Byno, vice president for operations of the American Airlines Employees Federal Credit Union, says bankers' arguments about"fairness" are cover to strip credit unions of whatever they can.

"They just play whatever card is best-received at that point in time," says Mr. Byno, whose credit union is the nation's third largest. He predicts that the banks will push legislation to strip credit unions of federal tax-exempt status"no matter if they win or lose" the membership lawsuit before the Supreme Court.

The case stems from a 1990 lawsuit filed by a group of North Carolina banks, which alleged that the AT&T Family Federal Credit Union was violating federal law. The credit union was created for Ma Bell employees but signed up tens of thousands of other members after the 1982 rule change.

Bank response

Joined by the American Bankers Association, the banks want the high court to forbid credit unions from signing up members outside the credit union's"common bond." For instance, a credit union set up to serve educators could only serve teachers, administrators and other school workers, as well as their families.

Earlier, an appeals court sided with the banks but later allowed credit unions to temporarily continue enrolling members from groups already affiliated with them. New employer groups still can't join federal credit unions, however.

The case could immediately affect about 15 million members of federal credit unions who don't fall under their institutions' original common bond, according to the National Credit Union Administration, the federal agency that regulates the industry.

Experts say the case isn't likely to directly affect thousands of other credit unions organized under state charters. But if the banks succeed in court, credit union officials expect the industry to go after state-chartered credit unions quickly.

"Once something happens with the federal charters, it's only a matter of time before similar lawsuits affect state charters," says Mr. Sorrels of the state-chartered Dallas Teachers Credit Union.

Barring any court action, credit unions expect to continue growing rapidly. In the last decade, membership has jumped to nearly 70 million from 50 million. Total assets have doubled to more than $300 million.

The success isn't hard to figure. Credit unions generally pay higher interest rates on deposits, provide auto and consumer loans at cheaper interest rates, and often have fewer service fees than banks.

According to a study last year by the Consumer Federation of America, consumers could save $8 billion annually by shifting their bank credit card balances to credit union cards with lower interest rates. The study also found that credit unions charge much less for a number of services - an average of $9.10 for a stop-payment order on a check, for example, compared with $14.41 at a bank.

Service offerings

Credit unions have made new inroads using more sophisticated products, such as setting up individual retirement accounts. But they have become particularly competitive on car loans, establishing extensive financing arrangements with networks of dealers.

Matt Doyle, chief executive of Texas First Bank in Galveston, says one of his credit union competitors recently offered car buyers the chance to pick their interest rate by pulling a slip of paper from a fishbowl."The lowest rate may be zero; the highest may be 7 percent]. How are you going to compete with that?" he asks.

Many members say credit unions simply offer better service."You can call up one person you know" to get a loan, says Billy Smith, a researcher at the University of Texas Southwestern Medical Center at Dallas who uses a credit union serving employees at Atlantic Richfield Co., where he used to work."With a bank, you have to talk to six people you've never heard of."

Maximo Lacayo, a maintenance worker in the Dallas Independent School District, says he has had trouble borrowing from banks in the past but is now happy as a member of the Dallas Teachers Credit Union."Banks put too many conditions on lending money."

Not all agree, however. Chuck Pickett, who owns a barber shop in White Settlement, says he tried banking at nearby Omni American Federal Credit Union. It is the former Carswell Air Force Base credit union, which diversified its membership as the base and nearby Lockheed Martin Corp. plant endured thousands of layoffs.

In search of friendlier service, he later switched to a nearby bank. At the credit union,"You'd get the attitude that you're here for us; we're not here for you."

Role of Congress

Few experts believe the fight will stop at the Supreme Court. A decision in the case, which is expected by next spring, might be just the first step in an odyssey that will move to Congress and state courts and legislatures across the nation.

"Regardless of how the Supreme Court decides, this is going to land squarely in the halls of Congress," says Chris Williston, president of the Independent Bankers Association of Texas, which represents community banks.

One bill pending in the House would give federal credit unions unquestioned authority to enroll people from numerous different businesses, industries or other groups. No substantial action is likely until after the Supreme Court ruling, industry officials say.

Although banks have more money, credit unions are a powerful political force because of the size of their membership, support from consumer groups and significant backing among lawmakers.

Anticipating upcoming legislative battles, they have blanketed members with literature. At Dallas Teachers Credit Union, members are offered a brochure with a picture of a noose and the comment nearby that"bankers want to strangle credit unions."

If the Supreme Court sides with the banks, lower courts will have to decide an even pricklier question: Do credit unions simply stop accepting new members who don't qualify? Or should they be forced to disenroll millions of members who have joined in recent years but don't meet the new common bond standard?

Banks would likely push for "some type of grandfathering" for existing members, though that still could force some disenrollments, says Mr. Heasley of the Texas Bankers Association. If banks seek too much, he allows, they"could risk a political backlash."

Dean Borland, vice president for business development at the state-chartered Texins Credit Union, which primarily serves current and former Texas Instruments Inc. employees but has other members, says he doesn't fear widespread disenrollment."I just can't believe Congress would allow that to happen," he says.

If the banks prevail, many federally chartered credit unions also could obtain state charters. That would allow them to seek more favorable treatment from state lawmakers and judges.

But Mr. Brobeck, the consumer advocate, predicts there is too much sentiment in favor of the credit unions to see them severely harmed. "Ultimately, credit unions will prevail because the public will support them," he says.

FIRST NATIONAL BANK AND TRUST COMPANY, et al., Appellants,

v.

NATIONAL CREDIT UNION ADMINISTRATION, et al.

FIRST NATIONAL BANK AND TRUST COMPANY,

et al., Lexington State Bank, Appellants,

v.

NATIONAL CREDIT UNION ADMINISTRATION

988 F.2d 1272

United States Court of Appeals, District of Columbia Circuit

Decided April 2, 1993.

. . . SILBERMAN, Circuit Judge:

Appellants, four North Carolina banks and the American Bankers Association, challenged the National Credit Union Administration's (NCUA) approval of several recent applications by AT & T Family Federal Credit Union (AT & T Family) to expand its membership. According to appellants, the NCUA's decisions violated the requirement of the Federal Credit Union Act (FCUA) that membership in federal credit unions be limited to "groups having a common bond of occupation or association." The banks complain that, by allowing AT & T Family improperly to extend its membership and thereby its number of potential borrowing customers, the NCUA has made the credit union a formidable competitor. The district court applied the "zone of interests" tests for prudential standing and determined that appellants lacked standing to sue. Although we agree with the district court that the appellants were not intended beneficiaries of the FCUA, we think that they are suitable challengers because the statute arguably prohibits the competition of which they complain. This case thus falls within the rationale of Clarke v. Securities Industry Association and Investment Company Institute v. Camp. We reverse and remand to the district court.

I.

Passed in 1934 in the midst of the Great Depression, the FCUA, was designed to improve access to credit for people of "small means. For many working Americans, credit at reasonable rates had essentially disappeared in the years following the stock market crash. Lacking the security necessary to obtain loans from banks, working Americans turned to loan sharks who typically charged usurious interest rates, which was thought to reduce the overall purchasing power of American consumers. Congress saw the solution to this problem in a system of federal credit unions that would provide credit at reasonable rates and thus would help spur economic recovery. To ensure that credit unions fulfilled their purpose of meeting members' credit needs, Congress restricted credit unions' management and business activities. For example, a federal credit union is owned and controlled by its members, and it can make loans only to members or to other credit unions. Congress expected that such measures guaranteeing democratic self-government would infuse the credit union with a spirit of cooperative self-help and ensure that the credit union would remain responsive to its members' needs.

