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CASENOTES

BANKING LAW—Bank Holding Company with Attributes of Traditional Branch Banking Does Not Violate State Branching Restrictions. *Grandview Bank & Trust Co. v. Board of Governors of the Federal Reserve System*, 550 F.2d 415 (8th Cir. 1977), *cert. denied*, 98 S. Ct. 64 (1977).

The demand for banking services in the United States has mushroomed since World War II. The emergence of a consumption-oriented society combined with a proliferation of consumer goods has unleashed a multibillion dollar demand for consumer credit.¹ Large scale commercial and industrial development, coupled with inflation, has generated an enormous need for new capital.² At the same time, rapid suburban growth and more frenetic lifestyles have necessitated more convenient banking services. Commercial banks have responded to these needs by establishing branch banks in many states.³ Despite the enlarged lending capacity and increased number of bank locations offered by branch banking, however, a majority of states restrict its use.⁴ Multibank hold-

1. Consumer loans have more than doubled in the last decade alone, from \$76 billion in 1967 to \$199 billion in mid-1977. *BUS. WEEK*, Sept. 19, 1977, at 2.

2. Commercial and industrial loans have jumped from \$64 billion in 1967 to \$124 billion in mid-1977. *Id.*

3. Statewide branching is permitted in the following nineteen states and the District of Columbia: Alaska, Arizona, California, Connecticut, Delaware, Hawaii, Idaho, Maine, Maryland, Nevada, New Jersey, New York, North Carolina, Oregon, Rhode Island, South Carolina, South Dakota, Vermont, and Washington. The total number of bank branches increased from 3,954 in 1945 to 29,795 in 1975. The American Bankers Association, *State Banking Law Service*, 80 (1976). Bankers have also responded to the increased demand for banking services by offering bank credit cards, automatic bank teller windows, customer bank communication terminals, and automatic bill payment services, and by establishing correspondent relationships with other banks.

4. Twelve states do not permit any form of branching: Colorado, Illinois, Kansas, Minnesota, Missouri, Montana, Nebraska, North Dakota, Oklahoma, Texas, West Virginia, and Wyoming. Nineteen states have geographic or other restrictions on branching: Alabama, Arkansas, Florida, Georgia, Indiana, Iowa, Kentucky, Louisiana, Massachusetts, Michigan, Mississippi, New Hampshire, New Mexico, Ohio, Pennsylvania, Tennessee, Utah, Virginia, and Wisconsin. Antibranching laws generally predate the Depression and reflect state concerns that branching would lead to overbanking and ruinous competition, jeopardizing the stability of the banking system. More recent opinions indicate that bank safety considerations weigh in favor of branching. *Federal Branching Policy: Hearings Before the Subcomm. on Financial Institutions of the Senate Comm. on Banking, Housing, & Urban Affairs*, 94th Cong., 2d Sess. 142-43 (1976) (statement of Larry Mote, staff member, Federal Reserve Bank of Chicago) [hereinafter cited as 1976

ing companies⁵ have emerged in these states as alternative vehicles for satisfying banking needs.⁶

While offering services similar to those of branch banks, multibank holding companies escape automatic condemnation under antibranching laws by virtue of the separate corporate existence of each bank within the holding company structure.⁷ As multibank holding companies have intruded into local banking markets, however, independent bankers have invoked antibranching laws to repel the threatened competition. Pointing to symbiotic relationships within the holding company systems, they have claimed that bank holding company operations constitute branch banking by another name. By declining to endorse this argument, the decision in *Grandview Bank & Trust Co. v. Board of Governors of the Federal Reserve System*⁸ stretched the tension between the expansionary activities of bank holding companies and the restraints of antibranching laws to the breaking point.

In March of 1975, Commerce Bancshares, Inc., a Missouri multibank holding company,⁹ sought Federal Reserve Board approval¹⁰ of a proposed acquisition of the Commerce Bank of Grandview, a newly formed national bank. The Grandview Bank & Trust Co., whose monopoly of

Hearings]. Branching makes it easier for bank regulators to save failing banks. Failures which do occur are less costly to the FDIC insurance fund in branching states. *Id.* at 125 (statement of Robert Bartell, President, Federal Home Loan Bank of Chicago).

5. A bank holding company (BHC) is defined under the Bank Holding Company Act, 12 U.S.C. §§ 1841-50 (1970), as "any company which has control over any bank." 12 U.S.C. § 1841(a)(1). "Control" exists when a company directly or indirectly has the power to vote 25% or more of any class of voting securities of a bank, when the company controls in any manner the election of a majority of the directors or trustees of a bank, or when the Federal Reserve Board determines that the company directly or indirectly exercises a controlling influence over the management or policies of a bank. 12 U.S.C. § 1841(a)(2). *See also* 12 C.F.R. § 225.2 (1977).

6. *See 1976 Hearings, supra* note 4, at 293 (statement of Jerome C. Darnell, Assistant Professor of Business Administration, University of Colorado). Bankers have also resorted to merger, chain, and affiliate arrangements to circumvent state branching restrictions. Nevertheless, bank holding companies have been the prevalent means by which bankers have avoided branching restraints. *See Boczar, The Growth of Multibank Holding Companies: 1956-73, summarized in* 62 FED. RES. BULL. 300 (1976). From 1970 through 1974, 60% of all BHC acquisitions of banks were in nonbranching states, 30% were in limited branching states, and less than 10% were in statewide branching states. *1976 Hearings* at 310.

7. *See* note 28 & accompanying text *infra*.

8. 550 F.2d 415 (8th Cir. 1977), *cert. denied*, 98 S. Ct. 64 (1977).

9. Commerce Bancshares controlled 31 other bank affiliates in Missouri. 550 F.2d at 417.

10. Under the Bank Holding Company Act, the Federal Reserve Board must approve all bank holding company formations and acquisitions of affiliate banks. 12 U.S.C. § 1842 (1970).

banking services in Grandview was threatened by the new bank,¹¹ challenged the acquisition on the ground that it would violate Missouri's ban on branch banking.¹² Grandview alleged that Commerce Bancshares operated its banking network in a unitary fashion and that the new bank would be a de facto branch. The Federal Reserve Board rejected the challenge, finding that the acquired bank would be a separate corporation independent of the holding company and its other bank subsidiaries.¹³ The new bank, it concluded, would not be managed as part of a "unitary operation" tantamount to branch banking.

The Board's reasoning failed to win complete endorsement on direct review by the United States Court of Appeals for the Eighth Circuit.¹⁴ The court observed that a commonality of directors and officers within the Bancshares system, its systemwide training program for bank managers, and its advertising claim to be a "family of banks" all suggested a de facto unitary banking operation.¹⁵ Nevertheless, the court upheld the acquisition, relying on the legality of multibank holding companies under the Bank Holding Company Act.¹⁶ Noting congressional awareness of the similarity between multibank holding companies and branch banking, the court asserted that disputes over bank holding company operations are suited for legislative rather than judicial resolution.¹⁷

I. CONFLICTING FEDERAL POLICIES ON BRANCHING

The tension between bank holding companies and state branching laws has its genesis in two federal statutes—the McFadden Act¹⁸ and the Bank

11. Grandview Bank & Trust Co. was the only commercial bank in the city of Grandview, Missouri, and was a potential competitor of the proposed new bank. Brief for Respondent at 5, *Grandview Bank & Trust Co. v. Board of Governors*, 550 F.2d 415 (8th Cir. 1977), *cert. denied*, 98 S. Ct. 64 (1977).

12. MO. REV. STAT. § 362.105.1(1) (1969) provides, in pertinent part, that "no bank or trust company shall maintain in this state a branch bank or trust company, or receive deposits or pay checks except in its own banking house"

13. 62 FED. RES. BULL. 368 (1976), 41 Fed. Reg. 12,093 (1976). The board found that the new bank would have separate reserve requirements, capital stock, and loan limits; that its officers and directors would be generally independent of the holding company; that it would maintain separate account records, issue distinctive checks, and use distinctive stationery; and that money deposited at the acquired bank would remain separate from accounts at Bancshares' other banks. 62 FED. RES. BULL. at 369-70, 41 Fed. Reg. at 12,093-94.

14. Under § 9 of the Bank Holding Company Act, 12 U.S.C. § 1848 (1970), initial review of Federal Reserve Board decisions lies with the courts of appeals.

15. 550 F.2d at 419.

16. 12 U.S.C. §§ 1841-50 (1970).

17. 550 F.2d at 419-20.

18. 12 U.S.C. § 36 (1970) (originally enacted as Act of Feb. 25, 1927, ch. 191, § 7, 44 Stat. 1228).

Holding Company Act.¹⁹ The former has worked to confine bank expansion while the latter has encouraged and facilitated it. Under the McFadden Act, federally chartered banks may operate branches only if state law permits state chartered banks to do so.²⁰ A branch is defined to include "any branch bank, branch office, branch agency, additional office, or any branch place of business located in any State or Territory . . . at which deposits are received, or checks paid, or money lent."²¹ The purpose of the McFadden Act is to insure "competitive equality"²² between state and national banks and thereby nourish a vigorous dual

19. 12 U.S.C. §§ 1841-50 (1970) (originally enacted as Act of May 9, 1956, ch. 240-50, § 2, 70 Stat. 133).

20. The McFadden Act provides, in pertinent part, that

A national banking association may, with the approval of the Comptroller of the Currency, establish and operate new branches: (1) Within the limits of the city, town or village in which said association is situated, if such establishment and operation are at the time expressly authorized to State banks by the law of the State in question; and (2) at any point within the State in which said association is situated, if such establishment and operation are at the same time authorized to State banks by the statute law of the State in question by language specifically granting such authority affirmatively and not merely by implication or recognition, and subject to the restrictions as to location imposed by the law of the State on State banks.

12 U.S.C. § 36(c) (1970).

21. 12 U.S.C. § 36(f) (1970). While federal law provides the definition of a branch, state laws supply the rules and conditions under which branching is permitted. 12 U.S.C. § 36(c) (1970). The deference that must be shown toward state law in determining whether a national bank is engaged in branch banking is unclear. *Compare, e.g.,* Independent Bankers Ass'n of America v. Smith, 534 F.2d 921, 933 (D.C. Cir. 1976) (what constitutes a national bank "branch" is a question of federal law to be determined without resort to state law) *with* Nebraskans for Independent Banking v. Omaha Nat'l Bank, 530 F.2d 755, 760 (8th Cir. 1976), *vacated and remanded on other grounds*, 426 U.S. 310 (1976) (in determining whether a national banking facility is a branch, prime consideration must be given to state law). The Supreme Court has looked to the purpose of the statute—fostering competitive equality—in deciding whether a given activity by a national bank is permissible under the McFadden Act. *First Nat'l Bank in Plant City v. Dickinson*, 396 U.S. 122 (1969); *First Nat'l Bank of Logan v. Walker Bank & Trust Co.*, 385 U.S. 252 (1966). The incorporation of 50 different state laws into federal law by the Act has spawned what has been described as a "bewildering, even ludicrous, system of branching laws which defies any rational explanation . . . particularly . . . if one is attempting to relate branching policy to the public interest." SUBCOMM. ON FINANCIAL INSTITUTIONS, SENATE COMM. ON BANKING, HOUSING, & URBAN AFFAIRS, 94th Cong. 2d Sess. (1976), COMPENDIUM OF ISSUES RELATING TO BRANCHING BY FINANCIAL INSTITUTIONS, at v. (Comm. Print) (comments of Senator Thomas McIntyre, Chairman, Senate Subcommittee on Financial Institutions) [hereinafter cited as COMPENDIUM]. State restrictions on branch banking vary according to such diverse factors as distance between banks, population, county or city lines, state "branching districts," paid-in capital and surplus of the main bank, minimum capital per branch, and number of auxiliary teller windows. J. WHITE, BANKING LAW 471-74 (1976). *See generally* Barrett, *A Judicial Impact Statement on the McFadden Act*, COMPENDIUM at 369.

22. *See* *First Nat'l Bank of Logan v. Walker Bank & Trust Co.*, 385 U.S. 252, 256-61

banking system.²³ Its effect, however, has been to dull competition within the banking industry by circumscribing banking markets and insulating banks from regional competition.²⁴

The Bank Holding Company Act undermines the McFadden Act's embrace of the dual banking system by interfering with a state's authority to control the structure of its banking system.²⁵ The Act authorizes the formation and expansion of bank holding companies (BHC's) through acquisitions of state and national banks with prior approval of the Federal Reserve Board.²⁶ In reviewing proposed acquisitions, the Board must consider the impact on competition, the financial and managerial resources and future prospects of the bank, and the convenience and needs of the community to be served.²⁷ Significantly, the Act is silent as to

(1966). The *Logan* Court stated, "[I]t appears clear . . . from the legislative history of §36(c)(1) and (2) that Congress intended to place national and state banks on a basis of 'competitive equality' insofar as branching was concerned." *Id.* at 261.

23. The dual banking system refers to the division of bank chartering and supervisory authority between the federal and state governments. The Comptroller of the Currency generally regulates national banks, while state banking officials regulate state banks. A fundamental purpose of the dual banking system is to preserve the right of the states to maintain a banking structure best suited to their individual needs. *See generally* Brown, "The Dual Banking System in the United States," (paper prepared for the Department of Economics and Research, The American Bankers Association), *reprinted in* COMPENDIUM, *supra* note 21, at 239.

24. One critic has commented, "[I]t is as if a blanket exemption to the most elementary antitrust principle—market division—was awarded to the banks of this Nation." COMPENDIUM, *supra* note 21, at vi (remarks of Senator Thomas McIntyre). Branching restrictions have also been frowned upon by the Supreme Court. In *United States v. Citizens & Southern Nat'l Bank*, 422 U.S. 86 (1975), the Court noted that "[t]he obvious purpose and effect of a rigid antibranching law are to make the potential bank customers of suburban, small town, and rural areas a captive market for small unit banks." 422 U.S. at 118. The Hunt Commission Report on reform of the nation's financial institutions recommended the elimination of all state restrictions on branch banking in the interests of enhancing competition in the banking industry. THE REPORT OF THE PRESIDENT'S COMMISSION ON FINANCIAL STRUCTURE AND REGULATION 45, 61-62 (Government Printing Office, 1971). *See also* the "Discussion Principles" of the Fine study recommending that interstate branching by all federally insured depository institutions be permitted except when in conflict with state laws. In states in which there is a conflict, the study proposed that national banks and federally insured out-of-state banks be allowed a branch in all standard metropolitan areas with population in excess of two million. HOUSE COMM. ON BANKING, HOUSING, & CURRENCY, FINANCIAL INSTITUTIONS AND THE NATION'S ECONOMY: DISCUSSION PRINCIPLES 3 (1975).

25. *See, e.g.,* Neally v. Brown, 284 A.2d 480 (Me. 1971) (overturning a state banking commissioner's denial under state law of permission for a BHC to operate on the grounds that the Federal Reserve Board is the exclusive arbiter of questions of state law relating to the establishment of BHC's). *But see In re Cleveland Trust Co.*, 38 Ohio St. 2d 183, 189 n. 4, 311 N.E.2d 854, 860 n.4 (1974) (criticizing *Neally*). *See also* Note, *Jurisdiction Over State Banks: Does the Bank Holding Company Act Preempt State Regulation?* 36 OHIO ST. L.J. 114 (1975).

26. 12 U.S.C. § 1842(a) (1970).

27. 12 U.S.C. § 1842(c) (1970).

whether the Board must consider state branching restrictions in ruling on BHC acquisitions. Section 7 of the Act reserves to each state the right to exercise "such powers and jurisdiction which it now has or may hereafter have with respect to banks, bank holding companies, and subsidiaries thereof."²⁸ In adopting section 7, however, Congress fully considered whether its language should be interpreted as automatically subsuming BHC activities under state branching laws and concluded that it should not.²⁹ Bolstered by this fact, the Federal Reserve Board's initial interpretation of its responsibilities under the Bank Holding Company Act was that state branching laws were irrelevant to its review of BHC applications.³⁰ That view did not gain the approval of the United States Supreme Court, which held that the Board must disapprove BHC acquisitions that would contravene state branching laws.³¹ The Court, however, offered no guidelines to aid the Board in its interpretative task.

28. 12 U.S.C. § 1846 (1970).

29. As it passed the House of Representatives, the Bank Holding Company Act would have limited BHC expansion to "the geographic limitations that would apply to the establishment of branches of banks" under state laws, unless the states affirmatively authorized wider expansion. H.R. 6227, § 5(c), 84th Cong., 1st Sess. (June 14, 1955). In deleting the restrictive section, the Senate Committee on Banking and Currency stated that the purpose of the Bank Holding Company Act differed from that underlying branching restrictions and that the Act contained provisions adequate to regulate BHC operations without aid of state branching laws. S. REP. NO. 1095, 84th Cong., 2d Sess. 11 (1956). The House ultimately concurred with the deletion and the present version of the Act contains no such restrictive provision.