A related provision of the FCUA, the common bond requirement, is at the heart of this case. Section 109 of the Act restricts membership in federal credit unions to "groups having a common bond of occupation or association." For much of the Act's history, the NCUA interpreted this provision to require all members of a credit union to share the same bond. In the 1980s, however, the NCUA issued a series of Interpretive Ruling and Policy Statements (IRPS) construing the statute to allow a number of different groups, each having its own bond, to form a credit union, even though no overall common bond united the different groups. The NCUA's most recent interpretation, made clear that a credit union could comprise a "combination of distinct, definable occupational and/or associational groups."

Appellants challenged several decisions in which the NCUA applied IRPS 89-1 to approve applications by AT & T Family to expand its field of membership. Until recently, AT & T Family's membership consisted primarily of employees of AT & T Technologies, Inc., AT & T Network Systems, and Bell Telephone Labs. In late 1989 and 1990, AT & T Family filed eight applications to extend its membership to include groups of employees from other companies such as the American Tobacco Company, Western Auto Supply Company, and WGHP-TV, to name but a few. In all, the NCUA approved the extension of AT & T Family's membership to 16 new employee groups. Appellants claimed before the agency and in the district court that IRPS 89-1 ignored the statutory language by allowing groups lacking any common bond between them to join together in a credit union. The banks contended that by allowing AT & T Family to expand to 71,000 members in violation of the statute, the NCUA has allowed the credit union, which is exempt from state and federal income taxes, to become a formidable competitor to banks.

The district court granted NCUA's motion to dismiss for lack of standing. The court determined that appellants were not pressing claims "arguably within the zone of interests" protected by the FCUA. Relying on the language of this court's post-Clarke decisions on prudential standing, the district court said that "[t]hose not regulated by an agency have standing only if they are the intended beneficiaries of the specific statute or are nonetheless 'suitable challengers' to the statute because their interests coincide with the interests which Congress did intend to protect."

The banks were not intended beneficiaries of the Act, thought the district court, because "the Act was passed to establish a place for credit unions within the country's financial market, and specifically not to protect the competitive interest of banks." Under applicable precedent, the district court believed that the banks were not suitable challengers either. Because the banks and the credit union competed for the same business, any coincidence in their interests "would be at best fortuitous." The banks, according to the district court, could not rely on the Supreme Court's cases that granted standing to competitors as suitable challengers because, unlike the competitors in those cases, the banks were not suing under an entry-restricting statute.

II.

It should be noted that no one questions appellants' Article III standing; that appellants will suffer competitive or economic injury is not in doubt. The question before us is whether under the FCUA the banks can claim prudential standing as well. In other words, are they pursuing an interest (not just an objective), arguably within the zone of interests Congress intended either to regulate or protect, and, thus, are they among the class of persons entitled to sue to enforce FCUA's restrictions? This "zone of interests" test ensures that standing is granted only to plaintiffs who will not distort congressional objectives. It excludes those plaintiffs whose "interests are so marginally related to or inconsistent with the purposes implicit in the statute that it cannot reasonably be assumed that Congress intended to permit the suit." Because the banks are not regulated by the common bond requirement, we must inquire whether the banks can be thought to have been "protected" by that statutory limitation on the activities of credit unions. Litigants can qualify as "protected" by a statute if they are intended beneficiaries of the legislation or are nevertheless what we have termed suitable challengers; that is, if their interests are sufficiently congruent with those of the intended beneficiaries that the litigants are not "more likely to frustrate than to further the statutory objectives."

Appellants claim that they qualify both as intended beneficiaries and as suitable challengers under the FCUA. We agree with the district court, however, that Congress did not, in 1934, intend to shield banks from competition from credit unions. Indeed, the very notion seems anomalous, because Congress' general purpose was to encourage the proliferation of credit unions, which were expected to provide service to those would-be customers that banks disdained. The common bond requirement, an existing characteristic of state credit unions, was designed, in combination with the restriction that permitted credit unions to loan only to members, to ensure that credit unions would effectively meet members' borrowing needs. It would seem, therefore, that Congress assumed implicitly that a common bond amongst members would ensure both that those making lending decisions would know more about applicants and that borrowers would be more reluctant to default. That is surely why it was thought that credit unions, unlike banks, could "loan on character." The common bond was seen as the cement that united credit union members in a cooperative venture, and was, therefore, thought important to credit unions' continued success.

To be sure, as time passed--as credit unions flourished and competition among consumer lending institutions intensified--bankers began to see the common bond requirement as a desirable limitation on credit union expansion. To that end, in the 1970s bankers, according to appellants, became active in lobbying Congress to urge the maintenance of the common bond requirement. But that fact, assuming it is true, hardly serves to illuminate the intent of the Congress that first enacted the common bond requirement in 1934. And we find no indication that Congress was, at that earlier time, concerned about the competitive position of banks.

There remains, however, the more subtle question, whether banks can be thought suitable challengers to enforce a requirement designed to benefit the members--particularly potential borrowers--of credit unions. Appellants rely on the Supreme Court's reasoning in ICI and Clarke, and it seems to us the parallels between those cases and the present one are striking. In ICI the securities industry challenged a ruling by the Comptroller of the Currency that would have permitted banks to slip the Glass-Steagall leash and enter what was considered a part of the securities business. As the Supreme Court later explained in Clarke, the Glass-Steagall Act, which limited the securities underwriting and investment activities of banks, was designed to protect bank depositors from risky bank activities--not to insulate investment bankers, or indeed, any noncommercial bankers, from competition. Nevertheless, because the investment bankers pursued interests congruent with those of the intended beneficiaries, they were permitted to sue in ICI to enforce Glass-Steagall's restrictions on banks.

A plaintiff who has a competitive interest in confining a regulated industry within certain congressionally imposed limitations may sue to prevent the alleged loosening of those restrictions, even if the plaintiff's interest is not precisely the one that Congress sought to protect. The limitations may be restrictions on entry--geographic or product line--or they might be, as in our case, limitations on growth, which are akin to entry restrictions. Like more classic entry restrictions, the common bond requirement, by limiting a credit union's customer base, effectively prevents the credit union from offering its services and competing in a broader market.

Appellees, sidestepping the entry-restriction cases, rely primarily on our refinement of prudential standing analysis in HWTC IV. In that case, an organization of companies that treated hazardous waste and marketed products derived from processed waste sued to force the EPA to adopt stricter environmental regulations on other companies so as to create a greater market for their own services and products. We held that HWTC's interests were not sufficiently congruent with those of the intended beneficiaries of the statute to make HWTC a suitable challenger.. The treatment firms' interest was in selling more services and equipment to the regulated companies, and therefore the firms would seek regulations that would increase demand for their product regardless of the effects on the statute's intended beneficiaries. We concluded that to have standing under the statute, HWTC would have to have shown a systematic alignment of interests with the statute's beneficiaries.

Our decision did not rest on a conclusion that the economic interests of the treatment firms were somehow less deserving than the environmental interests the statute was designed to foster; nor was it based on a view that the firms' economic incentives were inherently less worthy than the economic objectives of the securities industry plaintiffs in ICI and Clarke. On the contrary, the economic motivations could be thought analogous. If the watchword of the treatment firms in HWTC IV was "treatment is good and more treatment is better," it might be said that the watchword of all competitors with regard to their potential rivals must be "regulation is good and more restrictive regulation is better." And one cannot base standing on one's mere status as an economic beneficiary of government regulation of others.

The distinction between HWTC IV on the one hand and ICI and Clarke on the other must be that in ICI and Clarke the potentially limitless incentives of competitors were channeled by the terms of the statute into suits of a limited nature brought to enforce the statutory demarcation dividing the banking and securities industries. The interests the securities industry plaintiffs sought to protect were thus less open-ended and more confined than were the economic interests pursued in HWTC IV, and as a result there was a reduced danger of distorting congressional purpose.

The securities industry plaintiffs in ICI and Clarke were not seeking to impose new regulations on banks in areas unrelated to an existing, specific statutory norm simply to provide a demand for their services or to weaken banks as competitors. We certainly would not accept as a suitable plaintiff a party who had only a general economic interest in harming a competitor and who, accordingly, sought to impose some new, more onerous regulation upon that competitor. But, when the plaintiff seeks to enforce a statutory restriction on his competitor--a restriction the plaintiff enjoys as well as the statutory beneficiaries--there is a good deal less risk that recognizing the plaintiff's standing will lead to a misdirection of a statutory scheme.

Our reasoning in HWTC suggests that our reaction might be different if the banks appeared before us, not asking to patrol the common bond picket line, but seeking a new regulation that would squeeze the credit unions into a smaller market or even eliminate them from the market altogether. It is unnecessary, however, to extend our holding into a definitive answer to appellants' hypotheticals; we concede that the general issue is devilishly complex. We feel confident, however, that this case is a good deal closer to the paradigm of ICI and Clarke than it is to HWTC, and, therefore, we hold that appellants have standing. The judgment of the district court is reversed and the case remanded.

WALD, Circuit Judge, concurring:[OMITTED]

FIRST NATIONAL BANK AND TRUST COMPANY, et al., Appellants,

v.

NATIONAL CREDIT UNION ADMINISTRATION, Appellee,

AT&T Family Credit Union and Credit Union National Association, Appellees.

90 F.3d 525.

United States Court of Appeals, District of Columbia Circuit

Decided July 30, 1996.

. GINSBURG, Circuit Judge:

Section 109 of the Federal Credit Union Act (FCUA), 12 U.S.C. s 1759, provides that "Federal credit union membership shall be limited to groups having a common bond of occupation or association, or to groups within a well- defined neighborhood, community, or rural district." The question presented in this appeal is whether the members of an occupational FCU must all share a single "common bond of occupation" or, as the National Credit Union Administration (NCUA) contends, membership may be drawn from multiple unrelated groups, each with its own common bond. The district court held that the NCUA reasonably interpreted that Act to allow members of unrelated groups to join the same credit union, provided only that a common bond exists among the members of each constituent group. Because the Congress resolved this very issue the other way, we reverse the district court and disapprove the decision of the NCUA under step one of Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.

I. Background

The plaintiffs-appellants are the American Bankers Association and several North Carolina banks, including First National Bank and Trust Company (FNBT). They brought this suit against the NCUA, the federal regulatory agency that administers the FCUA, seeking to overturn that agency's approval of certain applications filed by AT&T Family Federal Credit Union (ATTF) to expand its field of membership to include employees of various small businesses in North Carolina and Virginia that are unaffiliated with the credit union's existing membership base. ATTF and the Credit Union National Association, a trade association, have intervened in support of the agency. Under the FCUA, an FCU is, like a mutual association or a cooperative, owned and controlled by its members; it can make loans to and take deposits from (formally, sell shares to) only its own members and other credit unions. The Congress expected that the Act, by "guaranteeing democratic self-government[,] would infuse the credit union with a spirit of cooperative self-help and ensure that the credit union would remain responsive to its members' needs."

The "common bond" provision has been part of the FCUA since the statute was enacted in 1934. The Congress did not fully explicate the purpose or limits of that provision, but "assumed implicitly that a common bond amongst members would ensure both that those making lending decisions would know more about applicants and that borrowers would be more reluctant to default.... The common bond was seen as the cement that united credit union members in a cooperative venture."

From 1934 until 1982 the NCUA interpreted the common bond requirement to mean that the members of each occupational FCU--we put aside the associational alternative, which plays no role in this case--must be drawn from a single occupational group, defined to mean the employees of a single employer. In 1982, however, the NCUA altered its interpretation of nearly 50-years' standing to allow an FCU to comprise not just one but "multiple occupational groups." Each such group need only be within a "well-defined area,", by which the NCUA means an area served by an actual or planned office (of which there may be any number) of the credit union.

The 1982 change of interpretation was intended to enable each FCU to realize economies of scale and to facilitate occupational diversification within the ranks of its membership. The new policy also made it possible for the employees of a company with fewer than 500 employees, the minimum for forming a new FCU, to join an existing FCU. The NCUA reiterated its new position through policy statements issued in 1989, when ATTF filed the first of the applications that FNBT here challenges, and most recently in 1994. The agency explained in 1989 that "[a] select group of persons seeking credit union service from an occupational, associational or multiple group Federal credit union must have its own common bond," but "[t]he group's common bond need not be similar to the common bond(s) of the existing Federal credit union."

FNBT's complaint is at bottom that Interpretive Ruling 89-1 violates the FCUA by allowing groups lacking any common bond among them to join together in a credit union, ATTF in particular. Originally chartered in 1952 as the Radio Shops Federal Credit Union, the common bond of ATTF members was that they were "[e]mployees of the Radio Shops of Western Electric Company, Inc., who work in Winston-Salem, Greensboro, and Burlington, North Carolina; employees of this credit union; members of their immediate families; and organizations of such persons." ATTF has since grown to have 112,000 members in more than 150 disparate occupational groups spread across all 50 states, including the employees of a major tobacco company, an auto supply chain, and a television station. Its potential membership exceeds 357,000. As of January 1994 ATTF had more than 63,000 loans outstanding, totaling over $268 million. FNBT maintains that by allowing ATTF to accept members from among the employees of any number of employers, the NCUA has in effect opened the membership to anyone with a job.

Initially, the district court dismissed this case for lack of standing. On appeal, however, we reversed on the ground that the banks are "what we have termed suitable challengers, that is ... their interests are sufficiently congruent with those of the intended beneficiaries that [they] are not more likely to frustrate than to further the statutory objectives." We remanded for a determination on the merits, as to which the district court granted the defendant's motion for summary judgment. . The district court held that the common bond requirement is ambiguous and that the NCUA's interpretation of the provision to mean that "a credit union may have several groups, each with its own common bond" is reasonable.

II. Analysis

We review an agency's interpretation of a statute entrusted to its administration under the familiar rubric of the Chevron case: If the Congress has "directly spoken to the precise question at issue," the court "must give effect to the unambiguously expressed intent of Congress"; if, however, the statute is silent or ambiguous on the question at issue, then the court will defer to the agency's interpretation if it is permissible in light of the structure and purpose of the statute. In resolving the threshold question whether congressional intent is sufficiently clear for us to review the case under step one of Chevron, "we are not required to grant any particular deference to the agency's parsing of statutory language or its interpretation of legislative history." FNBT argues this case under step one of Chevron only. According to FNBT, the intent of the Congress is clearly discernible from the statutory text and the purpose of the statute. We agree.

A. Section 109 by Its Terms

To repeat, s 109 provides in relevant part that "Federal credit union membership shall be limited to groups having a common bond of occupation ... or to groups within a well-defined neighborhood, community, or rural district." FNBT contends, first, that the article "a" in the phrase "groups having a common bond" means that all members of an FCU must be united by a single occupation. The NCUA counters that the plural noun "groups" in the same phrase indicates that there may be multiple groups in an FCU, so that the statute makes sense only if it is understood to contemplate multiple bonds, each uniting a single group even if the same bond does not unite all groups.

Neither syntactical argument is convincing. The article "a" could as easily mean one bond for each group as one bond for all groups in an FCU, and the plural noun "groups" could refer not to multiple groups in a single FCU but to each of the groups that forms a credit union under the FCUA. Indeed, focusing upon "groups" begs the question whether they must share a common bond; it is, after all, a common bond that makes a group of what would otherwise be a collection of individuals without a theme.