30. In a 1960 BHC ruling, the Federal Reserve Board stated that "notwithstanding proposals made on the floor of the Congress regarding the relation of state branch banking laws to holding company expansion, the existence in a particular State of a prohibition against branch banking cannot be weighed as an adverse consideration by the Board in exercising its judgment on a holding company's application to acquire stock of a bank in that State." *Farmers & Mechanics Trust Co.*, 46 FED. RES. BULL. 14, 16 (1960). The Board reaffirmed its position in *Denver U.S. Bancorporation*, 49 FED. RES. BULL. 1518, 1527 (1963), and in *First Arkansas Bankstock Corp.*, 56 FED. RES. BULL. 778, 779 (1970).

31. *Whitney Nat'l Bank v. Bank of New Orleans & Trust Co.*, 379 U.S. 411 (1965). Since *Whitney* was decided, neither the Federal Reserve Board nor the courts have condemned a proposed BHC acquisition on branching grounds. *But see* note 76 *infra*. Whether the Supreme Court's ruling raises any obstacle to multibank holding companies is thus questionable from both a practical and a legal standpoint. In holding state branching laws applicable to BHC acquisitions, the *Whitney* Court relied on vague language in the Bank Holding Company Act which Congress repealed the following year. The language, as cited by the Court, directed the Federal Reserve Board to consider "whether or not the effect of such acquisition . . . would be to expand the size or extent of the bank holding company system involved beyond limits consistent . . . with the public interest." 12 U.S.C. § 1842(c)(5) (1958), *cited in* 379 U.S. at 418. From this broad directive the Court reasoned that "a plan of organization violative of federal law [*i.e.*, the McFadden Act] would be hardly consistent with . . . the public interest." 379 U.S. at 418. By extracting the language of § 1842(c)(5) from its context, however, the Court gave it a dubious meaning. Taken in full, the clause relied on by the Court directed the Board to consider "whether or not the effect of such acquisition . . . would be to expand the size or extent

II. THE UNITARY OPERATION TEST

The federal courts of appeals have developed the so-called unitary operation test to determine whether a multibank holding company is, for all practical purposes, engaged in branch banking. Probing deeper than the McFadden Act definition of a branch,³² the unitary operation test requires an examination of the structure and functioning of BHC owned banks. Its roots lie in the ruling by the District of Columbia Circuit Court of Appeals in *Camden Trust Co. v. Gidney*.³³ In that case, the court declined to overturn the decision of the Comptroller of the Currency to award a national bank charter to a New Jersey group which controlled and managed another national bank. A competing bank attacked the Comptroller's decision on the theory that the new affiliate bank would be operated as a branch of the old and would thereby violate New Jersey's law restricting branching. While disclaiming judicial authority to find a branching violation in the guise of affiliate banking,³⁴ the

of the bank holding company system involved beyond limits consistent with adequate and sound banking, the public interest, and the preservation of competition in the field of banking." 12 U.S.C. § 1842(c)(5). To the extent that antibranching laws hinder competition in the banking industry and prevent diversification of risk in aid of bank soundness, see notes 83 & 84 *infra*, the Court's vindication of state branching restrictions was inconsistent with the language of § 1842(c)(5) when read in its entirety.

Congress amended § 1842(c)(5) in 1966 to bring it into conformity with the 1966 Bank Merger Act, 12 U.S.C. § 1828 (1970). S. REP. NO. 1179, 89th Cong., 2d Sess., reprinted in [1966] U.S. CODE CONG. & AD. NEWS 2385, 2393. In doing so it gave the vague "public interest" language relied on in *Whitney* a more definite meaning. As amended, § 1842(c) directs the Federal Reserve Board to disapprove any BHC acquisition

whose effect . . . may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint of trade, unless it finds that the anticompetitive effects of the proposed transactions are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served.

12 U.S.C. § 1842(c)(2) (1970). By specifically relating the public interest to the convenience and needs of the community to be served, the new language is inconsistent with the meaning *Whitney* would give it. Not only does it preclude any notion that the words "public interest" were intended to include deference to state branching laws, cf. *Western Bancshares, Inc. v. Board of Governors*, 480 F.2d 749 (10th Cir. 1973) (the "public interest" in § 1842(c)(2) is not to be construed broadly but is limited to the convenience and needs of the community to be served), it could reasonably be interpreted to imply that such laws may be ignored to the extent that they conflict with community banking needs and convenience.

The significance of the change in statutory language for purposes of interpreting the effect of state branching laws is uncertain, since the legislative history of the Bank Merger Act makes no reference to the *Whitney* decision. The Federal Reserve Board and the courts have continued to pay lip service to the Supreme Court's ruling despite its questionable validity, but have yet to give it practical effect.

32. See text accompanying note 21 *supra*.

33. 301 F.2d 521 (D.C. Cir. 1962), cert. denied, 369 U.S. 886 (1962).

34. The court stated that "[i]t is not within our province to pass upon the desirability

court proceeded to examine the relationship between the two banks. It found that the new bank would have an independent capital structure, separately elected directors, fully paid-in and subscribed stock, separate shareholder liability, a distinct name, a separate business location, separate deposit liability, independently determined loan limitations, and independent ceilings on indebtedness.³⁵ These facts, the court reasoned, dispelled the claim that the affiliate was masquerading as a branch and therefore deserving of condemnation under the McFadden Act.³⁶ The intent of the founders to circumvent New Jersey's branching law in order to expand their operations was deemed irrelevant.³⁷ The court's reliance on the independent corporate status of the affiliate became the foundation of the unitary operation test.

The next step in the evolution of the test came in *First National Bank in Billings v. First Bank Stock Corp.*³⁸ At issue in that case was whether a BHC acquisition of a newly formed bank contravened Montana's ban on branch banking. Unlike the *Camden* court, however, the United States Court of Appeals for the Ninth Circuit asserted judicial power to "pierce the corporate veil" in the banking field and uproot de facto violations of antibranching laws.³⁹ After enlisting that power to examine the relationship among the BHC subsidiary banks in the case before it, the court was nevertheless unable to detect a unitary operation.⁴⁰ An elusive quality in the unitary operation test was discernible in the court's reasoning. The mere fact that two banks have separate corporate organizations does not shelter them from potential McFadden Act liability, this court warned.

vel non of permitting a national bank to have an 'affiliate,' If such an affiliate is to be denied status, Congress must clearly say so." 301 F.2d at 525.

35. *Id.* at 524-25.

36. The dissent disagreed, pointing out in a strong opinion that the legislative history of the McFadden Act outspokenly condemned the use of affiliate banks as devices for evading state branching restrictions. Noting the State of New Jersey's amicus brief, which stated that the affiliation would have been disallowed under state law had the national bank been state chartered, the dissent reasoned that the arrangement should have been condemned. *Id.* at 525-26.

37. The court dispensed with the challenger's accusation that the arrangement was a subterfuge by pointing out that it was, on the contrary, "open and notorious." *Id.* at 523.

38. 306 F.2d 937 (9th Cir. 1962).

39. Citing the *Camden* decision, the court declared that a bank is engaged in de facto branch banking if it "is doing business through the instrumentality of [another bank], or vice versa, in the same way as if the institutions were one." 306 F.2d at 942.

40. The court found the following characteristics determinative: the banks had separate officers and employees and only one common director; each bank was subject to a different supervisory authority and operated under different statutes since one was a national and the other a state bank; the banks were correspondents but not solely with each other; the banks were not members of the same clearing house; deposits in one bank to be credited to the account of depositors of the other bank were not allowed; and no

On the other hand, common control of banks through stock ownership and active dual management did not necessarily prove a branch relationship.⁴¹

Only once has the unitary operation test carried sufficient potency to condemn a BHC acquisition. In *Whitney National Bank v. Bank of New Orleans & Trust Co.*,⁴² the "parent" Whitney National Bank, through an intricate arrangement, established both a new bank and a BHC which then acquired both banks.⁴³ The venture was a self-proclaimed attempt to conduct branch banking under the umbrella of the Bank Holding Company Act in violation of Louisiana law. The Federal Reserve Board's approval of the enterprise spurred emergency legislation by the state designed to prevent its implementation.⁴⁴ In reviewing the Board's decision, the United States Court of Appeals for the District of Columbia declined to consider the effect of that legislation, perhaps reflecting a reluctance to plunge into an unsettled area of the law.⁴⁵ At that time it was uncertain whether states could override the Federal Reserve Board's authority to permit BHC's under the Bank Holding Company Act.⁴⁶ The court instead based its ruling on the existence of a unitary operation between the two subsidiary banks. In doing so, it invoked the power to pierce the corporate veil which it had declined to exercise in

withdrawals were permitted from one bank of money deposited in the other. 306 F.2d at 942-43.

41. *Id.* at 942.

42. 323 F.2d 290 (D.C. Cir. 1963), *rev'd and remanded on other grounds*, 379 U.S. 411 (1965).

43. Whitney National Bank of New Orleans organized the Whitney Holding Corporation with a \$350,000 initial capital expenditure. Using that money, the Whitney Holding Corporation acquired the dummy Crescent City National Bank. Whitney of New Orleans then transferred its assets to the Crescent City Bank and changed Crescent City's name to its own name. Next, the "new" Whitney Bank furnished the Holding Corporation with a \$650,000 "dividend" with which the Whitney National Bank in Jefferson Parish was organized. All of the Holding Corporation's stock was distributed proportionately to the stockholders of the original Whitney National Bank of New Orleans. 323 F.2d at 293.

44. The legislation provided: "It shall be unlawful . . . for any bank holding company or subsidiary thereof to open for business any bank not now opened for business, whether or not, [sic] a charter, permit, license, or certificate to open for business has already been issued" *Id.* at 295.

45. The court indicated that the legislation would be effective against state bank expansion through BHC's but declined to rule on its applicability to national banks such as Whitney National. *Id.* at 299.

46. The constitutionality of state statutes banning BHC operations authorized by the Federal Reserve Board had never been conclusively decided by the Supreme Court. On the appeal of the *Whitney* case, the Court indicated that the statute would pass constitutional muster, 379 U.S. 411, 418-19 (1965), but remanded the question for review by the Federal Reserve Board. *Id.* at 424-25. The Board had earlier taken the position that § 7 of the Bank Holding Company Act permitted states to prevent the formation of BHC's. *See Trans-Nebraska Co.*, 49 FED. RES. BULL. 633 (1963). The Board has not altered its position. The Supreme Court's opinion in *Whitney* has been interpreted as allowing states

Camden.⁴⁷ Underneath the veil, the court found that the capital of the new bank was provided by Whitney National; that the new bank would be managed and controlled by Whitney National executives; and that its name would be publicly identified with Whitney National.⁴⁸ Although intent was declared irrelevant to identifying a unitary operation in *Camden*, it was embraced as a key element of identification by the *Whitney* court.⁴⁹ By relying on such a subjective factor, however, the court added further uncertainty in applying the unitary operation test. Ascertaining whether a proposed BHC acquisition is the offspring of legitimate business needs or a tainted desire to engage in branch banking is a hazardous task at best.

The United States Court of Appeals for the Eighth Circuit was faced with a less sinister looking BHC operation in *Commercial National Bank v. Board of Governors*.⁵⁰ The First Arkansas Bankstock Corporation (FABCO), a one-bank holding company operating in Little Rock, was given Federal Reserve Board approval⁵¹ to acquire the Arkansas First National Bank in Hot Springs, a well-established bank. Fifty-six other Arkansas banks protested the acquisition as a violation of Arkansas' ban on branching. The Arkansas legislature bolstered the attack by enacting prospective legislation to prohibit the creation or expansion of multibank holding companies.⁵² On appeal, the challengers urged the court to follow the D.C. Circuit's *Whitney* decision. The court declined to do so, contrasting the absence of an intent by FABCO to evade Arkansas' branching law with the blatant subterfuge undertaken by Whitney National.⁵³ Wary of relying on such a subjective factor as intent, however, the court acknowledged that future cooperation between the two FABCO banks would exist. The absence of a unitary operation was declared

to prohibit the formation of BHC's. *Commercial Nat'l Bank v. Board of Governors*, 451 F.2d 86, 89 (8th Cir. 1971). *But see* Neally v. Brown, 284 A.2d 480 (Me. 1971) *See also* Note, *supra* note 25.

47. The court declared that "[t]he nature of the arrangement, and not the label applied to it, determines the character of the relationship between two banking institutions." 323 F.2d at 301.

48. *Id.* at 304.

49. One commentator has criticized the court's emphasis on intent and unitary structure as blurring the importance of the effect of BHC acquisitions on competition. *See* Comment, *Branch Banking Limitations Held Applicable to Approved Bank Holding Company Operation*, 39 N.Y.U.L. REV. 686, 694 (1964). As if in response to such criticism, the D.C. Circuit, in remanding a later case, stated that the purpose of the unitary operation test is "to enable a determination to be made as to whether a national bank is attempting to gain a competitive advantage over state banks" *Independent Bankers Ass'n v. Board of Governors*, 516 F.2d 1206, 1223 (D.C. Cir. 1975).

50. 451 F.2d 86 (8th Cir. 1971).

51. *First Arkansas Bankstock Corp.*, 56 FED. RES. BULL. 778, 35 Fed. Reg. 15,185 (1970).

52. 451 F.2d at 88 n. 1.

53. *Id.* at 90.

to be the "decisive test."⁵⁴ The court found that the acquired bank would maintain a separate and independent board of directors with no interlocks, separate capital, surplus, and undivided profits, separate loan limits, and separate management by local officers. In addition, it would not be identified with the BHC by the public. There was thus no branching violation.⁵⁵

The Eighth Circuit reaffirmed the vitality of the unitary operation test in *Gravois Bank v. Board of Governors*⁵⁶ when it directed the Federal Reserve Board to use the test in reviewing BHC applications. Prior to *Gravois*, the Board had applied vague standards in reviewing BHC acquisitions,⁵⁷ reflecting its resistance to be bound by state branching laws.⁵⁸ In *Gravois*, it erred by rejecting a branching challenge to a BHC acquisition on the basis of prior Board decisions which had ignored state branching restrictions.⁵⁹ On appeal, however, the Board conceded for the first time that state branching laws must be considered in reviewing BHC applications.⁶⁰ Nevertheless, the court held that the Board had improperly considered the branching challenge and remanded the case for reconsideration in light of *Commercial*.⁶¹

III. THE DOWNFALL OF THE UNITARY OPERATION TEST

The unitary operation test was workable in polar cases like *Whitney* and *Commercial* since the facts plainly showed the presence or absence of an intent to engage in de facto branch banking. The test's weaknesses surfaced, however, with the more difficult factual situation presented in *Grandview National Bank & Trust Co.*⁶² In *Grandview*, each of the five

54. *Id.*

55. *Id.* The court deferred to the Federal Reserve Board's "expert conclusions" on the absence of a unitary operation, declaring that since its conclusions were supported by substantial evidence, "we will not reverse the Board even though we might reach a contrary conclusion if we were making the initial decision on the matter." *Id.* Under § 9 of the Bank Holding Company Act, 12 U.S.C. § 1848 (1970), the findings of the Board are conclusive if supported by substantial evidence.

56. 478 F.2d 546 (8th Cir. 1973).

57. *Id.* at 551.

58. In *Denver U.S. Bancorporation, Inc.*, 49 FED. RES. BULL. 1518 (1963), for example, the Federal Reserve Board had rejected the reasoning and holding of the D.C. Circuit in *Whitney* and had reaffirmed prior decisions ignoring state branching statutes. See note 29 & accompanying text *supra*.

59. 478 F.2d at 551.

60. Brief for Respondent at 12-13, *Gravois Bank & Trust Co. v. Board of Governors*, 478 F.2d 546 (8th Cir. 1973).

61. 478 F.2d at 552.

62. 550 F.2d 415 (8th Cir. 1977), *cert. denied*, 98 S. Ct. 64 (1977). The factual difficulty was reflected in the court's assertion, on one hand, that Bancshares' activities "appear to be 'unitary,'" and "suggest a *de facto* unitary system," 550 F.2d at 419, and, on the other, that "as a BHC Bancshares does not conduct a direct unitary operation. . . ." *Id.* at 420.

interim directors of the new bank was a director of other banks in the Bancshares' system and four were officers or directors of Bancshares itself. Bancshares' avowed intent was to make the directorships of the new bank and its other affiliates "substantially separate and independent" once the new bank was established.⁶³ On its face, the acquisition conceivably could survive the *Whitney* intent test.⁶⁴ However, it could not so easily hurdle the structural requirements of the unitary operation test. Bancshares had supplied all the capital of the new bank by purchasing its stock. Graduates of Bancshares' management training program staffed the new bank. Although the bank would maintain separate books of account, its recordkeeping would be performed by Bancshares' automated data processing services which provided general ledger service for all of its affiliates. In contrast to the old and well-established bank in *Commercial*, the acquired bank in *Grandview* was a newly formed bank whose identity would be merged with that of its BHC. All of the banks in the Bancshares system had similar names which linked them in the public eye. They were advertised as a "family of banks" which offered "statewide trust services" and a "team" of 140 trust specialists. Although the banks had separate legal loan limits, they could increase their loan capacity through participation arrangements in each other's loans.⁶⁵

On its facts, *Grandview* presented a compelling case for using the unitary operation test to vindicate state branching restrictions. But the court was troubled by the resemblance of legitimate BHC operations to branch banking. Acquisition of bank stock is the usual way a BHC acquires ownership of a bank, it observed. Common control, resulting in cooperation between a BHC and its subsidiaries, is a usual result of common ownership. Bancshares was doing nothing more than engaging in the traditional and legal means by which a BHC may work with its affiliates.⁶⁶ Furthermore, the proposed acquisition by Bancshares had been approved by the Missouri Director of Finance pursuant to Missouri's law governing BHC activities.⁶⁷ If the state did not perceive a violation of its branching laws, the court was reluctant to pierce the corporate veil and find one.⁶⁸

The *Grandview* court's dilemma was an outgrowth of the tension between the differing policies underlying the Bank Holding Company

63. *Id.* at 418.