Nonetheless, use of the word "groups" in s 109 does support FNBT's interpretation and not the NCUA's. As a leading dictionary of the time put it, a group is an "assemblage ... having some resemblance or common characteristic." By this definition, a common bond is implicit in the term "group." Therefore, if two or more "occupational groups" can be said to have a common bond, it must be because there is a characteristic common to each and every member of the several groups.

Or, viewing the question another way, the term "common bond" would be surplusage if it applied only to the members of each constituent group and not across all groups of members in an FCU. Instead of limiting membership to "groups having a common bond of occupation," the Congress could, without affecting the meaning of the statute, have simply said "occupational groups."

FNBT's second textual argument is that the term "groups" in the two parallel provisions of s 109--permitting credit unions composed either of (1) "groups having a common bond of occupation" among all the members or of (2) "groups within a well-defined neighborhood, community, or rural district"--must be interpreted in a consistent way. If the so-called community provision were construed in a manner consistent with the NCUA's revised interpretation of the occupational provision, then a single FCU could include residents of any number of "well-defined neighborhood[s], communit[ies], or rural district[s]" around the country. Yet this expansive construction has never been advocated by the NCUA; on the contrary, the NCUA regulation implementing the community provision expressly requires that all FCU members live, worship, or work in "a single, geographically well-defined area."

The NCUA answers this argument by noting that the two grammatically parallel provisions of s 109 do not, upon close inspection, use the same terms: "the limitation of geographic groups to those 'within' a defined area," we are told, "clearly supports the NCUA's conclusion that membership in a community credit union may not consist of groups from widely dispersed locales." But the NCUA's point is not at all responsive to FNBT's argument. The question is how "groups" can be given a different meaning in the two parallel phrases: "groups having a common bond of occupation" and "groups within a well-defined [area]." The statute does not allow multiple groups, each within a different neighborhood, to form a single community FCU. Nor therefore can the statute consistently allow multiple groups, each drawn from a different occupation (which the NCUA equates with a different employer), to form an occupational FCU.

In sum, the FCUA requires by its terms that all members of a credit union share a single common bond. Our example of two companies under joint ownership meets that statutory requirement--and does so without including unrelated groups, which would drain the phrase "common bond" of all meaning. The NCUA may identify and approve other types of common bonds, subject only to the rule of reason embedded in Chevron step two. If the statute is to be read as it is written, however, the one thing that the agency may not do is permit unrelated groups to form a single FCU unless a common bond unites all of the members.

B. The Purpose of s 109

First let us dispatch the suggestion . . that the Congress intended the common bond provision to foreclose unfair competition between credit unions, which are tax exempt, and banks, which are not. According to the Alliance, a principal purpose of the common bond is to constrict the market that credit unions can serve, thereby limiting the threat that they pose to banks. We squarely rejected this argument on the first appeal of this case: "Congress did not, in 1934, intend to shield banks from competition from credit unions. Indeed, the very notion seems anomalous, because Congress' general purpose was to encourage the proliferation of credit unions, which were expected to provide service to those would-be customers that banks disdained."

FNBT itself makes a more persuasive argument based upon the purpose of the common bond requirement. The Congress intended that each FCU be a cohesive association in which the members are known by the officers and by each other in order to "ensure both that those making lending decisions would know more about applicants and that borrowers would be more reluctant to default. That is surely why it was thought that credit unions, unlike banks, could 'loan on character.' " There can be little doubt that growth on the scale achieved by ATTF is inconsistent with that purpose.

The NCUA points out that under its regulations a new group is not permitted to join an existing FCU unless the members are within an area that can reasonably be served from an existing or proposed office of the credit union. This administrative policy might initially seem to blunt FNBT's claim that under the NCUA's current interpretation of the common bond requirement an FCU could accept anyone as a member simply because he or she is employed. Upon closer inspection, however, the agency's point is a makeweight. For whatever restraining force the common bond requirement retained after NCUA changed its interpretation of the Act in 1982, it did not impede ATTF's dramatic expansion.

In short, reading s 109 as the 73d Congress wrote it, i.e., to require that a single common bond be shared among all members of an occupational credit union, furthers the overriding purpose of the FCUA--to "unite[ ] credit union members in a cooperative venture." The NCUA's reading, which permits multiple unrelated groups to form an occupational FCU, frustrates that purpose. If this conception of an FCU seems dated in the world of ATMs and nearly nationwide financial institutions of a scale surely unimaginable in 1934, then the case for updating the FCUA must be addressed to the Congress.

C. The Legislative History of s 109

Finally, we look to the legislative history of the FCUA only to determine whether it so convincingly contradicts our interpretation of the text, reinforced by our understanding of the purpose of the statute, as to require that we rethink the matter.

FNBT emphasizes the Report of the Senate Committee on Banking and Currency, which defines a credit union, in part, as "a cooperative society ... limited in each case to the members of a specific group with a common bond of occupation or association." The NCUA and ATTF extract their version of the legislative history from the Report of the House Committee on Banking and Currency, which paraphrases s 109 as providing that "[m]embership in Federal credit unions is limited to groups having common bonds of occupation or association."

The district court itself assigned some weight to "the fact that Congress has not objected to ... the 1982 expansion" of the common bond requirement. In a Chevron step two analysis, where the issue is whether the agency's interpretation of the statute is reasonable, congressional inaction might be minimally enlightening. This is a Chevron step one analysis, however; the silence of a later Congress says nothing about the intent of the earlier Congress that spoke directly to the question here at issue.

III. Conclusion

Based upon the text and the purpose of the FCUA, we conclude under Chevron step one that all the members of an FCU must share a common bond. If there are multiple occupational groups within a single credit union, then it is not sufficient that the members of each different group have a bond common to that group only.

Accordingly, we reverse the judgment of the district court. The case is remanded to that court for the entry of declaratory and injunctive relief, consistent with the foregoing opinion, concerning the NCUA's 1989 and 1990 approvals of certain applications filed by ATTF. So ordered.

96-1400 CALIFORNIA V. DEEP SEA RESEARCH INC.

Ruling below (Deep Sea Research Inc. v. The Brother Jonathan, CA 9, 89 F.3d 680):

Intent of Abandoned Shipwreck Act is to transfer title to states only for shipwrecks that meet ASA's requirements, namely, that shipwreck be abandoned, be located on submerged lands of state, and be either embedded in sea floor or determined eligible for listing in National Register of Historic Places; accordingly, shipwrecks that do not meet requirements of ASA continue to be subject to exclusive admiralty jurisdiction of federal courts, and state law, to extent it gives state title to shipwrecks that do not meet ASA requirements, is preempted; ASA does not vest title to wrecks that satisfy its requirements directly in state but rather provides that federal government may assert title to such wrecks and transfer title to state; accordingly, federal court may adjudicate whether wreck meets ASA requirements without implicating Eleventh Amendment and trial court did not err in requiring state to establish by preponderance of evidence that it had colorable claim to shipwreck that would entitle it to immunity; trial court did not err in holding that wrecked vessel was not abandoned; insurance companies took title to portions of wreck by right of subrogation and under ASA regulations when they paid claims on vessel, evidence included agreements reached by salvager with two insurance companies assigning title to wreck to salvager, and because technology required to salvage vessel has been developed only recently, failure of claimants to come forward does not give rise to inference that they had abandoned title to vessel or personal property on board.

Questions presented: (1) In in rem admiralty action seeking title or salvage rights to shipwreck lying on submerged land of state, is state's successful invocation of Eleventh Amendment immunity dependent upon whether state can first prove to district court by preponderance of evidence that it owns shipwreck? (2) Does ASA "preempt" state title to shipwrecks that are not within coverage of act? (3) Should historic shipwreck be considered not "abandoned," and thus not subject to protections of ASA, solely because insurance company paid claim on portion of ship's cargo?

HIGH COURT TO DECIDE RIGHTS TO SHIPWRECK

Anchorage Daily News

Tuesday, June 10, 1997

Richard Carelli The Associated Press

The Supreme Court on Monday agreed to use the case of a California Gold Rush-era ship that sank 132 years ago to decide how courts --including those in Alaska -- should handle disputes between states and treasure hunters.

The court, granting an appeal by California officials, said it will review rulings that named Deep Sea Research Inc. -- and not the state -- sole owner of the sunken ship with exclusive salvage rights.

A decision is expected in 1998.

California's appeal was supported in friend-of-the-court briefs submitted by 15 other states and a coalition of groups dedicated to protecting historic shipwrecks.

The brief submitted in behalf of the 15 states told the justices that the lower court rulings in the California case "made it infinitely more difficult for the states to manage historic, abandoned vessels on their property."

Those states are Alaska, Alabama, Florida, Georgia, Idaho, Illinois, Louisiana, Maryland, Massachusetts, Michigan, Mississippi, New York, North Carolina, South Carolina and Virginia.

The other friend-of-the-court brief said a 9th U.S. Circuit Court of Appeals ruling in the California case "will return the law of historic shipwrecks to an era of confusion and unnecessary litigation, jeopardizing the ability of the states to protect these valuable historic resources." The justices were told their ruling could affect more than 5,000 such shipwrecks.

The Brother Jonathan, a 220-foot-long, wooden-hulled paddle steamer, sank in 1865 while en route to the Puget Sound from San Francisco. Most of its 250 passengers and crew members drowned. Deep Sea Research, a California-based company, searched for the Brother Jonathan for about 20 years before discovering it below 250 feet of water about 41/2 miles off of Crescent City, Calif.

Deep Sea Research located the two insurance companies that paid the lion's share of the wreck's claims and purchased title to the ship and its contents from them.

Both companies stated in the contracts that they had never abandoned their title to the shipwreck.

When Deep Sea Research sought exclusive salvage rights in federal court, California officials intervened and sought to have the case dismissed.

The state claimed ownership and invoked its 11th Amendment immunity from being sued in federal court without its permission.

After both sides stipulated that the shipwreck is located on state submerged land, a federal trial judge rejected the state's attempt to have the case dismissed.

The judge ruled that the state had failed to prove that the wreck was abandoned, a requirement under a 1987 federal law called the Abandoned Shipwreck Act.

COURT IS ASKED TO THWART TREASURE HUNTERS

The Sacramento Bee

Monday, March 10, 1997

Patrick Hoge Bee Staff Writer

Seeking to block private treasure hunters from salvaging the deadliest shipwreck in California history, the State Lands Commission has petitioned the U.S. Supreme Court for help in getting the vessel declared public property.

The Brother Jonathan, a wooden, side-wheeled steamship that sank in 1865 off the coast of Del Norte County, is a cultural resource that should not be touched without proper archaeological supervision, said Peter Pelkofer, the commission's senior counsel.

"Money's not the issue," said Pelkofer, who hopes to get a response from the Supreme Court this spring and perhaps a hearing next fall.

"We're not in there competing for the loot. We're in there for the ship. The whole idea is that it will become part of the historic culture of the people of the state of California," he said.

Two lower federal courts have found that the state has no say. Under maritime law, a San Diego company called Deep Sea Research Inc. was given sole rights in 1995 to salvage the ship -- which some believe carried large amounts of gold.

Fletcher Alford, a San Francisco attorney representing Deep Sea Research, says the company intends to preserve all artifacts.

"The primary disagreements between us and the state are the monetary issues," said Alford. "The state wants 50 percent off the top, without taking any of the risk."

Pelkofer said no specific financial arrangements have been discussed.

But Pelkofer, a maritime history buff who participates in Internet discussions on archaeology, said he doubts whether much gold was on the 220-foot ship when it struck a rock during a violent storm and went down 4 ½ miles off Crescent City.

The ship had left from San Francisco two days earlier bound for Portland, Ore. Only 16 of the nearly 250 aboard survived.

Deep Sea Research maintains it should not have to get a state permit because the firm bought out an insurance company that, in the 19th century, had paid a claim on some of the sunken cargo, Alford said.

The salvage company has videotaped the largely intact Brother Jonathan, which was located under 250 feet of water in 1993, and has brought some artifacts to the surface.

Deep Sea Research has about 100 private investors and has spent more than $1 million pursuing the Brother Jonathan, said David Flohr, the company's treasurer.

Flohr, a retired Navy pilot, called the state's latest legal salvo "a waste of taxpayers' money.

"The state case, as court documents show, was so poorly prepared and poorly founded that it is not really based on factual information," Flohr said.

To date, the State Lands Commission has had little luck in court, with a federal judge finding that Deep Sea Research had adequate archaeological preservation plans, and that the state had no claim to the ship.

The lands commission appealed, but the 9th U.S. Circuit Court of Appeals upheld the ruling last year.

According to the state's Supreme Court petition, those decisions erode California's 11th Amendment protection against being sued in federal court without the state's consent.

The way Alford sees it, that sort of protection would give the state sole authority to interpret the federal Abandoned Shipwrecks Act regarding ships in state waters.

"That's an argument that I don't think the Supreme Court is going to find particularly appealing," he said.

DEEP SEA RESEARCH, INC., Plaintiff-Appellee,

v.

The BROTHER JONATHAN, her Appurtenances, furniture, cargo, etc., Defendant,

and

State of California; State Lands Commission, Defendants-Intervenors-Appellants,

United States of America, Defendant-Intervenor.

United States Court of Appeals, Ninth Circuit.

89 F.3d 680

Decided July 17, 1996.

. . . D.W. NELSON, Circuit Judge:

Appellee Deep Sea Research ("DSR") brought this in rem admiralty action seeking salvage rights and title to the wreck of the Brother Jonathan, a double paddle wheel steamer that sank in 1865 off the coast of Crescent City, California. After nineteen years of searching, DSR claims to have discovered the Brother Jonathan and has stipulated for the purposes of these proceedings that it is located upon submerged lands of the State of California. The State of California intervened for the limited purpose of asserting that it has a colorable claim of ownership to the wreck and that as a result, the district court is barred by the Eleventh Amendment from adjudicating DSR's claim.

The State argues that it has a colorable claim to ownership under the Abandoned Shipwreck Act of 1987 ("ASA"), the Submerged Lands Act ("SLA") and Cal.Pub.Res.Code s 6313. After an evidentiary hearing, the district court held that the State had failed to establish a colorable claim to ownership and rejected its motion to dismiss the claim. The State appeals.

The United States intervened to defend the constitutionality of the ASA. The Columbus-America Discovery Group has filed an amicus curiae brief in which it argues that this circuit should not adopt the rule of the Fourth Circuit, which requires an express renunciation of ownership in order to establish abandonment.

We affirm.

FACTUAL AND PROCEDURAL BACKGROUND

DSR filed this in rem admiralty action in November, 1991, seeking to perfect its title to and salvage rights in the wreck of the Brother Jonathan. At the initiative of DSR, the case was dismissed without prejudice in June 1992, and reopened in February 1994, a few months after DSR actually discovered the wreck. DSR had been searching for the wreck of the Brother Jonathan for almost twenty years. Until DSR discovered the wreck, neither the State nor anyone else knew its location, and the State had not made any attempt to locate the wreck. DSR asserts title to the wreck as the assignee of the subrogation rights of two insurance companies that paid claims on the cargo of the Brother Jonathan. However, according to newspaper accounts published at the time of the disaster, about two thirds of the cargo on board was uninsured. Neither is there any evidence that the ship itself was insured.