64. The intention of Bancshares to install an independent board of directors was unquestioned by the Federal Reserve Board in its review of the proposed arrangement. 62 FED. RES. BULL. 368, 369-70 (1976), 41 Fed. Reg. 12,093 (1976).

65. 550 F.2d at 418-19.

66. *Id.* at 418.

67. *Id.* at 417 n.3.

68. *Id.* at 420.

Act and the McFadden Act.⁶⁹ In resolving the dilemma, the court concluded that state branching policies must yield to the authority of the Bank Holding Company Act. It noted that Congress was aware of the potential conflict with the McFadden Act when it authorized the formation of BHC's and had expressly reserved the right of states to regulate BHC operations directly in order to avoid conflicts with branching policies.⁷⁰ Therefore, the court reasoned, the judiciary should not invoke state branching laws to police BHC operations indirectly when states have declined to limit them directly through bank holding company laws.⁷¹

While not expressly acknowledging that it was abandoning the unitary operation test,⁷² the court left no doubt that such would be the effect. In the absence of state legislation restricting BHC activities, the court clearly indicated that it would no longer engage in a case-by-case examination of the structure of BHC operations. *Grandview Bank & Trust Co.* thus offers a haven to bankers seeking to expand their operations in states which restrict branching but have minimal BHC regulation.⁷³ The court's sanction of BHC operations in such states was not completely unqualified, however. If a subsidiary bank receives deposits, pays checks or lends money on behalf of a parent bank, the court hinted that it would find a branching violation.⁷⁴

Grandview Bank & Trust Co. may thus have sprouted a hybrid version of the unitary operation test based on the McFadden Act's three-pronged definition of a branch.⁷⁵ Although the Act's definition is open-ended, its minimum criteria offer a more satisfactory harmonization of the McFad-

69. See text accompanying notes 18-30, *supra*.

70. 550 F.2d at 419-20.

71. *Id.* at 420.

72. The court expressed little appreciation of the significance of its ruling. It failed to acknowledge its divergence from its prior opinions in *Commercial* and *Gravois*, nor did it discuss the correctness of its decision in light of the Supreme Court's mandate giving state branching statutes precedence. See note 30 *supra*. Its departure from the unitary operation test was somewhat guarded. Deferring to the D.C. Circuit's decision in *Whitney*, it cautioned that the unitary operation test "may have validity" in cases of fraud or complete subterfuge; nevertheless, the court defended its approach as "more realistic." 550 F.2d at 420.

73. Fourteen states which restrict branching have no limitations on BHC acquisitions of subsidiary banks. Five require state approval. Twelve have a variety of other restrictions, primarily limiting the aggregate percentage of bank stock that can be owned by a BHC. J. WHITE, *supra* note 21, at 59.

74. In sustaining the BHC operation, the court observed that "notwithstanding the similarity with some phases of branch banking, there is no showing that New Bank will, within the purview of 12 U.S.C § 36(f) [the McFadden Act], operate to receive deposits, pay checks or lend money on behalf of the parent bank." 550 F.2d at 420.

75. That the Eighth Circuit intended to give birth to a new test based on the McFadden definition of a branch is doubtful in light of its decision in *St. Louis County Nat'l Bank v. Mercantile Trust*, 548 F.2d 716 (8th Cir. 1976), in which it disapproved the operation of a

den Act and the Bank Holding Company Act than the vague and elusive unitary operation test. A limited McFadden test would enable the courts to pay deference to state branching laws in cases in which BHC's violate the clear language of the McFadden Act, while giving BHC's maximum leeway to expand their operations otherwise. The objective elements of the test would considerably simplify the courts' task and, by marking a clearer line between legitimate BHC activities and branch banking, would assist BHC's in planning their expansion within lawful bounds.⁷⁶

IV. *GRANDVIEW*'S IMPACT ON BRANCHING POLICY—SOME PRACTICAL CONSIDERATIONS

It is too early to gauge the impact of the *Grandview* decision in other circuits.⁷⁷ If the Eighth Circuit's reasoning is followed, it will undoubtedly stimulate legislatures to review state laws governing branch banking and bank holding company operations.⁷⁸ Small bankers seeking protection from BHC competition will urge stricter regulation of BHC operations.⁷⁹ Others eager to expand and compete with BHC's will advocate a

national bank's trust department as a branch office even though it did not accept deposits, make loans, or pay checks. The court stated that the three routine banking functions listed in § 36(f) are not the only indicia of branch banking and that branching questions must be considered in light of the McFadden Act's goal of maintaining competitive equality. 548 F.2d at 719.

76. A McFadden Act version of the unitary operation test is currently being tested in the Sixth Circuit. The Eastern District of Michigan recently struck down the Michigan National Corporation's "automatic transaction service" (ATS) which enabled customers of one of the BHC's sixteen banking subsidiaries to make deposits or withdrawals at any bank within the holding company system. *Kelley v. Michigan Nat'l Corp.*, No. 77-1240 (E.D. Mich. Feb. 28, 1978) (order granting permanent injunction). The Federal Reserve Board had earlier ruled that the ATS service constituted branch banking in violation of the McFadden Act and conditioned its approval of the BHC's acquisition of a new bank on that bank's non-participation in the service. *Michigan Nat'l Corp.*, Federal Reserve Board Press Release (Jan. 31, 1978). Prior challenges invoking the McFadden Act had failed. *See First Nat'l Bank in Howell v. Heimann*, No. 77-2264 (E.D. Mich. Oct. 25, 1977) (order granting summary judgment); *Central State Bank v. Bloom*, No. 77-0484 (D.D.C. July 27, 1977) (order granting summary judgment).

77. In a case arising in the Fifth Circuit one month after *Grandview*, the court sustained the Federal Reserve Board's approval of a BHC acquisition on the basis of the unitary operation test. *First State Bank of Clute v. Board of Governors*, 553 F.2d 950, 953-54 (5th Cir. 1977). *Grandview* was not cited in the opinion. The Board itself has continued to apply the unitary operation test despite the *Grandview* decision. *See, e.g.*, *First Int'l Bancshares, Inc.*, 42 Fed. Reg. 36,298 (July 14, 1977).

78. Review of branching and BHC statutes is already underway in several states. *See, e.g.*, TEXAS STATE HOUSE OF REPRESENTATIVES COMM. ON FINANCIAL INSTITUTIONS, INTERIM REPORT: BANK HOLDING COMPANIES, reprinted in 1976 *Hearings*, *supra* note 4, at 233; Michigan Department of Commerce Interoffice Communication: The Impact of Bank Holding Companies on Bank Performance and Structure in Michigan (November 29, 1976), reprinted in 1976 *Hearings* at 109; Golembe Assoc., Inc., Report and Recommendations from a Study of the Bureau of Banking of the Commonwealth of Virginia (Feb. 1976) (study for the Virginia Bureau of Banking recommending statewide branching).

79. The fear of small bankers that competition from BHC affiliated banks will drive

lifting of branching restrictions. If the states yield to the demands of the former and continue to impede bank expansion, then Congress should consider whether continued deference to state banking law is in the public interest.⁸⁰

There are several reasons to support the elimination of branching restrictions. One obvious benefit of branch banking is customer convenience due to a higher ratio of bank offices to bank customers.⁸¹ Another is larger lending capacity which benefits individual borrowers as well as business and government, whose demands for capital are skyrocketing. Branching also spurs economic growth by increasing the mobility of funds.⁸² By enabling banks to broaden their geographical base, branching reduces bank dependency on the special economic structure of a given area, thereby diversifying risk.⁸³ By promoting competition in local markets,⁸⁴ branch banking also tends to lower interest rates on loans.⁸⁵

them out of business does not appear to be warranted. Studies have shown that small unit banks have not been adversely affected by competition from branch banks and that such banks can be as profitable as branch operations. See Guttentag, *Branch Banking: A Summary of the Issues and the Evidence*, reprinted in COMPENDIUM, *supra* note 21, at 99, 108-09; Darnell & Keen *Small Bank Survival, Is the Wolf at the Door?*, FED. RES. BANK OF PHILADELPHIA, BUS. REV. 16 (Nov. 1974).

80. Congress has already taken an interest in the branching issue. See generally 1976 *Hearings*, *supra* note 4.

81. Compare the bank office per customer ratio of New York City—one full service office for every 9,075 people—with that of Chicago—one office for every 34,357 people. 1976 *Hearings*, *supra* note 4, at 149 (statement of James A. Cassin, Senior Vice President, The First National Bank of Chicago).

82. *Id.* at 154-155. The mobility of funds can also result in a flow of funds out of depressed inner city areas to high-growth suburban areas if precautions are not taken. *Id.* at 378 (statement of Carl J. Schmitt, Superintendent of Banks, State of California).

83. Statewide branching in California, for example, has made it easier for banks to withstand local adversities such as crop failures in drought stricken areas or layoffs in the aerospace industry.

84. The most common criticism of branch banking is that it increases concentration in the banking industry, thereby hampering competition. Such criticism may be warranted in some states, such as California (see 1976 *Hearings*, *supra* note 4, at 375-77), and may justify restrictions on the percentage of total deposits a single bank may control within a given state. Research indicates that, on the whole, branch banking has had a procompetitive impact and that its continued prohibition is anticompetitive. See Shull, *Multiple Office Banking and Competition: A Review of the Literature*, reprinted in COMPENDIUM, *supra* note 21, at 113, 116-17; 1976 *Hearings*, *supra* note 4, at 290-92. A study of Pennsylvania banking by the Federal Reserve Bank of Philadelphia indicated that the state would experience higher concentration regardless of whether or not it adopted branching. The study concluded that statewide branch banking would produce the least concentrated market structure and "offers the greatest potential for reaping the benefits of increased competition." *Changing Pennsylvania's Branching Laws: An Economic Analysis*, FED. RES. BANK OF PHILADELPHIA, BUS. REV. 13 (Dec. 5, 1972).

85. Note, *The Perennial Issue: Branch Banking*, FEDERAL RESERVE BANK OF CHICAGO, BUSINESS CONDITIONS, Feb. 1974, reprinted in COMPENDIUM, *supra* note 21, at 437, 448-50.

Additionally, the development of money-saving electronic funds transfer systems and customer bank communication terminals would progress faster without branch banking restrictions.⁸⁶

Bank holding companies offer many of the advantages of branch banking, but have important drawbacks which make them a poor substitute. Because of higher capitalization requirements, BHC's cannot respond to the changing needs of communities as readily as branch banks.⁸⁷ Since each bank in a BHC organization has its own lending limits, a BHC cannot allocate funds as efficiently as a branch bank. Branching allows for incremental expansion and thus makes banking services feasible in communities that could not support an independent bank as part of a BHC system.⁸⁸ Entry into new markets by de novo branching is a greater stimulus to competition than is entry by BHC acquisitions of established banks.⁸⁹ Finally, there is some indication that BHC's increase the risk exposure of acquired banks. BHC's generally pay out a higher portion of their earnings in dividends, resulting in a

86. Toward this end, the National Commission on Electronic Funds Transfers has recommended that geographic restrictions on EFTS be eliminated. NATIONAL COMMISSION ON ELECTRONIC FUND TRANSFERS, EFT AND THE PUBLIC INTEREST 31 (1977). This could require a change in state branching laws since the courts have deemed EFTS terminals to be branches. *Independent Bankers Ass'n v. Smith*, 534 F.2d 921 (D.C. Cir. 1976), *cert. denied*, 429 U.S. 862 (1976); *State of Illinois ex rel. Lignoul v. Continental Nat'l Bank & Trust Co.*, 536 F.2d 176 (7th Cir. 1976), *cert. denied*, 429 U.S. 871 (1976). See generally *Symposium on Electronic Funds Transfer Systems*, 25 CATH. U.L. REV. 687-842 (1976). However, Senator McIntyre has introduced legislation to permit national banks to establish EFT systems nationwide regardless of state restrictions. S. 2293, 95th Cong., 1st Sess. (1977).

87. Independent banks must meet paid-in capital requirements as a condition to receiving a charter. Branches of independent banks are free from this requirement, although many states require the parent bank to increase its capital base as a condition to establishing a branch.

88. For these reasons, BHC's have converted their subsidiaries into branches in states in which branching restrictions have been lifted. See, e.g., *United States v. Citizens & Southern Nat'l Bank*, 422 U.S. 86 (1975) (BHC converted bank subsidiaries into branches when Georgia branching restrictions were eased). See also Parcell, *Banking Structure and Statewide Branching: The Potential for Virginia*, 18 WM. & MARY L. REV. 93, 97 (1976).

89. The Bank Holding Company Act recognizes the greater competitive benefits of de novo entries as opposed to entries by acquisitions and permits the Federal Reserve Board to differentiate between the two. 12 U.S.C. § 1843 (c)(8) (1970). The Board has done so by providing an expedited procedure for de novo entry applications. 12 C.F.R. § 225.4(b) (1977). Although de novo entries by BHC's have increased in recent years, most have been in areas where the BHC was already represented. See Lawrence & Talley, *An Assessment of Bank Holding Companies*, 62 FED. RES. BULL. 15, 16 (1976).

The effect of BHC's on competition has been heavily criticized in recent years. See *Competition in Banking Act of 1976: Hearings on S. 2721 Before the Senate Comm. on Banking, Housing, & Urban Affairs*, 94th Cong., 2d Sess. 1-3 (1976) (statement of Senator William Proxmire and findings and purposes of S. 2721).

lower capital ratio than independent banks.⁹⁰ BHC's have also engaged in a large number of nonbanking activities in recent years, which has strained their bank subsidiaries.⁹¹

IV. CONCLUSION

Although multibank holding companies lack all of the virtues of branch banking, they have enabled bankers to respond to evolving banking needs in states which have erected artificial barriers to bank growth. By giving these entities a clear path around antibranching laws, the decision in *Grandview Bank & Trust Co.* is a strike in favor of more convenient and competitive banking. *Grandview* was the offspring of a clash between the McFadden Act's deference to the restrictive policies of state branching laws and the endorsement of legitimate multibank holding company activity by the Bank Holding Company Act. Previous decisions attempted to reconcile the two statutes by employing an elusive test to determine whether a BHC had transgressed into the forbidden territory of branch banking. Taking a more realistic approach, the Eighth Circuit recognized the inherent similarities between multibank holding companies and branch banking and made no attempt to harmonize the conflicting policies of the two laws. Giving precedence to the Bank Holding Company Act, the court declined to invoke antibranching laws to thwart BHC expansion judicially when states have failed to do so legislatively. By hinting that it might find a branching violation when a BHC subsidiary receives deposits, cashes checks, or makes loans on behalf of a sister bank, however, the decision offers a pragmatic accommodation of the McFadden Act based on its three-pronged definition of a branch.

Grandview was necessarily an imperfect victory for multiple office banking. States remain free to exercise their authority under the Bank Holding Company Act to impose antibranching restraints on BHC opera-

90. Lawrence & Talley, *supra* note 89, at 18-19.

91. The Bank Holding Company Act permits BHC's to engage in non-banking activities which are "so closely related to banking . . . as to be a proper incident thereto." 12 U.S.C. § 1843(c)(8) (1970). The Federal Reserve Board has approved the following non-banking activities, among others: investment advising, economic and management consulting, automobile leasing, insurance brokering, and the providing of courier, book-keeping, data processing, and billing services. 12 C.F.R. § 225.4 (1977). In addition, § 1843(a)(2) contains a "grandfather clause" allowing companies which became BHC's by virtue of the 1970 Bank Holding Company Act Amendments to continue certain nonbank activities engaged in prior thereto. These activities include advertising, trucking, coal mining, farming, and window cleaning. J. WHITE, *supra* note 21, at 349-52. See generally *Hearings on S. 2721*, *supra* note 89, and P. HELLER, *HANDBOOK OF FEDERAL BANK HOLDING COMPANY LAW*, chs. 4 & 5 (1976).

tions by direct legislation. By forcing independent bankers to turn to state legislators to shield them from BHC competition, the *Grandview* decision will undoubtedly increase the pressure on states to use that authority. If the states display infidelity to the public interest by extending antibranching laws to BHC operations, congressional action will be needed to unshackle the banking industry in order to meet changing banking needs.

Melanie L. Fein

INSURANCE: McCarran-Ferguson Act Section 1013(b) Applies to Insured-Insurer Relationship. *Barry v. St. Paul Fire & Marine Insurance Co.*, 555 F.2d 3 (1st Cir. 1977).