The State intervened and moved to dismiss, arguing that the wreck belonged to the State under both the ASA and Cal.Pub.Res.Code s 6313. It asserted that even though the State was not named in the complaint, the suit was, in reality, against the State and therefore barred by the Eleventh Amendment. The State also argued that because the wreck met the requirements of the ASA, the district court lacked subject matter jurisdiction over DSR's claim.

Under the ASA, the federal government asserts title to certain historic wrecks and transfers it to the states on whose submerged lands the wrecks are found. A shipwreck meets the requirements of the ASA if it is 1) abandoned; 2) located on a state's submerged lands; and 3) either embedded in the sea floor or determined eligible for listing in the National Register of Historic Places ("National Register").

In cases involving wrecks that fall under the ASA, the traditional admiralty law of salvage and finds does not apply. Instead, these wrecks are governed by the provisions of the ASA. As a result, the fate of these vessels may be determined in state or federal court. However, the statute makes clear that the "laws of the United States relating to shipwrecks" shall continue to apply to all other wrecks. Thus, the federal courts retain exclusive admiralty jurisdiction over cases involving wrecks that do not meet the requirements of the ASA.

Section 6313 of the California Public Resources Code is broader than the ASA, because under that provision California asserts title to all abandoned shipwrecks on state-owned submerged lands. Under the SLA, the state owns all submerged lands within three miles of the mean high tide.

The district court held two evidentiary hearings on the State's motion to dismiss. The first hearing was devoted to the issue of whether the Brother Jonathan was located on state submerged lands. DSR subsequently stipulated that it was. At the second hearing, the parties addressed the issues of abandonment, embeddedness and the historical significance of the wreck.

The district court denied the State's motion to dismiss, holding that the State had not established a colorable claim to the wreck of the Brother Jonathan under the ASA. The court reasoned, based on ITSI TV Productions, Inc. v. Agricultural Ass'ns, that a party asserting sovereign immunity must prove by a preponderance of the evidence that the privilege applies. The court determined that the State did not establish by a preponderance of the evidence that the wreck of the Brother Jonathan was abandoned, embedded or eligible for listing in the National Register. It further held that the ASA preempts Cal.Pub.Res.Code s 6313 to the extent that s 6313 asserts title to shipwrecks that are beyond the scope of the ASA. Because it held that the ASA did not apply to the Brother Jonathan, the court did not reach DSR's challenge to the constitutionality of the ASA.

The State appeals, arguing that it need not demonstrate by a preponderance of the evidence that the wreck of the Brother Jonathan meets the requirements of the ASA in order to make a colorable claim of ownership and qualify for Eleventh Amendment immunity. It asserts that under Marx v. Government of Guam, it has demonstrated all that is necessary to make a colorable claim to the Brother Jonathan. It also asserts that the district court erroneously held that the ASA preempts Cal.Pub.Res.Code s 6313. Finally, the State challenges the district court's exclusion of the audio portion of a video tape that suggests that the Brother Jonathan is, in fact, embedded in the ocean floor.

STANDARD OF REVIEW

The district court's determination that the State was required to demonstrate by a preponderance of the evidence that it had a colorable claim to the Brother Jonathan in order to qualify for Eleventh Amendment immunity is a legal question, which we review de novo. Twenty-Three Nineteen Creekside, Inc. v. Commissioner. Similarly, we review de novo the district court's holding that the ASA preempts Cal.Pub.Res.Code s 6313. We review for clear error the district court's factual determination that the Brother Jonathan does not meet the requirements of the ASA. Finally, the district court's exclusion as hearsay of the audio portion of the video tape that may suggest the Brother Jonathan is embedded is reviewed for abuse of discretion.

ANALYSIS

I. Preemption of Cal.Pub.Res.Code s 6313 by the ASA

The State challenges the district court's holding that the ASA preempts Cal.Pub.Res.Code s 6313 insofar as s 6313 asserts title to shipwrecks that are not covered by the ASA. This provision grants the state title to all abandoned shipwrecks located on its submerged lands that are more than fifty years old or of special historical significance. According to the State, the district court erroneously construed s 7 of the ASA as explicitly preempting the California provision. Section 7 provides that the Act "shall not change the laws of the United States relating to shipwrecks other than those to which this chapter applies." The State argues that because state law is incorporated into federal maritime law, s 7 of the ASA does not preempt Cal.Pub.Res.Code s 6313. The State's argument is incorrect.

Federal law can preempt a state statute either by explicit language in the statute or when the intent of Congress to preempt state action is "implicit from a pervasive scheme of federal regulation that leaves no room for state and local supplementation." Federal law also may preempt state law when there is an actual conflict between state and federal law. Section 7 of the ASA makes clear that Congress intended to transfer title to the states only for shipwrecks that meet the requirements of the ASA. All other shipwrecks continue to be subject to the exclusive admiralty jurisdiction of the federal courts, as provided by Article III, section 2 of the United States Constitution. Cal.Pub.Res.Code s 6313 takes title to shipwrecks that do not meet the requirements of the ASA and which are therefore within the exclusive admiralty jurisdiction of the federal courts. Thus, the district court correctly held that s 6313 is preempted to the extent that it gives the State title to shipwrecks that do not meet the requirements of the ASA.

II. The State's Entitlement to Eleventh Amendment Immunity

The State argues on appeal that the district court erred in holding that the State did not have a colorable claim to the Brother Jonathan and therefore was not entitled to immunity under the Eleventh Amendment. First, the State contends, the district court should not have required it to demonstrate by a preponderance of the evidence that it met the criteria of the ASA in order to make a colorable claim to the Brother Jonathan. Rather, it argues, this case is governed by Marx v. Government of Guam. In that case, the 9th Circuit held that the government of Guam had made a colorable claim to an abandoned shipwreck by demonstrating that the shipwreck in question was on state submerged lands and that one of Guam's statutes asserted ownership to shipwrecks located on state submerged lands. According to the State, in order to make a colorable claim in this case, it need only assert that the Brother Jonathan is on its submerged lands and that Cal.Pub.Res.Code s 6313 vests title in the State to abandoned shipwrecks on its submerged lands.

The State also challenges the district court's holding that the Brother Jonathan was not abandoned or embedded, arguing that it has a colorable claim to the shipwreck under the ASA as well. In addition to arguing that the State presented adequate evidence of both abandonment and embeddedness, the State contends that the district court applied the wrong test with respect to abandonment. The State argues that the district court erroneously required that abandonment be shown by an affirmative act on the part of the original owner demonstrating intent to renounce ownership.

A. Requirements for Making a Colorable Claim to the Brother Jonathan

The State argues that the Eleventh Amendment limits the showing required to make a colorable claim to ownership of an abandoned shipwreck. It reasons that "[i]f a state has to prove the merits of its ownership claim in order to establish its Eleventh Amendment immunity, then it has no Eleventh Amendment immunity." Thus, in cases involving a state's assertion of ownership of wrecks on its submerged lands, the State asserts, it is inappropriate to adopt the rule of ITSI TV, which requires that the State demonstrate by a preponderance of the evidence that it is entitled to immunity. Rather, citing Marx v. Government of Guam, the State asserts that it should be required to demonstrate only that the shipwreck is on state submerged lands and that there is a state statute giving it title to shipwrecks on its submerged lands. The State's argument is without merit.