The McCarran-Ferguson Act¹ grants the insurance industry broad antitrust immunity to the extent that the industry is regulated by the states.² An explicit exception to this immunity, however, is provided by section 1013(b)³ of the Act, which subjects insurers to liability under the Sherman Antitrust Act⁴ if they engage in agreements or acts involving

1. 15 U.S.C. §§ 1011-15 (1976) [hereinafter referred to as the Act].

2. So long as insurance is regulated by state law, the federal antitrust laws are generally inapplicable. Section 1012(b) of the Act provides:

No act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance. *Provided*, That after June 30, 1948, the Act of July 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law.

3. Section 1013(b) provides: "Nothing contained in this chapter shall render the said Sherman Act inapplicable to any agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation." A concise analysis of the Act is provided in 7 J. VON KALINOWSKI, *ANTITRUST LAWS AND TRADE REGULATION*, ch. 47 (1969 & Supp. 1977).

4. 15 U.S.C. §§ 1-7 (1976). In general, the Sherman Act forbids contracts, combinations, conspiracies in restraint of trade, and the acts of monopolizing or attempting to monopolize in restraint of trade. For background information on the Sherman Act and developments that led to the subsequent enactment of its counterparts, the Clayton Act, and the Federal Trade Commission Act, see W. LETWIN, *LAW AND ECONOMIC POLICY IN AMERICA: THE EVOLUTION OF THE SHERMAN ANTITRUST ACT* (1965).

boycotts, coercion, or intimidation.⁵ In *Barry v. St. Paul Fire & Marine Insurance Co.*,⁶ the United States Court of Appeals for the First Circuit was recently called upon to determine whether this so-called "boycott exception" applies only to insurance company boycotts of other insurance companies and agents, or whether it applies as well to insurers' refusals to deal with policyholders.⁷ In holding that the boycott exception is applicable to the insured-insurer relationship, the court rejected a growing line of case authority to the contrary,⁸ thus suggesting the possibility of a greater role for antitrust in the regulation of insurance and a stronger position for consumers in the regulatory process.⁹

In June 1975, eight Rhode Island doctors and six patients filed a class action suit against four companies selling medical malpractice insurance.¹⁰ The plaintiffs sought to represent two classes — all licensed physicians practicing in Rhode Island and all citizens of that state who were or would be under a doctor's care.¹¹ They claimed that St. Paul Fire & Marine changed its malpractice renewal policies so as to diminish the effectiveness of the insurance coverage, and that when the dissatisfied policyholders tried to take their business elsewhere, other companies refused to sell them malpractice insurance of any sort.¹² Alleging that

5. In analyzing the validity of a federal antitrust claim under the McCarran-Ferguson Act, one's initial determination is whether or not the act complained of constitutes "the business of insurance" within the meaning of § 1012(b), and if so, whether it is regulated by state law. A negative answer to either of these inquiries removes the case from the antitrust immunity of the Act. But if the answer to both is in the affirmative, the Act protects the insurer from federal antitrust claims unless there is an agreement or act of boycott, coercion, or intimidation within the scope of section 1013(b). See, e.g., VON KALINOWSKI, *supra* note 3; Annot., 21 L. Ed. 2d 938, 944-47 (1969).

6. 555 F.2d 3 (1st Cir.), *cert. granted*, 98 S. Ct. 391 (1977).

7. *Id.* at 5.

8. See note 41 & accompanying text *infra*.

9. Insurance regulation is generally considered to have three main objectives: avoiding overreaching by insurers, assuring solidity and solvency of insurers, and assuring reasonable and fair rating classifications and rates. R. KEETON, BASIC TEXT ON INSURANCE LAW 554 (1971). To date, insurance consumers have been unorganized, and their complaints about insurers have tended to have little or no beneficial impact upon the regulatory process. *Id.* at 565.

10. *Barry v. St. Paul Fire & Marine Ins. Co.*, No. 75-176, slip op. at 1-2 (D.R.I. Nov. 19, 1975). The other defendants were Hartford Casualty Company, Hartford Fire Insurance Company, Aetna Casualty & Surety Company, and Travelers Insurance Company.

11. All questions relating to class certification were deferred until resolution of the motions for dismissal. *Id.* at 20 n.1.

12. *Id.* at 3; 555 F.2d at 5. The physicians alleged that St. Paul Fire & Marine changed its future malpractice policies to provide coverage only on a "claims made" basis, rather than an "occurrence" basis. The latter protects the holder from liability for any act performed while the policy is in effect, while the former protects the holder only against claims made during the policy period. Thus, as the court noted, a doctor who practiced for

these actions manifested a conspiracy to monopolize the selling of malpractice insurance in violation of the Sherman Act, the plaintiffs sought both injunctive relief¹³ and treble damages.¹⁴ The initial success of their Sherman Act claim depended entirely on whether section 1013(b) of the McCarran-Ferguson Act included policyholders among those protected from boycott, coercion, or intimidation.¹⁵ Concluding that Congress intended this section to be narrowly applied to protect only insurance agents and companies from being blacklisted by combinations of insurers, the district court dismissed the case.¹⁶

On appeal, the First Circuit reversed and remanded, with one judge dissenting.¹⁷ The appellate court was particularly concerned with the lower court's reliance on the legislative history of section 1013(b), and held that the section clearly prohibited any agreement or act of boycott, coercion, or intimidation, including insurers' refusals to deal with policyholders.¹⁸ Because the statutory language of the section was unambigu-

only one year would need only one year's "occurrence" policy to be fully covered, but would need several years of "claims made" coverage to protect himself from claims arising from his acts during the single year. *Id.* at 20 n.1.

13. The Clayton Act § 16, 15 U.S.C. § 26 (1976), authorizes private antitrust suits for injunctive relief.

14. *Id.* § 4, 5 U.S.C. § 15 (1976), provides a treble damage remedy for antitrust violations.

In addition to the federal antitrust claim, the plaintiffs alleged certain violations of state common law. *Barry v. St. Paul Fire & Marine Ins. Co.*, No. 75-176, slip op. at 2-3; 555 F.2d at 12-13.

15. Since the McCarran-Ferguson Act insulates the insurance industry from federal antitrust laws to the extent it is state regulated, once state regulation exists, the only way to assert a Sherman Act claim is through the Act's boycott exception. Otherwise, antitrust claims against insurers must be brought under state antitrust laws. *See* note 23 & accompanying text *infra*.

16. *Barry v. St. Paul Fire & Marine Ins. Co.*, No. 75-176, slip op. at 10-12. In reaching this conclusion, the district court did not analyze the McCarran-Ferguson Act or its legislative history. It simply relied on an established line of case authority interpreting the history. *See* note 41 & accompanying text *infra*.

17. 555 F.2d 3 (1st Cir.), *cert. granted*, 98 S. Ct. 391 (1977).

18. *Id.* at 12. Although ruling against the lower court's dismissal based on a narrow reading of § 1013(b), the First Circuit mentioned two other grounds for dismissal which the district court had found no need to consider. One was mootness. Shortly after Dr. Barry filed suit, Rhode Island established a joint underwriting association to provide all medical malpractice insurance in the state. After requesting briefs from both sides on the mootness issue, the court concluded that for purposes of its jurisdiction, the state's act did not entirely extinguish the plaintiffs' claims for relief. *Id.* at 5-6. The other ground was standing. In this connection, the court noted that dismissal could be affirmed if none of the plaintiffs had standing to sue, but it noted also that the change in malpractice coverage had increased costs for doctors and that no one was more directly injured by a conspiracy among insurance sellers than those who purchased insurance. Concluding that the doctors had standing, the court found it unnecessary to decide whether the patients also had standing. *Id.* at 12 n.7.

ous on its face, the court concluded there was no need to rely on its legislative history.¹⁹

I. THE SCOPE OF SECTION 1013(b)—INCONSISTENT JUDICIAL PRECEDENT

The first successful antitrust action against the insurance industry was *United States v. South-Eastern Underwriters Association*,²⁰ in which the Supreme Court held that the Sherman Act would prohibit an association of insurance companies from conspiring to fix rates and commissions and from engaging in boycotts and other types of coercion against nonmember companies and their customers.²¹ Less than a year after this decision, Congress enacted the McCarran-Ferguson Act which largely overruled *South-Eastern* and, in effect, left the industry subject to antitrust regulation only through section 1013(b). The Act declared that state regulation of insurance was in the public interest. In order to provide the states with both incentive and time to enact their own taxing and regulatory laws, it established a three-year moratorium²² during which federal antitrust laws were to be inapplicable to the industry. At the end of this period, the antitrust laws would apply to the insurance business, but only to the extent it was not regulated by state law. Through section 1013(b), however, the Sherman Act would continue to reach the industry regardless of state regulation, if insurers engaged in the specifically forbidden acts.²³

The narrow construction of section 1013(b), upon which the lower court in *Barry* relied, seems to have been first suggested by the United States District Court for the District of Oregon in *Transnational Insur-*

19. *Id.* at 7-8. Judge Campbell, in dissent, agreed with the majority that reliance on legislative history was unnecessary, but he noted nevertheless that explicit support could be found in that history for the lower court's interpretation of § 1013(b). To avoid the ambiguity of the history, however, he grounded his support of the district court's ruling primarily on statutory construction and administrative concerns. *Id.* at 14-15. See notes 62-69 & accompanying text *infra*.

20. 322 U.S. 533 (1944). In *South-Eastern*, the Supreme Court held that the business of insurance was interstate commerce and, therefore, subject to federal regulation. For more than 70 years before this ruling, the highest court had held that insurance was not interstate commerce. Those earlier decisions are surveyed in Powell, *Insurance as Commerce*, 57 HARV. L. REV. 937 (1944).

21. 322 U.S. at 562.

22. The moratorium was later extended for an additional six months by the Act of July 25, 1947, Pub. L. No. 80-238, ch. 326, 61 Stat. 448 (1947).

23. For background information on the enactment of the McCarran-Ferguson Act, see 3 H. TOULMIN, TREATISE ON ANTI-TRUST LAWS OF THE UNITED STATES § 22.2 (1949 & Supp. 1976). See also VON KALINOWSKI, *supra* note 3.

ance Co. v. Rosenlund.²⁴ The dispute in *Transnational* centered around an agreement whereby the defendants organized and operated a general agency to solicit and underwrite the plaintiff's mobile home insurance. When the agency was later sold to another insurer and the defendants channeled to it nearly all the insurance business previously handled by the plaintiff, *Transnational* charged them with boycotting and other antitrust violations.²⁵ The court considered whether *Transnational's* boycott allegations were sufficient to trigger section 1013(b), thus removing the McCarran-Ferguson Act's antitrust immunity. After a detailed consideration of the meaning of the word "boycott," the court granted the defendants' motion for summary judgment, finding no evidence of boycott, coercion, or intimidation.²⁶ In dicta, however, the court suggested that a narrow construction of section 1013(b) based on the Act's legislative history might provide another ground for dismissal.²⁷

24. 261 F. Supp. 12 (D. Ore. 1966).

25. *Id.* at 25. In addition to the antitrust claim, *Transnational* charged breach of contract and unjust enrichment. *Id.* at 18-19.

26. *Id.* at 28. Judge Kilkenny, writing for the court, observed that the Irish originated the character for whom the term "boycott" was named and referred to a discussion of the origin of the name included in *State v. Glidden*, 55 Conn. 46, 8 A. 890, 896 (1887). "To fall within the generally accepted meaning of boycott, [he concluded] there must be . . . a concerted refrainment from business relations with another or . . . a concerted persuasion of third persons outside of the combination to so refrain." 261 F. Supp. at 28.

27. *Id.* at 26. The court stated:

It would seem that the Congress, when enacting the McCarran-Ferguson Act, was concerned with an activity which is not here indicated. The legislative history shows that the boycott, coercion and intimidation exception, was placed in the legislation to protect insurance agents from the issuance by insurance companies of a "black-list," which would name companies or agents which were beyond the *pale*. This list, in effect, was a directive to an agent not to write insurance in the name of or for the black-listed company; otherwise, he would be stripped of his agency and not permitted to write insurance for any of the members of the governing organization of insurance companies.

Id. (Emphasis in original). To support this interpretation of the legislative history, the court cited one page from the *Congressional Record* during House debate on the bill (S. 340) that was to become the McCarran-Ferguson Act, 91 CONG. REC. 1087 (1945). *Id.* at 27 n.1. The court provided no explanation for singling out one page from the more than 30 pages comprising congressional debate leading to passage of the Act. Debate on the bill is reported in 91 CONG. REC. 478-88 (1945) (Senate) and 91 CONG. REC. 1085-93 (1945) (House). Although the House adopted the conference report by voice vote with no debate, 91 CONG. REC. 1396 (1945), the Senate debated the report at some length before adopting it by a vote of 68-8, 91 CONG. REC. 1442-44, 1474, 1477-89 (1945).

The statement of Mr. Celler, which appears on the single page cited, was aimed at convincing the House that the Senate-passed bill was preferable to the bill reported by the House Judiciary Committee because it made the Sherman Act applicable to agreements as well as acts of boycott, coercion, or intimidation. The House bill omitted the word "agreement," leaving only acts within reach of the Sherman Act. Mr. Celler's reference to blacklisting of small companies and agents was made to illustrate for his colleagues the importance of amending the bill, and it is clear from his remarks that such blacklisting was

This dicta was substantially reinforced in *Meicler v. Aetna Casualty & Surety Co.*,²⁸ when the United States District Court for the Southern District of Texas relied on the *Transnational* version of the legislative history to dismiss a claim brought by consumers against automobile liability insurers. The plaintiffs, whose insurer had reclassified them in a higher risk category upon expiration of their policy, attempted to purchase coverage from other companies at their former rate. They soon found, however, that no one would sell them insurance at this price, and accordingly they brought suit alleging a concerted refusal to deal in violation of the Sherman Act.²⁹ The court found that since the state of Texas regulated auto insurance rates and rate classifications, the anti-trust claim would be barred by the McCarran-Ferguson Act unless the Meiclars could find shelter in section 1013(b). Noting that no authority could be located for applying the section in the context of company relations with policyholders, the court quoted from the *Transnational* court's version of the legislative history to support its holding that the section was inapplicable. Further, in the court's view, if the Meiclars' allegations were to fall within the section's purview, the intent of the Act would be subverted.³⁰ It reached this conclusion by reasoning that the purpose of the Act was to exempt insurance from federal antitrust laws insofar as the industry was regulated by the states. Accordingly, because Texas regulated rate classifications and rate setting, federal antitrust laws could not be used to attack them. Thus the court dismissed the case for failure to state a claim upon which relief could be granted.³¹

This dismissal is in accord with the McCarran-Ferguson Act, for both the Act and the legislative history indicate that a major purpose in its enactment was to allow state-regulated rate fixing.³² While it reached the

a serious concern of the Justice Department and many members of Congress. It is not clear, however, that he or any other representative thought that only blacklisting of this sort should fall within the scope of the boycott exception. Years later, Mr. Celler stated that his "entire purpose" in urging this amendment had been to broaden and not to restrict the applicability of the Sherman Act. 120 CONG. REC. 37,352 (1974).

28. 372 F. Supp. 509 (S.D. Tex.), *aff'd*, 506 F.2d 732 (5th Cir. 1975).

29. 372 F. Supp. at 511. The Meiclars filed a class action suit against all liability insurers licensed to do business in the state. *Id.* at 510.

30. *Id.* at 514.

31. *Id.*

32. That the Act allowed rate fixing was the subject of considerable discussion at the time Congress was considering its enactment. *See, e.g.*, 91 CONG. REC. 1481 (1945) (exchange between Senator Ferguson, one of the bill's co-sponsors, and Senator Pepper during debate preceding adoption of the conference report). Senator Ferguson stated that the bill was intended to permit rating bureaus so long as they were regulated by the states. When asked if the bill permitted rate fixing, Senator Ferguson said, "Yes. There is no doubt that the bill allows it. . . ." In this colloquy he emphasized that the bill would not allow private agreement, but only those regulated by the states. *Id.*

correct result, the *Meicler* court based its ruling on shaky ground. Rather than holding that state-regulated rates and classifications did not constitute an agreement or an act of boycotting within the scope of section 1013(b), the court resurrected the *Transnational* court's version of the legislative history to justify a broader conclusion that the section was inapplicable to policyholders. On appeal, the Fifth Circuit approved this historical reading and affirmed the lower court's holding that the boycott exception did not apply to the Meiclars' claim.³³ The appellate court emphasized that to hold otherwise would "emasculate" the McCarran-Ferguson Act, which left the states in charge of relations between policyholders and insurance companies.³⁴

While the problem with *Meicler* lies not so much in the result as in the imprecision of the court's analysis, the same cannot be said of *Addrisi v. Equitable Life Assurance Society of the United States*,³⁵ in which the Ninth Circuit applied a logical, precise analysis to an antitrust claim, but, because of its reliance on the *Meicler* and *Transnational* courts' interpretation of the legislative history, arrived at a surprising conclusion. The challenged practice in *Addrisi* was the defendant life insurance company's offer of loans to prospective policyholders at interest rates below the prevailing ones. As security for such a loan, the borrower was required to purchase a high-cost life insurance policy from the defendant. Addrissi applied for an Equitable loan and claimed he was coerced into purchasing a policy which cost him \$864 more than the cost of the usual type of life insurance policy.³⁶ The Ninth Circuit held that there was no need to consider whether Addrissi's allegations of economic coercion fit within the meaning of the words "acts of coercion" as used in section 1013(b), because the legislative history showed that this section was intended to be applied only to the narrow area of boycott or

33. 506 F.2d 732, 734 (5th Cir. 1975). Interestingly, the Fifth Circuit, in its affirmance, seems to have narrowed the judicial construction of § 1013(b) beyond that of the lower court. The district courts stated that the section was designed "primarily" to deal with insurance company blacklists of other insurers and agents, while the appellate court omitted the word "primarily," stating that the boycott exception was designed to reach the blacklisting situation. *Id.*

34. *Id.* at 734-35. This concern that § 1013(b) would nullify the antitrust immunity granted by the Act unless it were narrowly construed was also raised by the defendants in *Barry*. They stated that if policyholders were included within the section's scope, it would be difficult to conceive of any alleged antitrust violation relating to the insurance contract or the insurer-insured relationship that could not be pleaded as a "boycott," or as involving "coercion" or "intimidation." Brief for Appellees at 21, *Barry v. St. Paul Fire & Marine Ins. Co.*, 555 F.2d 3 (1st Cir.), *cert. granted*, 98 S. Ct. 391 (1977).