In Marx v. Government of Guam, Guam claimed two shipwrecks located on its submerged lands and argued that sovereign immunity precluded the exercise of federal jurisdiction over the wrecks in an in rem admiralty action. The court expressly did not base its decision on the ASA because that case was initiated prior to that statute's adoption and the Act specifically exempts such proceedings. Rather, its decision was based on Guam's Underwater Historic Property Act, which conveyed to Guam broad title and control over property located on its submerged lands. The court rejected the argument that adoption of the ASA indicated that the previously enacted Guam statute was invalid, finding that in adopting the ASA Congress "merely wanted to clarify the effect of the Submerged Lands Act and did not intend to express an opinion about preexisting law." On the basis of the Guam statute and the Submerged Lands Act, the court found that Guam had a "colorable claim" to the wrecks and dismissed the case on the basis of Guam's sovereign immunity.

The State of California asserts that the facts in this case are virtually identical to those in Marx v. Government of Guam because the Brother Jonathan is located on California's submerged lands and Cal.Pub.Res.Code s 6313 asserts title to abandoned shipwrecks on state submerged lands. Thus, it argues, it has made an adequate showing to establish a colorable claim to the Brother Jonathan and this case should be dismissed on the basis of sovereign immunity.

However, the State's argument fails to take into account the impact of the adoption of the ASA on the requirements for making a colorable claim to a wreck. In adopting the ASA, Congress preempted state laws which purported to take title to all shipwrecks on their submerged lands, at least to the extent that such laws took title to shipwrecks that did not meet the requirements of the ASA. Thus, while the Government of Guam was able to make a colorable claim under its broad statute, it follows that a more extensive showing is required in this case, in which the ASA applies, to make a colorable claim to the Brother Jonathan.

Furthermore, a federal court has both the power and duty to determine whether a case falls within its subject matter jurisdiction. Therefore, it was appropriate for the district court to require the State to present evidence that the ASA applied to the Brother Jonathan, i.e., that it was abandoned and either embedded or eligible for listing in the National Register, before dismissing the case. Otherwise, as DSR points out, the State could receive immunity simply by asserting that it was entitled to it. For a federal court to renounce jurisdiction over an admiralty case on the basis of a mere assertion of entitlement to immunity on the part of the State is inconsistent with the court's duty to assess whether it has jurisdiction.

The State also argues that the district court erroneously relied on ITSI TV in imposing on the State the burden of proving by a preponderance of the evidence that the ASA applies to the Brother Jonathan. In ITSI TV, this court addressed the question, "who bears the burden of persuasion when a putative state entity claims immunity from suit in federal court under the Eleventh Amendment?" There, a television production company sued California State Fair and Exposition and various district agricultural associations for copyright infringement. The defendants moved to dismiss on the ground that they were arms of the State and therefore were immune from suit under the Eleventh Amendment. They further argued that because Eleventh Amendment immunity is a jurisdictional bar, the burden is on the plaintiffs to establish that the defendants are not entitled to such immunity.

The court rejected the defendants' argument, holding instead that "Eleventh Amendment immunity, whatever its jurisdictional attributes, should be treated as an affirmative defense," which "must be proved by the party that asserts it and would benefit from its acceptance." In reaching this conclusion, the court drew on the law governing the Foreign Sovereign Immunity Act ("FSIA"), and the Federal Tort Claims Act ("FTCA"). Both acts place the burden on the defendant to prove that it is entitled to immunity, and the former explicitly requires that the defendant demonstrate its entitlement to immunity by a preponderance of the evidence. The court in ITSI TV also points out that Eleventh Amendment immunity is most likely to be the subject of dispute when a "complex institutional arrangement makes it unclear whether a given entity ought to be treated as an arm of the State." Because the details of these institutional arrangements are "peculiarly within the knowledge of the party claiming immunity," considerations of fairness support placing the burden of proof on the party claiming to be a state entity. Id. (internal quotations omitted).

The State argues that this case is distinguishable from ITSI TV because it does not concern the defendant's status as a state entity. Rather, to determine whether or not the State was entitled to immunity, the district court in this case evaluated the strength of the State's claim to title of the Brother Jonathan under the ASA and Cal.Pub.Res.Code s 6313. As a result, the district court required the State to prove by a preponderance of the evidence that the shipwreck was abandoned and that it was embedded in the ocean floor or eligible for listing in the National Register. The State argues that facts relating to these questions, in contrast to the one at issue in ITSI, are not "peculiarly within the knowledge of the party claiming immunity," but instead, within the knowledge of DSR. Therefore, the State argues, the burden should be on DSR rather than the State to demonstrate that the State does not have a colorable claim to the Brother Jonathan.

While the State is correct that the factual question in ITSI TV differs from the one at issue in this case, it does not follow that the burden should be on the plaintiff to establish that the State is immune under the Eleventh Amendment. In ITSI TV, the court draws analogies to both the FSIA and the FTCA. In doing so, it makes no distinction between cases involving the defendant's status as an agent of the State and cases in which a party's entitlement to immunity turns on other issues. Further, the State of California cites no authority for the proposition that such a distinction should be made. We find that, according to the reasoning of the court in ITSI TV, the party asserting immunity has the burden to establish that it is entitled to immunity even if the determination of that issue touches the merits of the claim.

Finally, in addressing the questions of abandonment, embeddedness, and historical significance of the wreck under the ASA, a federal court does not adjudicate the state's rights. The ASA does not vest title to wrecks that satisfy its requirements directly in the state. Rather, it provides that the federal government may assert title to such wrecks. Only after the federal government takes title to the abandoned shipwreck may title then be transferred to the state. Thus, a federal court may adjudicate the question of whether a wreck meets the requirements of the ASA without implicating the Eleventh Amendment. Therefore, we hold that the district court did not err in requiring the State to prove by a preponderance of the evidence that it was entitled to Eleventh Amendment immunity.

B. Validity of District Court's Factual Determination that the Brother Jonathan Was Not Abandoned

The State challenges the district court's holding that the Brother Jonathan is abandoned. It argues that the district court erroneously required the State to demonstrate affirmative intent on the part of the owner to abandon. Instead, the State asserts, the district court should have found that the State made a colorable claim to abandonment because the original owner of the ship is long gone and the wreck has lain undisturbed on the bottom of the ocean for 130 years. Further, the State argues, even if the insurers of the Brother Jonathan did not abandon title, at least a portion of the wreck is abandoned because only part of the cargo was insured and the vessel itself was not insured.

1. Test for abandonment

The ASA does not define the term "abandonment." Thus, Congress presumably intended that courts apply the definition of abandonment that has evolved under maritime law. Traditionally, maritime law has found abandonment when title to a vessel has been affirmatively renounced, or when circumstances give rise to an inference that the vessel has been abandoned; courts have found abandonment, for instance, when a vessel is "so long lost that time can be presumed to have eroded any realistic claim of original title."

The Fourth Circuit in Columbus-America reversed the district court's finding that even though a number of insurance companies had paid claims on a wreck in 1857, the insurance companies had abandoned their title to the wreck. The district court inferred abandonment by the insurance companies on the basis of its finding that the insurance companies had made no efforts to find the wreck and had destroyed any documentation they once had concerning the case. In holding that abandonment could only be found on the basis of an express renunciation of ownership, the Fourth Circuit introduced a significant modification into maritime law. The State of California argues that the district court erred by adopting the Fourth Circuit's rule in this case, rather than relying on the traditional approach to abandonment which allows abandonment to be inferred on the basis of circumstantial evidence.

Although the district court in this case cites the Fourth Circuit's decision in Columbus-America, its holding that the Brother Jonathan is not abandoned rests on the traditional rule that a wreck is not abandoned unless either 1) title is affirmatively renounced or 2) abandonment can be inferred from the lapse of time or failure to pursue salvage efforts on the part of the owners. Thus, the State's argument that the district court applied the wrong test lacks merit.