35. 503 F.2d 725 (9th Cir. 1974), *cert. denied*, 420 U.S. 929 (1975).

36. 503 F.2d at 726.

coercion among insurance companies and agents. It was enough for the Ninth Circuit to consider what class of persons or "business relationship" is protected from acts of coercion by operation of the section. On that ground alone, it held that *Addrisi*'s claim must be dismissed.³⁷

Thus, while the Fifth Circuit in *Meicler* was not quite explicit as to whether its holding could rest solely on the fact that state-regulated rate fixing was permitted by the McCarran-Ferguson Act, and did not, therefore, constitute boycotting within the meaning of the Act's boycott exception, or whether it must rest also on the interpretation of the Act's legislative history that only blacklisted companies and agents were intended to have the protection of section 1013(b), the Ninth Circuit in *Addrisi* was perfectly clear. Although claiming reliance on *Transnational* and the district court holding in *Meicler*,³⁸ the Ninth Circuit went a step further by ruling that the section could be found inapplicable regardless of the substance of the allegation if the claim were brought by anyone other than an insurance company or agent. Neither of the earlier cases had explicitly held that dismissal would follow from a mere examination of the class of persons involved. The holding in *Transnational* rested on insufficient evidence of a boycott, and the question of the class was considered only in dicta.³⁹ In *Meicler*, the court appeared to confuse the separate issues of class and lack of evidence of a boycott, and its holding does not specifically rest on one or the other, but seemingly on both as if they were one.⁴⁰ Unlike the Fifth Circuit's blurred vision in *Meicler*, the Ninth Circuit's reasoning in *Addrisi* is precise, but it is altogether dependent upon the weak foundation of the *Transnational* court's view of the legislative history. In the wake of *Meicler* and *Addrisi*, a number of district courts faced with section 1013(b) antitrust suits against insurance companies have simply dismissed them on the ground that this section is to be narrowly applied to protect only insurance companies and agents from blacklisting.⁴¹

37. *Id.* at 729.

38. When the Ninth Circuit decided *Addrisi*, the Fifth Circuit had not yet affirmed the lower court's holding in *Meicler*.

39. 261 F. Supp. at 27.

40. 506 F.2d at 734.

41. See, e.g., *Pierucci v. Continental Cas. Co.*, 418 F. Supp. 704 (W.D. Pa. 1976) (section only applies to acts of coercion not involving interaction between a company and its policyholders); *McIlhenny v. American Title Ins. Co.*, 418 F. Supp. 364 (E.D. Pa. 1976) (section meant to cover narrow area of activity totally foreign to policyholder suit); *Royal Drug Co. v. Group Life & Health Ins. Co.*, 415 F. Supp. 343 (W.D. Tex. 1976), *rev'd on other grounds*, 556 F.2d 1375 (5th Cir. 1977), *cert. granted*, 46 U.S.L.W. 3536 (U.S. Feb. 28, 1978) (No. 77-952) (sole purpose of exception is to protect against issuance of blacklists naming insurance companies or agents); *Seasongood v. K & K Ins. Agency*, 414 F. Supp. 698 (E.D. Mo. 1976), *rev'd on other grounds*, 548 F.2d 729 (8th Cir. 1977)

Despite the apparent readiness with which the courts have adopted the *Meicler-Addrisi* formula for dismissal, some notable exceptions have occurred. For example, in *Battle v. Liberty National Life Insurance Co.*⁴² the Fifth Circuit held that under section 1013(b) several funeral homes were entitled to a hearing on the merits of their allegations against a life insurance company and its wholly owned subsidiary which contracted for funeral services for holders of the company's burial insurance.⁴³ While the court did not elaborate on the reasoning behind its ruling on the boycott exception, it was clearly influenced by the gravity of the plaintiffs' allegations, which included threats of physical violence and cancellation of insurance contracts, as well as threats to build funeral homes in competition with those operated by the plaintiffs.⁴⁴

Similarly, in *Ballard v. Blue Shield*,⁴⁵ the Fourth Circuit held that six West Virginia chiropractors were entitled to use section 1013(b) to assert antitrust claims against insurance companies which refused to extend health insurance coverage for chiropractic services.⁴⁶ The *Ballard* court, like the *Battle* court, seemed impressed with the plaintiffs' allegations. Even though the chiropractors' complaint did not use the term "boy-

(legislative history shows the section is to be narrowly applied to blacklisting); *Mathis v. Auto. Club Inter-Ins. Exch.*, 410 F. Supp. 1037 (W.D. Mo. 1976) (section not applicable to boycott of policyholders); *Mitgang v. Western Title Ins. Co.*, 1974-2 Trade Cas. ¶ 75,322 (N.D. Cal. 1974) (boycott exception has a very narrow meaning).

In another line of cases, the courts have not found it necessary to decide whether the plaintiffs belong to the class of persons protected by § 1013(b), and have instead grounded their dismissals on insufficient evidence of boycott. *See, e.g., Frankford Hosp. v. Blue Cross*, 554 F.2d 1253 (3d Cir. 1977), *cert. denied*, 98 S. Ct. 186 (1977) (assuming *arguendo* that the section applies, no triable issue of material fact exists as to alleged boycott); *Travelers Ins. Co. v. Blue Cross*, 481 F.2d 80 (3d Cir.), *cert. denied*, 414 U.S. 1093 (1973) (even if antitrust exemption not applicable, no evidence of antitrust violations). *But see Proctor v. State Farm Mut. Auto. Ins. Co.*, 561 F.2d 262 (D.C. Cir. 1977) (section applicable to plaintiff auto repairers, but evidence of a boycott is insufficient).

42. 493 F.2d 39 (5th Cir. 1974), *cert. denied*, 419 U.S. 1110 (1975).

43. 493 F.2d at 51.

44. *Id.* The plaintiffs in *Barry* placed great reliance on *Battle*, which they said stood for the proposition that:

in a case other than one solely involving the blacklisting of insurance companies and/or agents by other insurance companies, any preponderant proof of boycott, coercion, or intimidation on the part of the Defendant insurance companies would eviscerate the application of those provisions of the McCarran Act which generally serve to preclude and prohibit federal court antitrust litigation against so-called "national" insurance companies.

Brief for Appellants at 53, *Barry v. St. Paul Fire & Marine Ins. Co.*, 555 F.2d 3 (1st Cir.), *cert. granted*, 98 S. Ct. 391 (1977).

45. 543 F.2d 1075 (4th Cir.), *cert. denied*, 97 S. Ct. 1341 (1977).

46. *Id.* at 1077.

cott," the Fourth Circuit found that the allegations were sufficient to charge a boycott in violation of the Sherman Act, thus triggering section 1013(b) of the McCarran-Ferguson Act.⁴⁷ Neither the Fourth Circuit in *Ballard*, nor the Fifth Circuit in *Battle* mentioned the class of persons meant to be protected by the boycott exception, a factor which had been so important to the Ninth Circuit in *Addrisi*. Rather, they looked directly to the sufficiency of the plaintiffs' allegations of coercive acts and concluded in each case that such charges were sufficient to state a cause of action under section 1013(b). Had the Ninth Circuit's reasoning in *Addrisi* been applied to *Battle* or *Ballard*, arguably both the funeral homes and the chiropractors would have been out of court solely because neither was within the class of persons meant to be protected by the boycott exception.⁴⁸

II. SECTION 1013(b): A STRAIGHTFORWARD INTERPRETATION

Given the inconsistent and inconclusive precedent concerning the scope of section 1013(b), the First Circuit initiated a much needed review of both the case law and the legislative history of the McCarran-Ferguson Act. As a result, it has suggested a clearer direction for the future. In holding that antitrust principles apply to the relationship between the insured and the insurer under section 1013(b), the First Circuit in *Barry* relied on statutory construction buttressed by historical considerations and public policy. Before analyzing the legislative history, which the *Transnational* court had suggested as rationale for confining the section to the narrow area of certain blacklisting activities, the court first considered the possible consequences of applying the section to policyholders. Allowing consumers the protection of the boycott exception would not, in the court's view, vitiate the McCarran-Ferguson Act.⁴⁹ Instead it believed that the protection afforded the industry by the Act would remain strong. To illustrate, the court noted that state tax and regulatory programs would remain protected from challenges based on the dormant commerce clause,⁵⁰ that the industry would continue to be immune from

47. *Id.* at 1078.

48. See notes 35-38 & accompanying text *supra*. In *Barry*, the district court pointed out that the plaintiffs in *Battle* were not policyholders, and if there was any inconsistency between the Fifth Circuit's holding in *Battle* and its ruling in *Meicler*, the latter must be read as implicitly overruling *Battle* since it was decided a year later. *Barry v. St. Paul Fire & Marine Ins. Co.*, No. 75-176, slip op. at 12 (D.R.I. Nov. 19, 1975).

49. 555 F.2d at 8. See text accompanying notes 29-31 *supra*. See also notes 62-63 & accompanying text *infra*.

50. U.S. CONST. art. 1, § 8, cl. 3.

federal regulatory statutes other than the Sherman Act,⁵¹ and that not every Sherman Act violation would fall within the rubric of "boycott, coercion or intimidation."⁵² Furthermore, the First Circuit found that allowing consumers a right of action under the section would be in keeping with the modern trend toward narrowing exceptions to the general rule favoring free competition.⁵³ In a brief consideration of possible unfairness to the industry, which had perhaps come to rely on a narrow judicial interpretation excluding policyholders from section 1013(b), the court found that this construction of the Act was a relatively recent one and consequently it was due no special respect based on longevity.⁵⁴ In addition, the *Barry* court disagreed with the industry's claim that injecting antitrust principles into dealings between policyholders and insurers would disrupt state regulatory functions, finding to the contrary that state regulation would be protected while concerted boycotts against consumers which did not rest on state authority would have no antitrust immunity.⁵⁵

Having thus demonstrated that the inclusion of policyholders within the scope of section 1013(b) would not have disastrous consequences, the First Circuit then narrowed its focus to the statutory language of the

51. 555 F.2d at 8. Only the Sherman Act is made applicable through § 1013(b), so the industry remains immune from attacks under the Clayton and Federal Trade Commission Acts. *Id.*

52. *Id.*

53. *Id.* at 9. To support this point, the court cited *Cantor v. Detroit Edison Co.*, 428 U.S. 579 (1976) ("state action" exception narrowed); *Goldfarb v. Virginia State Bar*, 421 U.S. 773 (1975) ("learned profession" exception questioned); *United States v. International Boxing Club of N.Y., Inc.*, 348 U.S. 236 (1955) (refusing to extend "baseball" exemption to boxing); *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 U.S. 384 (1951) (narrow view of "fair trade" exception). *Id.*

Among commentators calling for reducing the antitrust immunity of the insurance industry are: L. Hamric, *The McCarran-Ferguson Act: A Time for Procompetitive Reforms*, 29 VAND. L. REV. 1271 (1976); G. Nedrow, *The McCarran Act's Antitrust Exemption for "The Business of Insurance": A Shrinking Umbrella*, 43 TENN. L. REV. 329 (1976). See also Note, *Insurance Regulation and Antitrust Exemptions: McCarran-Ferguson, the Boycott Exception, and the Public Interest*, 27 RUTGERS L. REV. 140 (1973). In addition, both the Federal Trade Commission and the Justice Department have questioned the industry's immunity. J. Carper, *Insurance: Federal Investigators Press Life Insurance Firms on Overpricing, Hidden Costs, Antitrust*, Wash. Post, Oct. 2, 1977, § C, at 1, col. 3.

54. 555 F.2d at 7.

55. *Id.* at 8-9. In the court's view, § 1013(b) merely neutralized the McCarran-Ferguson Act's grant of antitrust immunity, "leaving intact" the state action doctrine of *Parker v. Brown*, 317 U.S. 341 (1943), which grants antitrust immunity to the states. Indeed, the court suggested that *Parker* may have added strength in the insurance field because of the policies reflected in the McCarran-Ferguson Act. Regulation by the states would be protected, but concerted boycotts against consumers not resting on state authority would have no immunity. *Id.*

section. It concluded that there was no ambiguity or unworkability in the statutory language, and that as a result it could see no justification for probing the legislative history of the Act.⁵⁶ The Court construed the statute as being plainly applicable to *any* agreement or act of boycott, and noted that a narrow construction confining the boycott exception to insurance blacklisting situations was a purely artificial one which could only be characterized as a judge-made expansion of the McCarran-Ferguson Act.⁵⁷ However, in deference to all the courts that had relied on the legislative history for a special interpretation of the section, the court carefully reviewed the Act's history, beginning with the landmark *South-Eastern* decision in 1944.⁵⁸

The First Circuit traced the bill that was to become the McCarran-Ferguson Act from the time it first passed the Senate until the conference report was adopted. It noted that on two occasions the language of the boycott exception was modified, and that each time the result had been to broaden, not narrow, the scope of the section.⁵⁹ Although it acknowledged that at no time during the congressional debates were any remarks directed toward the possibility of boycotts aimed at consumers, the First Circuit refused to find this silence a justification for the lower court's interpretation. Instead, the appellate court reasoned that the legislative history did not demonstrate a clear intent on the part of Congress to limit the boycott exception to acts or agreements affecting the relationships between insurance companies and their competitors and agents.⁶⁰ The court concluded that absent this clear showing, the plain meaning of the statutory language, the nation's strong commitment to a free marketplace, and the substantial antitrust immunity provided by the Act all combined to support its holding that policyholders were entitled to the section's protection.⁶¹

56. *Id.* at 9.

57. *Id.*

58. See notes 20-21 & accompanying text *supra*.

59. 555 F.2d at 10. See note 27 *supra*.

60. 555 F.2d at 12.

61. *Id.* at 11. While the court did not press the point, it observed that the words "boycott, coercion, or intimidation" were traceable to the *South-Eastern* decision, a case that involved evidence of threats and boycotts directed against policyholders. Accordingly, it reasoned that boycotts of consumers were not unknown to the drafters of the McCarran-Ferguson Act. Further, since the insurance industry participated actively in drafting the Act, its representatives could have written the boycott exception more specifically if the intent were to cover only a narrow area of boycotts. *Id.* While it is true that *South-Eastern* involved boycotts of policyholders and that the industry drafted the bill that became the McCarran-Ferguson Act, it is somewhat questionable to conclude that the industry's representatives could have drawn the boycott exception more narrowly. Their original goal had been enactment of a measure granting complete antitrust immunity,

Although it found that the clear statutory language of section 1013(b) made resort to legislative history unnecessary, the First Circuit's meticulous review of the history set in perspective the questionable foundation upon which the narrow reading of the section had rested. Judge Campbell dissented, subscribing to the view that the section excluded policyholders. In an attempt to marshal justifications other than legislative history to support this position, he suggested that administrative considerations and the possible disruption of state regulatory policies were appropriate,⁶² but he concentrated particularly on the relationship between the grant of antitrust immunity provided by section 1012 and the exception provided by section 1013(b). The statutory positioning of the exception after the grant of immunity indicated to Judge Campbell that it should be construed in a manner complementary to, rather than subversive of, the major premises of the Act.⁶³ The majority's interpretation of section 1013(b), in his view simply reintroduced by the back door much of the federal antitrust law eliminated by section 1012.⁶⁴ Although this argument seemed plausible to Judge Campbell, as it did to earlier courts facing the issue,⁶⁵ it failed to consider the meaning to be accorded the words "boycott, coercion or intimidation." Finding policyholders entitled to sue insurance companies under the boycott exception did not decide the question of whether there was sufficient evidence of forbidden conduct to establish a Sherman Act violation through section 1013(b) of the McCarran-Ferguson Act. The legislative history quoted by the majority made it clear that Congress intended to permit certain agreements and combinations in the insurance industry which it found to be in the public interest, for example, state-regulated rating bureaus, but did not intend to permit private unregulated agreements and combinations which were not in that interest.⁶⁶ Thus, only if the courts were to disregard completely this distinction, which lies at the

but opposition in the Senate resulted in the compromise measure that finally passed. For congressional objections to the earlier bill granting complete immunity, see the minority views of Senator O'Mahoney in S. REP. NO. 1112, 78th Cong., 2d Sess. (1944). For arguments of the industry in support of complete immunity, see *Joint Hearings Before the Subcomm. of the Comm. on the Judiciary on S. 1362, H.R. 3269, and H.R. 3270*, 78th Cong., 1st & 2d Sess. (1943-44).