Further, the district court's failure to infer abandonment from the evidence presented by the State was not clearly erroneous. DSR presented a newspaper article dating from the time of the wreck listing a number of insurance companies that insured the cargo of the Brother Jonathan. These insurance companies took title to at least part of the wreck by right of subrogation and under the ASA regulations when they paid claims on the Brother Jonathan. DSR also presented evidence of agreements it reached with two of the insurance companies assigning title to the wreck to DSR. Finally, DSR presented undisputed evidence that the technology required to salvage the Brother Jonathan has been developed only in the last few years, so that successful salvage efforts would have been impossible until very recently. When the technology to conduct salvage operations has been developed recently, failure on the part of an owner to attempt to salvage the wreck does not give rise to an inference that the owner has abandoned title to the vessel.

In response, the State presented a single witness on the issue of abandonment, who had conducted only twenty-two hours of research in the week before the hearing and did not know whether the insurance companies who paid claims on the Brother Jonathan had conducted any salvage efforts. Thus, the State presented the district court with no evidence that the insurance companies intended to abandon the wreck. The district court did not clearly err in finding that the insurance companies did not abandon title.

2. Partial abandonment

The State argues, however, that even if the insurance companies did not abandon title to the Brother Jonathan, they held title to only the part of the cargo for which they paid claims. Thus, the State asserts, the portion of the wreck that was uninsured should be considered abandoned, as there is no one before the court claiming ownership of that part of the wreck. In support of its argument, the State points to the ASA Guidelines, which specify that title passes to an insurer when the insurer has paid the full value of the vessel to the owner. The district court responded by noting that it is "premature for the court to find that any individual items of cargo or personal property have been abandoned," pointing out that when the discovery of the wreck gains publicity, additional claimants are likely to come forward. The court further held that "[t]he State's assertion that any abandoned personal property and uninsured cargo automatically becomes the property of the State is incorrect."

The district court, thus, did not address the issue of whether, under the ASA, when claims were paid on only a fraction of a ship's cargo, an inference of abandonment arises with respect to the uninsured vessel and remaining cargo. This is a question of first impression.

The State would have us divide the wreck into the portion on which claims were paid (which would not be considered abandoned) and the portion that was uninsured (which would be considered abandoned). If we were to adopt this approach, we would have to dismiss the action in federal court with respect to he abandoned part of the wreck and retain jurisdiction over the part on which insurance claims were paid.

We decline to divide the wreck of the Brother Jonathan into abandoned and unabandoned portions for the purposes of the ASA for two reasons. First, if we were to find that the vessel had been partially abandoned, both the federal court and the state court would be adjudicating the fate of the Brother Jonathan. It is unlikely that Congress intended such a confusing and inefficient approach in adopting the ASA.

Second, such an approach is inconsistent with the general rule in maritime law of treating wrecks as a legally unified res. In fact, the Fourth Circuit's decision in Columbus-America appears to be the only admiralty case in which a wreck has not been treated as a unified whole. There, the court held that a number of insurance companies retained title to parts of the wreck and remanded to the district court for a determination of how the wreck would be apportioned among them.

Having concluded that the Brother Jonathan should be treated as a unified res, the question remains, should the wreck be considered abandoned (because the vessel and much of its cargo were not insured) or should the vessel be considered not to have been abandoned (because part of the cargo was insured)? Because the law is reluctant to find abandonment and because a finding of partial abandonment would deprive those holding title to the unabandoned portion of the wreck access to the federal forum, we hold that the Brother Jonathan was not abandoned. We reserve the question of whether there is some point at which the portion of the wreck that is insured becomes so negligible that the wreck might be considered abandoned for the purposes of the ASA.

III. Conclusion

Because we find that the Brother Jonathan was not abandoned and that therefore, it does not fall under the ASA, we need not reach the State's argument that the district court erred in finding that the Brother Jonathan was not embedded. Even if the district court erroneously excluded the audio portion of a tape that suggested that the Brother Jonathan was embedded, the error was harmless. Nor need we address the question of whether we should take judicial notice of evidence that on October 12, 1995, the Brother Jonathan was determined eligible for inclusion in the National Register. Finally, because we find that the ASA does not apply, we do not reach the constitutionality of that statute. We therefore hold that the district court properly denied the state's motion to dismiss on the grounds of Eleventh Amendment immunity.

We AFFIRM.

96-643 STEEL CO. V. CITIZENS FOR A BETTER ENVIRONMENT

Ruling below (CA 7, 90 F.3d 1237, 65 LW 2069, 42 ERC 2057):
Citizen suit provision of 1986 Emergency Planning and Community Right-to-Know Act permits citizens to seek penalties against facility for past failure to report toxic chemical releases within statutory deadline, even if facility cures reporting violations before complaint is filed.
Question presented: In enacting citizen suit provision of EPCRA, 42 USC 11046, did Congress intend to authorize citizens to seek penalties for violations that were cured before citizen suit was filed, thereby granting EPCRA citizen suit plaintiffs greater enforcement authority than that granted to other citizen suit plaintiffs under other federal environmental statutes?

96-1370 FIDELITY FINANCIAL SERVICES INC. V. FINK

Ruling below (CA 8, 102 F.3d 334):
State relation-back law, which permits creditor's lien in automobile that is perfected within 30 days after purchase to be treated as perfected as of date of purchase, is inapplicable to determination under Section 547(c)(3) (B) of Bankruptcy Code of whether security interest is actually perfected within 20 days after transfer and thus not voidable as preferential transfer.
Question presented: Did petitioner's acquisition of purchase money security interest in debtor's automobile constitute preferential transfer that bankruptcy trustee could avoid pursuant to 11 USC 547?

96-1462 LUNDING V. NEW YORK STATE TAX APPEALS TRIBUNAL

Ruling below (NY CtApp, 89 N.Y.2d 283, 675 N.E.2d 816, 653 N.Y.S.2d 62, 65 LW 2452):
Disparity created by New York income tax statute that disallows non-residents full deduction for alimony payments available to residents is offset by statutes that tax residents on all income but non-residents only on income earned in state and, thus, does not violate Privileges and Immunities Clause.
Question presented: Did court below err in holding that New York Tax Law Section 631(b) (6), which discriminates against non-residents of New York who pay New York state income tax by expressly denying them entirely tax deduction for alimony payments that New York residents are allowed fully to take, does not violate Privileges and Immunities Clause (Article IV, Section 2) of U.S. Constitution?

96-1470 QUALITY KING DISTRIBUTORS INC. V. L'ANZA RESEARCH INTERNATIONAL INC.

Ruling below (CA 9, 98 F.3d 1109, 65 LW 2293, 40 USPQ2d 1385):
Prohibition of Section 602 (a) of 1976 Copyright Act against importation, without permission of copyright owner, of U.S. copyrighted goods originally manufactured in United States but acquired outside of United States is not limited by first-sale doctrine embodied in Section 109 (a), which permits owner of copies "lawfully made under this title" to "sell or otherwise dispose" of such copies.
Question presented: May U.S. copyright owner, who itself manufactures, first distributes, and sells to foreign purchaser consumer product with copyrighted label, sue subsequent purchaser of that same product for infringement of its distribution rights under section 602 (a) of Copyright Act--or does first-sale doctrine contained in section 109 (a) bar lawsuit?

96-1613 U.S. V. ESTATE OF ROMANI

Ruling below (Pa SupCt, 688 A.2d 703, 65 LW 2501):
Section 6323 of Internal Revenue Code, which accords lien priority in federal tax lien matters on first-in-time basis, limits absolute priority given federal tax claims by federal insolvency statute, 31 USC 3713, and thus holder of properly entered judgment lien against insolvent decedent's estate has priority over subsequently filed federal tax lien.
Question presented: Is federal tax claim against insolvent estate to 'be paid first' when judgment lien arose before notice of tax lien was filed?