62. 555 F.2d at 14-15 (Campbell, J., dissenting). The judge noted that the legislative history was capable of being argued both ways and that he did not choose to enter this arena. Instead, he worried about burdening the courts with a new category of antitrust suit, as well as the potential for conflict between federal antitrust policies and state regulation. *Id.* at 15.

63. *Id.*

64. *Id.* at 14-15.

65. See note 34 & accompanying text *supra*.

66. See, e.g., remarks of Senator O'Mahoney, *quoted in* 555 F.2d at 10-11.

very heart of the Act, would section 1013(b) let in by the back door the very antitrust activity section 1012 eliminated.⁶⁷

The dissent also suggested that the meaning of "boycott" in section 1013(b) must have a different meaning from the use of this same term in the context of the Sherman Act, since the language in the section did not follow the broad "contract, combination . . . or conspiracy" language of the Sherman Act.⁶⁸ In support of this view, Judge Campbell stated that Congress would have used the same language if it had intended the boycott exception in the McCarran-Ferguson Act to be broadly construed.⁶⁹ The majority, however, disagreed, noting that in antitrust law a boycott is a "concerted refusal to deal," and that precedent existed for the proposition that a boycott of consumers is a boycott for antitrust purposes.⁷⁰ There is case authority to support both views⁷¹ and *Barry* is not dispositive of this question. However, by eliminating an artificially narrow interpretation that excluded policyholders as a class from the section's protection, *Barry* clears the way for a reasoned consideration of the meaning of the word "boycott" in section 1013(b).

III. CONCLUSION

Because of a restrictive judicial interpretation of section 1013(b) of the McCarran-Ferguson Act, policyholders have been unsuccessful in their efforts to charge insurers with federal antitrust violations. The decision in *Barry* narrows the scope of the industry's antitrust immunity by holding that consumers are not, as a class, automatically excluded from the section's protection. Courts faced with antitrust suits under section

67. See note 2 *supra*.

68. 555 F.2d at 14.

69. *Id.*

70. *Id.* at 7-8. As authority for the proposition that a boycott of consumers is a boycott for antitrust purposes, the court cited Washington State Bowling Proprietors Ass'n v. Pacific Lanes, Inc., 356 F.2d 371, 376 (9th Cir.), *cert. denied*, 384 U.S. 963 (1966). *Id.* at 8 n.4.

71. See, e.g., Monarch Life Ins. Co. v. Loyal Protective Life Ins. Co., 326 F.2d 841 (2d Cir.), *cert. denied*, 376 U.S. 952 (1964) (boycott exception covers all boycotts or agreements to boycott condemned by the Sherman Act); *accord*, Ballard v. Blue Shield, 543 F.2d 1075 (4th Cir. 1976) (boycotts condemned by Sherman Act are condemned by McCarran-Ferguson Act); Cooperativa de Seguros Multiples de Puerto Rico v. San Juan, 294 F. Supp. 627 (D.P.R. 1968) (meaning of "boycott" within McCarran-Ferguson Act not narrower than its meaning under Sherman Act); Professional & Bus. Men's Life Ins. Co. v. Bankers Life Co., 163 F. Supp. 274 (D. Mont. 1958) (exception in § 1013(b) applies to all boycotts). *But see* Proctor v. State Farm Mut. Auto. Ins. Co., 561 F.2d 262 (D.C. Cir. 1977) (boycott exception must be applied so as to accommodate the respective purposes of the antitrust exemption on the one hand, and the boycott exception to this exemption, on the other).

1013(b) will have a more difficult job if they follow *Barry*, however, for it will no longer be possible to take a short cut to dismissal based on the class of the plaintiffs. Instead, charges of illegal boycott will have to be considered on their merits, which has not been the case in policyholder-insurer antitrust suits to date. The First Circuit's holding suggests the possibility of a stronger antitrust role in insurance regulation and a greater opportunity for consumers, through antitrust suits, to participate in the regulatory process. In the long run, the significance of *Barry* will depend on how the courts resolve their differences as to the meaning of "boycott" in section 1013(b).

Sara Case

COMMUNICATIONS LAW—FCC Lacks Authority to Promulgate Rules Controlling Content of Cablecast Programming Unless Such Regulations Promote Objectives Previously Held Valid in the Regulation of Broadcast Programming. *Home Box Office, Inc. v. FCC*, 567 F.2d 9 (D.C. Cir.), *cert. denied*, 98 S. Ct. 111 (1977).

It has become judicially commonplace to describe the growth of cable television as explosive. This growth is reflected not only in the number of cable systems,¹ but also in the continually expanding variety of cable services.² Cable systems first appeared as Community Antenna Television (CATV), a system which generally delivered only the signals of

1. The first commercial Community Antenna Television (CATV) system went into operation in 1950. By 1952, there were 70 systems with a total of 14,000 subscribers. The number of systems had increased to 640 by 1960 and had reached 2,490 by 1970. In 1977, the estimated cable television audience was approximately 11,900,000 distributed among 3,801 systems. See TELEVISION DIGEST, INC., TELEVISION FACTBOOK NO. 46, at 73a-75a (1977); LaPierre, *Cable Television and the Promise of Programming Diversity*, 42 FORDHAM L. REV. 25, 29 (1973).

2. Early CATV systems could carry only a few channels, which were usually devoted to the retransmission of off-the-air television. In contrast, modern cable systems often have a capacity for over 20 channels, with the potential of carrying up to 80. The large number of available channels, coupled with the lower cost of transmitting over cable, make it feasible for a broader spectrum of interests to use television. Moreover, cable offers such sophisticated services as two-way communication and facsimile transmission which hold promise for the future. See SLOAN COMMISSION ON CABLE COMMUNICATIONS, ON THE CABLE: THE TELEVISION OF ABUNDANCE 36-42 (1971) [hereinafter Sloan Report]; R. SMITH, THE WIRED NATION 10-21 (1972); LaPierre, *supra* note 1, at 31-34.

distant broadcast stations to rural subscribers.³ Although this provided television service to many who would not have otherwise received it, the imported signals often drew audiences away from television stations which were struggling to establish themselves in rural areas. Consequently, these small broadcasters turned to the Federal Communications Commission (FCC) for protection. But, since the Communications Act of 1934⁴ did not contemplate the development of CATV, the Commission was initially hesitant to regulate cable television. As the complaints of broadcasters mounted, however, the FCC was able to establish a tenuous authority over cable systems based on the medium's close relationship to broadcast television.⁵ Cable television increasingly is moving away from strict dependence on over-the-air signals. Today, many systems originate, or "cablecast," their own programming in direct competition with broadcast television.⁶ The recent decision in *Home Box Office, Inc. v. FCC*⁷ indicates that this new manifestation of the cable explosion may take the medium beyond the Commission's regulatory grasp.

When it became apparent that cable systems would begin selling cablecast as well as retransmitted programming to their subscribers, the FCC feared that nationwide cable networks might one day grow rich enough to outbid broadcasters for the motion pictures and sports events which are a staple of advertiser-supported television.⁸ Hoping to prevent cable systems from siphoning⁹ away broadcast television's best programs, the Commission severely restricted the types of programming a cable system

3. The basic CATV system consists of a large, prominently placed antenna for capturing the signals of broadcasting stations, an amplifier, and a network of coaxial cable for delivering the signals to subscribers. It is also possible to transmit directly over a cable system from a studio, bringing viewers television without any use of the airwaves. See SMITH, *supra* note 2, at 10-21. The term "CATV" is usually applied to cable systems which only retransmit broadcast signals. "Cable television" is used to describe systems which provide other viewing services as well. See Cable Television Report and Order, 36 F.C.C.2d 143, 144 n.9 (1972).

4. 47 U.S.C. §§ 151-609 (1970).

5. See *United States v. Midwest Video Corp.*, 406 U.S. 649 (1972); *United States v. Southwestern Cable Co.*, 392 U.S. 157 (1968).

6. As of Sept. 1, 1976, 2,404 cable systems were engaged in some form of cablecasting. About half of these offered only automatic originations, such as a channel devoted solely to showing a news wire service teletype. Other systems carry more varied fare including motion pictures or taped programs. Only 303 systems offer a pay cable channel. TELEVISION DIGEST, INC., TELEVISION FACTBOOK No. 46, 75a (1977).

7. 567 F.2d 9 (D.C. Cir.), *cert. denied*, 98 S. Ct. 111 (1977).

8. See Memorandum Opinion & Order, 23 F.C.C.2d 825, 827-29 (1970).

9. The Commission coined the term "siphoning" to describe the buying away of programs from conventional television broadcasters by competing media. Sometimes the word "migration" is used for the same purpose. See *Home Box Office, Inc. v. FCC*, 567 F.2d 9, 21 n.20 (D.C. Cir.), *cert. denied*, 98 S. Ct. 111 (1977).

could carry.¹⁰ Home Box Office, Inc., a company supplying motion pictures to cablecasters, petitioned the FCC for a waiver of the restrictions so that it could release a film over which it had acquired the cable rights.¹¹ The Commission denied the petition¹² and Home Box Office appealed to the United States Court of Appeals for the District of Columbia Circuit.¹³

The court held that although the FCC could assert jurisdiction over cable television under the Communications Act,¹⁴ it could not promulgate the rules in question without showing that it was advancing some regulatory policy either set forth in the Act itself or recognized as a long-established goal in the field of broadcasting.¹⁵ In the court's view, none of the justifications offered by the Commission met these standards.¹⁶ Accordingly, the programming restrictions were declared invalid as applied to cable television. The District of Columbia Circuit further warned that even if the anti-siphoning rules could pass this threshold test, they

10. The rules introduced by the Commission precluded cable systems from exhibiting feature films which had been in general release for more than two years, but less than ten years, and from cablecasting live sports events which had been shown over conventional broadcast television in the previous two years. Other provisions restricted cable systems from carrying series-type programs, limited the percentage of total programming which could be devoted to feature films and sports events, and forbid advertising on cable channels for which a separate fee is charged. See Memorandum Opinion & Order, 23 F.C.C.2d 825, 830-31 (1970).

11. See Home Box Office, Inc., 51 F.C.C.2d 317 (1975). Home Box Office's main argument for waiver was that the American Broadcasting Co. had already secured the broadcast rights to the film so there was no danger that viewers of conventional television would be prevented from seeing the film. *Id.* at 318.

12. The FCC refused to grant the waiver absent a showing that the public interest would benefit. *Id.* at 322.

13. Jurisdiction for the appeal was based on 47 U.S.C. § 402 (1970) and 28 U.S.C. § 2342(1) (1970) which provide that appeals of FCC orders may be taken to the United States Court of Appeals for the District of Columbia Circuit.

While the *Home Box Office* appeal was pending, the Commission announced its general policy and regulations on cablecast television in the First Report & Order, 52 F.C.C.2d 1 (1975). The new regulations relaxed the film restrictions somewhat, allowing cable operators to show motion pictures which had been in general release for up to three years, but they also tightened the sports rules by forbidding cablecasters from carrying sports events which had appeared on conventional television in the preceding five years. See 52 F.C.C.2d at 70-72. Various parties appealed these orders, and their petitions were joined with the *Home Box Office* case. *Home Box Office, Inc. v. FCC*, 567 F.2d 9, 17-18 (D.C. Cir.), cert. denied, 98 S. Ct. 111 (1977).

14. 47 U.S.C. § 152(a) (1970) provides that provisions of the Act will be applied to all interstate communications by wire.

15. 567 F.2d at 28.

16. The FCC argued that it had a duty to maintain the current level of program quality on conventional television and that broadcasting generally deserved protection because it is the superior form of television service. *Id.* at 28-29.

would probably still run afoul of the first amendment, since the FCC's traditional authority to limit program content in the public interest could only operate if the communicator was using the broadcast spectrum.¹⁷

I. CABLE, THE COMMISSION, AND THE COURTS

At least some of the credit for cable television's rapid expansion should go to the FCC, whose policies may have inadvertently touched off the cable explosion. In 1948, when television was still largely an urban phenomenon, the Commission put an indefinite freeze on new broadcast licenses¹⁸ while it developed a better channel distribution plan. Although the action halted the spread of the new medium,¹⁹ the demand for television continued to increase and before long, the first community antenna systems were erected to bring television to those areas beyond the reach of existing stations.²⁰ The CATV idea spread quickly. There were seventy systems operating by 1952²¹ when the freeze was lifted and the new table of channel assignments was announced. The end of the licensing freeze, however, did not mean an end to CATV. Under the new allocation plan, most VHF channels were allotted to cities,²² leaving less populous areas with UHF frequencies which are more difficult to transmit.²³ The resulting situation inhibited the development of rural television and preserved a market for cable systems.

17. *Id.* at 43-51.

18. Report & Order (F.C.C. 48-2182, Sept. 30, 1948).

19. Under the Commission's original plan, television would only be broadcast on VHF frequencies. See Public Notice (June 27, 1946), reprinted in 39 F.C.C. 236 (1970). These channels (at that time VHF was limited to channels 1-13) were distributed according to a table of assignments which included only the 140 largest markets in the United States. See 47 C.F.R. § 3.606 (Supp. 1945) (current version at 47 C.F.R. § 73.606(b) (1976)). Applicants for stations outside these areas were required to show that their use of a channel would not interfere with any existing or future station. See 47 C.F.R. § 3.605 (Supp. 1945) (current version at 47 C.F.R. § 73.607 (1976)).

20. The first commercial CATV was erected by Robert J. Tarlton in Lansford, Pa., a small town in hilly country approximately 65 miles from Philadelphia. Tarlton had been selling television sets and hoped the system would stimulate demand for this product. See SMITH, *supra* note 2, at 3-4. A noncommercial CATV had been erected earlier in a mountainous area of Oregon. See La Pierre, *supra* note 1, at 29 n.19.

21. See TELEVISION DIGEST, INC., TELEVISION FACTBOOK NO. 46, 75a (1977).

22. See Sixth Report & Order, (Apr. 11, 1952), reprinted in 41 F.C.C. 148 (1970).

23. There are several difficulties involved in UHF broadcasting. Since more energy is required to generate and broadcast the higher frequencies, the UHF station operator will need a more powerful transmitter than his VHF counterpart. A UHF wave will dissipate its transmission energy faster than the VHF wave, thus limiting the distance over which it can be broadcast. In addition, the higher UHF frequencies tend to bounce off obstacles rather than curving around them, thus further restricting their range. See Sloan Report, *supra* note 2, at 15-20.

By the late fifties, broadcast television was making considerable headway outside the cities, but new broadcasters found CATV an unexpected source of audience competition. It was not unusual for viewers to prefer the variety of big-city stations brought by CATV to the limited fare offered by local stations. In *Frontier Broadcasting Co. v. Collier*,²⁴ several broadcasters in this predicament petitioned the FCC to declare CATV systems common carriers within the meaning of the Communications Act²⁵ and to adopt rules governing CATV operations. This proposed basis of jurisdiction was unacceptable to the Commission since, unlike traditional common carriers, the CATV operator had more control over the content of transmissions than his customer.²⁶ The FCC did subsequently conduct a more extensive inquiry into the CATV problem, although the resulting *Report and Order on CATV and TV Repeater Services*²⁷ merely reiterated the conclusion that CATV systems were outside the Commission's authority. During the CATV hearings, several new theories of jurisdiction were advanced, but all were rejected since they required either an extremely broad interpretation of the FCC's power or a redefinition of broadcasting to include CATV systems.²⁸

24. 24 F.C.C. 251 (1958).

25. Under 47 U.S.C. § 201 (1970), the Commission is empowered to regulate the charges and practices of common carriers engaged in interstate communications.

26. In the FCC's view, a common carrier supplied a means of communications and only transmitted matter which its customers requested. Although to some extent, a CATV system carried programming favored by its subscribers, the Commission found it significant that the final choice of material rested solely with the system operator. *Frontier Broadcasting Co. v. Collier*, 24 F.C.C. 251, 253-55 (1958).

27. 26 F.C.C. 403 (1959).

28. Four possible bases for jurisdiction were considered in the report:

1. CATV systems as common carriers: The Commission, however, affirmed its prior holding in *Frontier Broadcasting* that CATV systems could not be properly classified as common carriers.
2. CATV systems as persons engaged in broadcasting: In the FCC's view, however, broadcasting required that the medium of transmission be radio waves, not cable.
3. Under the Commission's "plenary power" over communications: Subparagraph (r) of § 303 of the Communications Act empowers the FCC to make such laws as necessary to carry out the aims of the Act. 47 U.S.C. § 303(r) (1970). The Commission, however, did not believe that this power extended to all enterprises having a nexus with the communications field.
4. Under the Commission's power to prevent the rebroadcast of signals: The Communications Act forbids stations from rebroadcasting the signals of other stations without permission. 47 U.S.C. § 325(a) (1970). It was argued that this section of the statute gave the FCC authority to prevent any reuse of broadcast signals. The Commission disagreed, believing that its authority was confined to actual rebroadcasting, as opposed to retransmission through cable.

See *Report & Order on CATV and TV Repeater Services*, 26 F.C.C. 403, 427-31 (1959).

Several years later, however, when stronger evidence that CATV competition could undermine a broadcast station was presented, the result was somewhat different. In *Carter Mountain Transmission Corp.*,²⁹ the Commission found a way to regulate cable systems indirectly. KWRB television, a broadcaster serving an area of Wyoming in conjunction with several CATV systems, demonstrated that it had only begun drawing large audiences when it started delivering a better picture over the air than viewers could pick up from the cable.³⁰ The station claimed that this competitive advantage would disappear if the CATV systems were able to take their distant signals from the microwave relay that the Commission had given Carter Mountain Transmission Corporation permission to build.³¹ On this evidence, the FCC withdrew Carter Mountain's microwave license until the company could show that none of the CATV systems planning to use the proposed facility would duplicate KWRB's programming.³² Carter Mountain appealed the ruling,³³ arguing that the first amendment prohibited the Commission from placing such restraints on the use of a communications instrument.³⁴ The argument, however, did not convince the District of Columbia Circuit, which held that the restrictions fell within the FCC's traditional licensing power. The court based its view on the general proposition that any form of radio transmission involves the use of a scarce resource—the electromagnetic spectrum—which, pursuant to the Communications Act, should only be licensed when the “public interest, convenience and necessity” will be served.³⁵ In the past, this spectrum scarcity rationale

29. 32 F.C.C. 459 (1962).

30. *Id.* at 462-64.

31. A microwave relay would pick up broadcast signals at a point close to their location and beam them directly to the CATV. Under this system, the signals would suffer less interference than if they were received over the usual community antenna. *See Report & Order on CATV and TV Repeater Services*, 26 F.C.C. 403, 409 (1959).

32. The Commission was convinced that KWRB's demise would be inevitable since the station was already in a precarious financial situation. The disappearance of KWRB would deprive its service area of its only source of locally oriented programming and would mean a total loss of television to those areas in which it would be uneconomical to run cable. The economic hardship of KWRB thus assumed the proportions of an injury to the public interest. *See Carter Mountain Transmission Corp.*, 32 F.C.C. 459, 464-65 (1962). *Cf. Carrol Broadcasting Co. v. FCC*, 258 F.2d 440 (D.C. Cir. 1958) (economic injury to existing broadcaster not relevant to new license application unless threat to public interest involved).

33. *Carter Mountain Transmission Corp. v. FCC*, 321 F.2d 359 (D.C. Cir.), *cert. denied*, 375 U.S. 951 (1963).

34. The company argued that its customers had the right to use the facility freely regardless of the competitive impact of their messages. *Id.* at 364.

35. *Id.* (citing *National Broadcasting Co. v. United States*, 319 U.S. 190, 227 (1943)). The D.C. Circuit did not engage in a lengthy discussion of spectrum scarcity. It merely

had been used to authorize various restrictions on broadcast content when the public interest was threatened.³⁶ In this case, the public interest was identified with the locally-oriented programming which KWRB alone provided and, in order to protect this public benefit, the court was willing to allow the FCC to regulate the content of Carter Mountain's transmissions.³⁷

Armed with the *Carter Mountain* decision, the FCC began restricting the signals that all microwave relay systems could sell to CATV systems.³⁸ Broadcast interests complained that they still faced a considerable audience-splitting threat from cable systems which did not use microwave feeds.³⁹ The Commission responded by applying the nonduplication requirements directly to CATV systems regardless of the method by which they received their signals.⁴⁰ Jurisdiction for the new rules depended on a finding that cable systems were engaged in "interstate communication by wire" and were therefore subject to the FCC's authority under the Communications Act.⁴¹ The restrictions on signals carried were justified as necessary to protect the system of television broadcasting the Commission had licensed.⁴² When the FCC began issu-

noted that although FCC licensing requirements may keep some communication off the air, they do not unconstitutionally deny free speech when the applicant fails to meet the standard of public interest, convenience, and necessity. *Id.* In *National Broadcasting Co.*, the Supreme Court had stated that:

Freedom of utterance is abridged to many who wish to use the limited facilities of radio. Unlike other modes of expression, radio inherently is not available to all. That is its unique characteristic, and that is why, unlike other modes of expression, it is subject to governmental regulation. Because it cannot be used by all, some who wish to use it must be denied.

319 U.S. at 226. See also Hoffer, *The Power of the FCC to Regulate Cable Pay-TV: Jurisdictional and Constitutional Limitations*, 53 DEN. L.J. 477, 491-92 (1976).

36. At issue in *National Broadcasting Co.* were regulations which limited the amount of network programming a radio station could carry. The Commission felt that the broadcasters' dependence on the networks was inhibiting the growth of locally responsive programming. 319 U.S. at 202-04. This spectrum scarcity argument was used most recently to uphold the FCC's fairness doctrine. 47 C.F.R. § 73.123 (1976). See *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 387-89 (1969).

37. *Carter Mountain Transmission Corp. v. FCC*, 321 F.2d 359, 364 (D.C. Cir.), cert. denied, 375 U.S. 951 (1963).

38. The regulations would have allowed microwave licensees to enter into contracts only with CATV systems which carried the signals of all the stations in whose broadcast contours they operated and which did not duplicate the programming of local stations in the other signals they carried. See *First Report & Order*, 38 F.C.C. 683, 741-46 (1965).

39. See *Notice of Inquiry & Proposed Rulemaking*, 1 F.C.C.2d 453 (1965).

40. See *Second Report & Order*, 2 F.C.C.2d 725 (1966).

41. 47 U.S.C. § 152(a) (1970) states that provisions of the Act will apply "to all interstate and foreign communications by wire." See *Second Report & Order*, 2 F.C.C.2d 725, 729 (1966).

42. Under 47 U.S.C. § 303(h) (1970), the Commission has the authority to "establish areas or zones to be served by any (broadcast) stations." 47 U.S.C. § 312(b) (1970) gives

ing cease and desist orders pursuant to these new rules, however, its authority was immediately challenged and eventually argued before the Supreme Court in *United States v. Southwestern Cable Co.*⁴³ The CATV interests in *Southwestern Cable* did not deny that they were engaged in interstate communication by wire, but urged that since cable systems were neither common carriers nor broadcasters they were not properly subject to the Communications Act.⁴⁴ The Supreme Court held that the Act could not be read so narrowly.⁴⁵ In the Court's view, the Commission must be allowed to issue CATV orders which are "reasonably ancillary" to the performance of its other duties under the Communications Act.⁴⁶ The Court noted that one of the FCC's primary duties is to provide a fair distribution of television service throughout the country.⁴⁷ Accepting the Commission's judgment that audience fragmentation caused by CATV systems was a genuine threat to the FCC's ability to provide such a system,⁴⁸ the Court approved the cease and desist order

the FCC the power to issue cease and desist orders to anyone who fails to observe a Commission regulation. The Commission construed this to mean that it had the power to prevent CATV systems from taking broadcast signals beyond their designated contours. See Second Report & Order, 2 F.C.C.2d 725, 729 (1966).

43. 392 U.S. 157 (1968). Midwest Television, Inc., owner of a San Diego broadcasting station, had petitioned the FCC to prevent several San Diego CATV systems, including Southwestern Cable Company, from importing the signals of Los Angeles stations. See Memorandum Opinion & Order, 4 F.C.C.2d 612 (1966). On appeal, the Ninth Circuit held that the Commission could not bring a cease and desist order against entities which it had not licensed. *Southwestern Cable Co. v. United States*, 378 F.2d 118, 123 (9th Cir. 1967), *rev'd*, 392 U.S. 157 (1968).

44. The FCC had already ruled that CATV systems were neither engaged in broadcasting nor functioning as common carriers. See notes 24-27 & accompanying text *supra*. This finding would exempt CATV systems from the major provisions of the Communications Act. See *United States v. Southwestern Cable Co.*, 392 U.S. at 171-72.

45. *Id.* at 172.

46. *Id.* at 178. The Court felt that in this instance the achievement of the agency's ultimate purpose was at stake. *Id.* at 177. The Court, however, emphasized that the FCC's authority over cable was "restricted to that reasonably ancillary to the effective performance of the Commission's various responsibilities for the regulation of television broadcasting." *Id.* at 178.

47. *Id.* at 173-74. The Court drew support for this policy from the Communications Act itself. See 47 U.S.C. § 307(b) (1970) (The Commission shall grant licenses so "as to provide a fair, efficient distribution" of service among "the several States and communities"). It was also felt that the congressionally approved policy of encouraging education and UHF stations was involved, since these stations would be particularly vulnerable to the audience-splitting effects of unregulated CATV systems. See 392 U.S. at 174-76.

48. The Court did not require the Commission to demonstrate conclusively that unregulated CATV growth would cause the collapse of broadcast television; rather it was satisfied that substantial evidence on the record showed that authority over cable communication was necessary for the Commission to fulfill its broadcast duties. *Id.* at 176-77.

issued to Southwestern Cable Company.⁴⁹

Even though the Supreme Court upheld the jurisdictional basis of the CATV regulations, the validity of the rules themselves were only considered at the circuit court level. The decisions in *Buckeye Cablevision, Inc. v. FCC*⁵⁰ and *Black Hills Video Corp. v. FCC*⁵¹ exemplify the circuit court approaches to the first amendment implications of the regulations.⁵² In both cases, cable companies challenged the constitutionality of the cable restrictions and, in each opinion, their claims were rejected with only brief discussion. In *Buckeye*, the District of Columbia Circuit held that the distant signal rules imposed no more restraint "than is reasonably required to effectuate the public interest requirements of the (Communications) Act."⁵³ The court ostensibly based its holding on *Carter Mountain*, although the spectrum scarcity underpinnings of that decision are difficult to analogize to cable transmissions which are carried over wire rather than airwaves.⁵⁴ In *Black Hills*, the Eighth Circuit similarly decided that first amendment objections could be overridden in the public interest, but went a step further, calling it irrelevant that CATV systems did not use the airwaves.⁵⁵ In its view, all that mattered was that CATV systems used radio signals and had a potentially adverse affect on broadcast television.⁵⁶

49. Justice White concurred in the result, although, in his opinion, the FCC had sufficient authority under §§ 301 and 303 of the Act to issue the cease and desist order in question. *Id.* at 181-82. See 47 U.S.C. §§ 301 (granting broad authority over broadcasting) and 303 (allowing the FCC to make regulations necessary to prevent interference between broadcast stations) (1970).

50. 387 F.2d 220 (D.C. Cir. 1967). *Buckeye* was an appeal of a cease and desist order. *Buckeye Cablevision, Inc.*, 3 F.C.C.2d 798 (1966). The case was decided before *Southwestern Cable* and was noted in that opinion. See *United States v. Southwestern Cable Co.*, 392 U.S. 157, 161 n.7 (1968).

51. 399 F.2d 65 (8th Cir. 1968).

52. Although the rules were considered by other circuit courts, those decisions generally relied upon *Buckeye* and *Black Hills*. See, e.g., *Total Telecable, Inc. v. FCC*, 411 F.2d 639 (9th Cir. 1969); *Titusville Telecable TV, Inc. v. United States*, 404 F.2d 1187 (3d Cir. 1968); *Conley Elect. Corp. v. FCC*, 394 F.2d 620 (10th Cir.), *cert. denied*, 343 U.S. 858 (1968).

53. 387 F.2d at 225.

54. The D.C. Circuit did not analyze the spectrum scarcity rationale in the cable television context, but merely held that *Carter Mountain* and *National Broadcasting Co.* were sufficient authority for the rules in question. *Id.* nn. 21 & 23.

55. 399 F.2d at 69. Petitioners in *Black Hills* were microwave-served CATV systems, so the first amendment issue involved the grant of a license. The Eighth Circuit, however, did not confine its discussion to the rights of microwave operators but also considered the problem from the CATV operators' viewpoint. *Id.*

56. *Id.* The Eighth Circuit cited no authority for this, but seemed to rely on *Southwestern Cable* which had recently been decided and appeared to indicate that the FCC could fully regulate CATV systems as long as they posed a threat to broadcast television. See note 47 *supra*.

It was not long before the FCC moved to expand its authority over CATV. Although the earlier cable regulation was intended solely to protect broadcasters, the Commission subsequently acted to require cable systems to provide the diversified programming and outlets for local expression that it had always sought in broadcast television.⁵⁷ These goals were to be achieved by compelling larger cable systems to begin originating their own programs.⁵⁸ In the FCC's view, this requirement would serve the public interest and provide an appropriate quid pro quo for cable television's continued use of broadcast signals.⁵⁹ As might be expected, the rules were challenged by cable interests. But in *United States v. Midwest Video Corp.*⁶⁰ the Supreme Court again upheld the Commission, albeit by a narrower margin. A plurality⁶¹ held that the origination requirements fell within the "reasonably ancillary" standard of *Southwestern Cable* since they furthered "the achievement of long-established regulatory goals in the field of television broadcasting."⁶² Chief Justice Burger concurred in the judgment, but only because he felt it inappropriate to review an agency policy decision.⁶³ He admitted, however, that he would prefer the Commission to base its policies on congressional mandate and characterized the existing rules as straining the outer limits of the FCC's judicially approved authority over cable television.⁶⁴

While *Midwest Video* advanced through the courts, the Commission moved to counter what it perceived as another of cable's potential

57. See First Report & Order, 20 F.C.C.2d 201 (1969).

58. The rules introduced in the new order precluded cable systems with over 3,500 subscribers from carrying broadcast signals unless the system also operated "to a significant extent as a local outlet" and maintained facilities for production and exhibition of programming. 20 F.C.C.2d at 223. These cablecasts would be subject to FCC broadcast rules such as the fairness doctrine, 47 C.F.R. § 73.123 (1976). See 20 F.C.C.2d at 223-25.

59. 20 F.C.C.2d at 208-09.

60. 406 U.S. 649 (1972).

61. Justice Brennan wrote an opinion in which Justices White, Marshall, and Blackmun joined. Justice Douglas wrote a dissenting opinion in which Justices Stewart, Powell, and Rehnquist joined. The deciding vote was cast by Chief Justice Burger in a concurring opinion.

62. 406 U.S. at 667-68. The plurality noted that the cablecasts mandated by the rules would not use the broadcast spectrum. Nevertheless, since the effect of the regulations was to provide viewers of retransmitted television with diversified programming, the rules were reasonably ancillary to the FCC's broadcast duties. *Id.* at 669.

63. *Id.* at 676. The Chief Justice did not necessarily think the rules unfair, feeling that the use of broadcast signals should make CATV systems subject to FCC regulation. *Id.*

64. Until Congress acted on the matter, the Chief Justice advocated giving the FCC some latitude in regulating cable television. *Id.* Justice Douglas, speaking for the dissenters, complained that the plurality was giving the FCC more power over cable television under the reasonably ancillary standard than the Commission had over broadcast television under the Communications Act. *Id.* at 681.

threats to broadcast television. Ironically, the new threat came from the cablecast programing the FCC had tried to foster in its *Midwest Video* rules.⁶⁵ Cable operators were beginning to show motion pictures and sports events over channels that subscribers could view by paying an extra fee.⁶⁶ The Commission feared that if cable systems acquired a large enough audience for the service, they would be able to outbid the networks for this type of programing, with a consequent lowering in the overall quality of broadcast television.⁶⁷ Similar fears had motivated the FCC to place severe restrictions on the kind of material over-the-air pay television could carry,⁶⁸ and it now imposed the same limits on "pay cable" programing.⁶⁹ The pay television rules had already withstood judicial scrutiny in *National Association of Theatre Owners v. FCC*,⁷⁰ but that opinion could provide no more than arguable support for pay cable rules.⁷¹ Though similar to the cable service, pay television stations use the airwaves⁷² and, therefore, must be licensed by the Commission. Any first amendment objections to the pay television rules could proper-

65. The FCC curtailed many of the origination requirements soon after the *Midwest* decision. See Clarification of Cable Television Rules, 46 F.C.C.2d 176 (1974). See generally Price, *Requiem for the Wired Nation: Cable Rulemaking at the FCC*, 61 VA. L. REV. 541 (1975).

66. There are several methods for distributing cable programs for a fee. In some systems, the programing is transmitted on a channel which television sets cannot normally receive. The subscriber is supplied with a device to enable his set to receive these channels. Other systems allow the subscriber to pay for only the programs actually viewed. See First Report & Order, 52 F.C.C.2d 1, 2 (1975).

67. See Memorandum Opinion & Order, 23 F.C.C.2d 825, 827-28 (1970).

68. The pay television rules prohibited such stations from showing films which had been in general release for more than two but less than ten years and from broadcasting sports events which had been televised on a regular basis on conventional stations in the preceding two years. Other provisions banned advertising and series-type programs on subscription television and limited the amount of programing which could be devoted to films and sports events. See Fourth Report & Order, 15 F.C.C.2d 466, 597-98 (1968). The Commission considered the possibility that cable systems might also originate pay programing, but at the time of the *Fourth Report & Order*, did not feel it had the authority to regulate such systems. See 15 F.C.C.2d at 583-87.

69. See Memorandum Opinion & Order, 23 F.C.C.2d 825, 830-31 (1970).

70. 420 F.2d 194 (D.C. Cir. 1969), cert. denied, 397 U.S. 922 (1970).

71. *National Ass'n of Theatre Owners* involved a petition for review of the Fourth Report & Order, 15 F.C.C.2d 466 (1968), brought by a group representing motion picture exhibitors. The theater owners, viewing pay television as a threat to their business, challenged the FCC's power to license such a system of broadcasting. The D.C. Circuit, noting that the Communications Act encouraged new uses of the broadcast spectrum, approved the Commission's authorization of pay television. 420 F.2d at 200-02. First amendment objections to the rules themselves were raised by the exhibitors, but the court felt the restrictions necessary to insure the financial stability of conventional television and to guarantee diversity in the programing available to all viewers. 420 F.2d at 207-08.

72. Pay television is broadcast on a scrambled signal which only specially equipped television sets can receive. See 420 F.2d at 195 n.1.

ly be countered by the "spectrum scarcity"⁷³ argument. It was, therefore, questionable whether the result would be the same with pay cable, in which the broadcast spectrum is not a factor.

II. *HOME BOX OFFICE V. FCC*

The United States Court of Appeals for the District of Columbia Circuit examined the pay cable rules from several perspectives, but in each instance found them beyond the FCC's power.⁷⁴ Although courts have generally construed the Commission's jurisdiction over the rapidly developing communications industry broadly,⁷⁵ the court in *Home Box Office* warned that this authority is not open-ended.⁷⁶ The Commission's use of its power to prevent virtually any competition from pay cable systems for film and sports programs made the District of Columbia Circuit even more circumspect.⁷⁷ In the court's opinion, past Supreme Court interpretations of the FCC's cable authority were both expansive and narrow. *Southwestern Cable* recognized the Commission's jurisdiction over cable television but narrowly construed its power to promulgate regulations which were "reasonably ancillary" to its other regulatory duties.⁷⁸ *Midwest Video* expanded the list of permissible objectives to include ends for which the FCC might also regulate broadcasting.⁷⁹ None of the Commission's justifications for the pay cable rules, however, were deemed to fall within the standards which evolved from those

73. For an explanation of spectrum scarcity, see notes 34 & 35 & accompanying text *supra*.

74. *Home Box Office, Inc. v. FCC*, 567 F.2d 9 (D.C. Cir.), *cert. denied*, 98 S. Ct. 111 (1977).

75. See, e.g., *United States v. Southwestern Cable Co.*, 392 U.S. 157, 172 (1968); *National Broadcasting Co. v. United States*, 319 U.S. 190, 217 (1943); *FCC v. Pottsville Broadcasting Co.*, 309 U.S. 134, 138 (1940).

76. *Home Box Office, Inc. v. FCC*, 567 F.2d 9 (D.C. Cir.), *cert. denied*, 98 S. Ct. 111 (1977).

77. Under the film rules, pay cable entrepreneurs were not allowed to exhibit a motion picture that had been in general release for more than three but less than ten years. First Report & Order, 52 F.C.C.2d 1, 69 (1975). The average age of films shown on network television for the first time, however, is around five years. *Id.* at 26. Broadcasters would thus have no competition for the films they generally show. The court noted also that waivers of the rules would be granted only when the cable operator could show that the film desired was unsuitable for conventional television, a requirement it felt was further evidence of the anti-competitive nature of the rules. *Home Box Office, Inc. v. F.C.C.*, 567 F.2d 9, 28 n.46 (D.C. Cir.), *cert. denied*, 98 S. Ct. 111 (1977).

78. The court emphasized that all the regulatory duties involved in *Southwestern Cable* enjoyed considerable congressional approval. *Id.* at 26 n.43; see note 47 & accompanying text *supra*.

79. The *Home Box Office* court confined the list of permissible objectives to those specifically approved in *Midwest Video*: the "enhancement of local service" and the "diversification of control of available television and cable programming." *Id.* at 27; see note 62 & accompanying text *supra*.

cases. The FCC contended that past judicial interpretations of the Communications Act compelled the agency to protect advertiser-financed broadcasting.⁸⁰ It pointed to the approval of the pay television restrictions in *National Association of Theatre Owners* as recognition of conventional television's preferred status.⁸¹ The *Home Box Office* court disputed this reading of the case. In its view, the only construction of the Communications Act involved in *National Association of Theatre Owners* leaned in the opposite direction, since the court had found that the Act encouraged the alternative form of broadcasting.⁸²

The FCC's other argument, although related somewhat to the first, was more difficult to dismiss because it drew support from the circuit's previous opinions. Basically, the Commission alleged that the overall level of public program enjoyment would decline if the televising of motion pictures and sports events was limited to subscription cablecasting.⁸³ Thus, the public interest required the FCC to take steps to prevent such reduction.⁸⁴ The Commission inferred this obligation from a line of cases in which the District of Columbia Circuit had instructed it to consider certain factors, such as possible loss of unique programming

80. During oral argument, counsel for the FCC urged that the Communications Act itself required the favoring of free broadcast television. Counsel argued that the agency was mandated by statute "to make available . . . a rapid, efficient, nation-wide, and world-wide wire and radio communication service." 47 U.S.C. § 151 (1970). Since cable television will only reach those willing to pay for it, the FCC contended that conventional broadcasting would be the optimal method of television distribution. The court, however, was not convinced that program siphoning posed a significant threat to the Commission's ability to provide a nationwide communications system. *Home Box Office, Inc. v. FCC*, 567 F.2d 9, 33-34 (D.C. Cir.), *cert. denied*, 98 S. Ct. 111 (1977).

81. *Id.* at 32-33.

82. *Id.* at 33. Further support for a policy of favoritism might be inferred from *Southwestern Cable* since the restrictions approved in that case were intended to protect broadcast television. The FCC seemed to adopt this position when it asserted that the regulation of cable operations to prevent them from "depriving the public of the various benefits of local broadcasting stations would come within the 'reasonably ancillary' standard." Brief for Appellee at 26-27, *Home Box Office, Inc. v. FCC*, 567 F.2d 9 (D.C. Cir.), *cert. denied*, 98 S. Ct. 111 (1977) (quoting *United States v. Southwestern Cable Co.*, 392 U.S. 157, 175 (1967)). The D.C. Circuit, however, responded that *Southwestern Cable* would be inapposite in this context since the Commission had in no way alleged that program siphoning would result in the demise of broadcast television stations, a major consideration in that prior case. 567 F.2d at 27-28.

83. *Id.* at 35-36. The Commission saw films and sports events as essential to conventional television, since it was through these programs that broadcasters would attract the mass audiences needed to sell advertising. See Brief for Appellee at 10, *Home Box Office, Inc. v. FCC*, 567 F.2d 9 (D.C. Cir.), *cert. denied*, 98 S. Ct. 111 (1977); First Report & Order, 52 F.C.C.2d 1, 43 (1975).

84. 567 F.2d at 28-29.

service, when passing on requests to transfer radio station licenses.⁸⁵ The *Home Box Office* court noted, however, that the FCC had generally refused to follow these holdings because it regarded inquiries into program content as beyond its authority under the Communications Act.⁸⁶ Moreover, the Commission had expressed the view that it was incapable of dealing with such a subjective consideration.⁸⁷ The court, therefore, reasoned that if the FCC was incompetent to deal with these matters in regulating broadcasting, it was likewise incompetent in the area of cable programing.⁸⁸

Although the pay cable rules were invalidated on the grounds that they exceeded the Commission's cable authority, the court also analyzed the first amendment consequences of the regulations.⁸⁹ Observing that substantially the same rules had been approved for pay television in *National Association of Theatre Owners*, it distinguished that decision because it had not been based on first amendment grounds. Instead, the court characterized that decision as being restricted solely to the issue of whether the granting of a broadcasting license could be conditioned on the nature of the programing planned by the applicant.⁹⁰ This characterization placed the *National Association of Theatre Owners* decision firmly in line with other licensing cases in which the exigencies of spectrum scarcity had allowed the Commission discretion in regulating program content in the public interest.⁹¹ In contrast, at least two CATV opinions, *Buckeye Cablevision* and *Black Hills Video*, had expressly granted the FCC's cable rules the same first amendment status as its broadcast

85. See *Citizens Comm. to Save WEFM v. FCC*, 506 F.2d 246, 260 (D.C. Cir. 1974); *Citizens Comm. to Keep Progressive Rock v. FCC*, 478 F.2d 926 (D.C. Cir. 1973); *Citizens Comm. v. FCC*, 436 F.2d 263 (D.C. Cir. 1970). In each of these cases, radio stations with unique programing in their areas were being sold to persons who intended to change the station format.

86. 567 F.2d at 31.

87. *Id.* at 41; see also Memorandum Opinion & Order, 60 F.C.C.2d 858, 862 (1976).

88. 567 F.2d at 31. There is evidence that the *Home Box Office* court was somewhat disenchanted with the *Citizens Comm.* holdings. See *Citizens Comm. to Save WEFM v. FCC*, 506 F.2d 246, 269-84 (D.C. Cir. 1974) (Bazelon, C.J., concurring).

89. 567 F.2d at 43-51. The court felt that its jurisdictional objections could be cured by a more convincing showing of need for the regulations. *Id.* at 39-40. Nevertheless, in order to avoid multiple remands, the D.C. Circuit outlined its other reservations, which included the lack of evidence on the actual existence of siphoning and FCC's failure to consider the anti-competitive effects of the rules. *Id.* at 37-39, 43.

90. *Id.* at 43.

91. *Id.* at 43-44. See *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 394 (1969); *National Broadcasting Co. v. United States*, 319 U.S. 190, 216 (1943); *Carter Mountain Transmission Corp. v. FCC*, 321 F.2d 359, 364 (D.C. Cir.), *cert. denied*, 375 U.S. 951 (1963).

rules.⁹² The *Home Box Office* court, however, distinguished both cases. It observed that *Buckeye* had been based on *Carter Mountain*, a case which dealt solely with the grant of a microwave license and failed to address the first amendment issue from a cable perspective.⁹³ Likewise, the *Black Hills* decision had been based on *Buckeye*, although it reinforced its holding by stating that the use of broadcast signals alone was sufficient to invoke complete FCC jurisdiction.⁹⁴ The *Home Box Office* court found this latter rationale to be equally unpersuasive because it assumed that the FCC "owns" the broadcast spectrum in the same manner that the government owns parks, sidewalks, and natural resources.⁹⁵ The court noted that public ownership of those facilities does not give the government the right to condition their enjoyment on ideas the user might express and doubted that the FCC could claim any more authority than the public in this regard.⁹⁶

The *Home Box Office* court did not hold that the first amendment would bar any FCC regulation affecting cable program content. It did believe, however, that such rules would have to be tested by the same criteria as any other law affecting speech-related conduct, a test which the pay cable rules in their present form did not come close to satisfying.⁹⁷ The court conceded that the Commission's intent in promulgating

92. See *Black Hills Video Corp. v. FCC*, 399 F.2d 65, 69 (8th Cir. 1968); *Buckeye Cablevision, Inc. v. FCC*, 387 F.2d 220, 225 (D.C. Cir. 1967).

93. 567 F.2d at 45 n.80.

94. See *Black Hills Video Corp. v. FCC*, 399 F.2d 65, 69 (8th Cir. 1968).

95. 567 F.2d at 45 n.80.

96. *Id.* See, e.g., *Police Dept. v. Mosley*, 408 U.S. 926 (1972) (city ordinance allowing only peaceful picketers to use sidewalk held violative of equal protection).

97. 567 F.2d at 46-48. The D.C. Circuit used the test developed in *United States v. O'Brien*, 391 U.S. 367 (1968), which involved a federal law forbidding the burning of draft cards. Although the Supreme Court did not consider draft card burning an expressive act, it held that the law would not infringe on first amendment rights provided that: (1) its purpose was unrelated to the suppression of speech; (2) it furthered an important government interest; and (3) any incidental restriction on speech was no greater than necessary to the furtherance of that interest. 391 U.S. at 376-77. See *Virginia State Bd. of Pharmacy v. Virginia Citizens Consumer Council, Inc.*, 425 U.S. 748, 770-71 (1976); *Procunier v. Martinez*, 416 U.S. 396, 411 (1974). The *Home Box Office* court never expressly held that the transmission of films or sports events over cable was protected by the first amendment. At one point, the court alluded to "speech of cablecasters" but quickly noted that the rules do not affect "traditional broadcast modes of persuasive speech such as news broadcasts or editorials." 567 F.2d at 49. Cable interests urged that the Supreme Court had recognized the exhibition of motion pictures as a protected activity in *Joseph Burstyn, Inc. v. Wilson*, 343 U.S. 495 (1952). See 567 F.2d at 46 n.83. *Burstyn*, however involved the outright banning of a film so that the rights of the public and the producer were also implicated. The pay cable rules would not prevent a producer of films from reaching the public; but would only affect the means by which he did it. *Id.* at 49. The *O'Brien* test however, may still apply since the affected conduct need only be arguably speech-related. 391 U.S. at 376.

the rules was not to regulate program content, but rather to protect the interests of viewers who could not afford a cable hook-up.⁹⁸ Concluding that the Commission's purpose was proper, the court further required it to show that the pay cable regulations advance a substantial government interest and infringe on speech-related conduct to no greater degree than necessary.⁹⁹ In order to fulfill these requirements, the Commission would first have to convince the court that program siphoning is a problem of significant proportions and that the FCC is mandated by statute to correct it.¹⁰⁰ Then the Commission would further be required to show that the rules were narrowly drawn to exclude from cable only those programs essential to viewer enjoyment of broadcast television.¹⁰¹ Broadly stated rules similar to the ones proposed could only pass scrutiny if they insured that material not actually broadcast was made immediately available to cablecasters.¹⁰² More specific rules, clearly relating the restrictions to the maintenance of television quality, might stand a better chance.¹⁰³ The court warned, however, that any prior restraint on speech, no matter how carefully drawn, would be heavily disfavored.¹⁰⁴

III. CABLE REGULATION AFTER *HOME BOX OFFICE*

Under the guidelines set forth in *Home Box Office*, the FCC would probably have to monitor continually programs being shown on broadcast television to guarantee that pay cable television is supplied with all

98. 567 F.2d at 48.

99. *Id.* See *United States v. O'Brien*, 391 U.S. at 377.

100. 567 F.2d at 49-50. The court felt that the FCC had failed on both points. The Commission had relied on a mathematical model to prove that pay cable would have enough income by 1980 to outbid broadcasters for available programming. The model, however, did not take into account the fact that pay cable entrepreneurs would have to use some of this money for expenditures besides programming. *Id.* at 37-39. Moreover, the court was unconvinced that pay cable's use of the films would cause any harm greater than a slightly later airing on broadcast television. *Id.* at 39. The circuit court doubted that prevention of this slight delay could be considered a substantial government interest. *Id.* at 50. Finally, Judge Weigel, in his concurrence, argued that the Commission was not empowered by Congress to assert any interest justifying this form of censorship. *Id.* at 61 (Weigel, J., concurring).

101. *Id.* at 50. The court found the present rules overbroad. Under the film restrictions, a motion picture over three years old could not be shown over a pay channel even though the film might be entirely unsuitable for broadcast television. Similarly, the sports rules would forbid pay cable from carrying games even if they had been dropped from regular broadcast schedules. See *id.* at 51.

102. *Id.* at 50. The court observed that, although the pay cable rules contained a waiver provision, it took the FCC six and one half months to process *Home Box Office's* waiver petition. *Id.* at 51.

103. See *id.* at 50.

104. *Id.* at 51.

the programming to which it is entitled. Alternatively, the Commission could attempt to tailor the pay cable regulations more closely to its policy objectives, but this method would call for the kind of content evaluation the FCC has previously shunned. Moreover, whatever difficulties such sensitive restraints encounter in the abstract are magnified when viewed in real life. Television is one of the most dynamic and competitive industries in the country. The networks continually experiment with programs and program formats. It is doubtful whether any permanent standards could be employed in this mercurial situation.

While *Home Box Office* may raise an insurmountable barrier to the narrow area of pay cable regulation, the case also suggests new limits and refinements on the Commission's overall cable authority. In *Midwest Video*, the Supreme Court plurality reached its conclusion by applying the "reasonably ancillary" standard of *Southwestern Cable*. The District of Columbia Circuit, however, seemed to view the two cases as distinct formulations of cable authority. The *Home Box Office* court decided that the "reasonably ancillary" test is only relevant when cable practices threaten the very existence of broadcasting. When the danger is not so grave, this court would use the *Midwest Video* concept of "long-established regulatory goals" as a separate test of authority. The District of Columbia Circuit, however, carefully circumscribed that holding, recognizing no valid policy goals other than those actually approved in *Midwest Video*. Thus, it may be that the outer limits of cable authority have been reached.

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