

RECENT CASES

Administrative Law—Securities and Exchange Commission—Validity of Use of Administrative Discretion in Denying Participation in Reorganization under Public Utility Holding Company Act—[District of Columbia].—In 1937 the Federal Water Service Corporation¹ and the Securities and Exchange Commission began seeking an acceptable plan for the voluntary reorganization of the corporation under the Public Utility Holding Company Act.² During this period the officers and directors³ of Federal were also purchasing the corporation's preferred stock on the over-the-counter market at below book value, having reason to believe that this class would be given the equity in the reorganized corporation. On September 24, 1941 the Commission finally approved a plan of reorganization which provided, among other things, that none of this stock so purchased by the officers was to be permitted to participate in the new corporation.⁴ The Commission, citing equity precedents, held that even without proof of fraud or bad faith on the part of these men, their activities were a violation of the fiduciary duty which they owed to Federal's stockholders⁵ and could therefore be proscribed under the "detrimental to the public interest" and "unfair and inequitable" provisions of the Holding Company Act.⁶ On appeal, the Court of Appeals for the District of Columbia set aside the order on the grounds that the equity precedents cited by the Commission failed to support its finding.⁷ On certiorari, the Supreme Court in a four-to-three decision upheld the Court of Appeals and remanded the case to the SEC for further proceedings.⁸ On February 7, 1945, the

¹ Hereinafter referred to as "Federal."

² 49 Stat. 803 (1935), 15 U.S.C.A. § 79 (1941).

³ Also involved were the officers and directors of certain of Federal's subsidiaries and of its corporate parent, as well as the Chenery Corporation, the personal holding company of Federal's president.

⁴ Matter of Federal Water Service Corp., 10 S.E.C. 200 (1941).

⁵ For discussion of the substantive problems raised by this case, see *Stock Purchases by Directors during Voluntary Reorganization*, 10 Univ. Chi. L. Rev. 70 (1942); *Chenery Corp. v. SEC: Power of the SEC to Limit Directors' Purchases of Stock*, 56 Harv. L. Rev. 126 (1942).

⁶ Section 7(e): "If the requirements of subsection (g) are satisfied, the Commission shall permit a declaration to become effective . . . unless the Commission finds that the exercise of such privilege or right . . . is otherwise detrimental to the public interest or the interest of investors or consumers. . . ." Section 11(e): "If, after notice and opportunity for hearing, the Commission shall find such plan . . . fair and equitable to the persons affected by such plan, the Commission shall make an order approving such plan. . . ." 49 Stat. 803, 816, 822 (1935), 15 U.S.C.A. §§ 79g(e), k(e) (1941).

⁷ *Chenery Corp. v. SEC*, 128 F. 2d 303 (App. D.C., 1942).

⁸ *SEC v. Chenery Corp.*, 318 U.S. 80 (1943). See *The Chenery Corporation Case: A New Landmark in the Law of Administrative Procedure*, 56 Harv. L. Rev. 1002 (1943).

Commission issued a new order again denying the suspect stock any participation in the reorganized corporation⁹ but upon the new ground that it could reach such a result merely by exercising its administrative discretion without resort to specific precedents.¹⁰ On appeal to the Court of Appeals for the District of Columbia, *held*, the order could not be approved since it was basically the same order as that disapproved by the Supreme Court, and no new evidence had been produced by the Commission to show that Federal's management had violated any previously formulated standards of conduct. The mere exercise of administrative discretion would not suffice to support the order. *Chenery Corp. v. SEC.*¹¹

As the Court of Appeals indicated, the only question open for review was whether the Commission had rightly construed and rightly followed the mandate of the Supreme Court. The lower court interpreted the Supreme Court's decision as holding that all Commission findings had to be supported by some previously formulated standards of conduct which could only be derived from one of three sources: a specific provision of the Act, judicial precedents interpreting the Act, or an exercise of the Commission's rule-making powers delegated to it by the Act. Since the Commission's new order looked to none of these sources of authority it was invalid.¹² Further, said the court, the order could not be supported as an ad hoc prohibition based upon an exercise of administrative discretion to effectuate the policies of the Act, since there was no proof of specific wrongdoing on the part of the stock purchasers. The SEC argued, however, that its scope was not so limited because the Supreme Court's decision had recognized administrative discretion as a fourth source of authority for the promulgation of standards of conduct. This meant, said the Commission, that it could use its special competence and experience gained in administering the Act to decide by order what result would be required by the statute in applying it to the

⁹ The underlying rationale of the Commission's judgment in proscribing the stock purchases is set forth in full in this order. Briefly summarized, the SEC stated that Federal's management had a dominant position in the reorganization proceedings under the Act; and that in simultaneously embarking upon a stock purchase program they created a conflict between their personal interests as purchasers and their position as reorganization managers duty-bound to represent the public security holders in the reorganization. "At that point, any management, no matter how honorable, makes its own motives suspect." *Matter of Federal Water Service Corp., Holding Company Act Release No. 5584, at 25 (1945)*. The result was the creation of a risk that harm might ensue to these persons supposed to be protected by the Act. As expounders of the Act, therefore, the SEC had to be convinced beyond all doubt that no such factors or influences were present in the situation. In the instant case, said the Commission, it was not so convinced.

¹⁰ *Matter of Federal Water Service Corp., Holding Company Act Release No. 5584 (1945)*.

¹¹ 154 F. 2d 6 (App. D.C., 1945), cert. granted sub nom. *SEC v. Chenery Corp.*, 326 U.S. 1025 (1946).

¹² "In practical effect, therefore, the Commission now insists upon doing precisely what the Supreme Court said it could not do; that is to say, in applying to this specific case a standard which has never been promulgated, either by the Commission in its regulations or by legislative act, and which the Commission says can not fairly be generally applied." *Ibid.*, at 10.

facts of a particular case. Therefore, according to the SEC, all that the Supreme Court decision stood for was that the Commission in its holdings had to make clear the grounds for its decisions.¹³

There is support for both the SEC and the Court of Appeals in their conflicting interpretations of the overgenerous language of the Supreme Court opinion. Thus, the Court, speaking through Mr. Justice Frankfurter, went out of its way to affirm the Commission's discretionary power to correct reorganization abuses of the type present in this case. Similarly, in illustrating how the SEC might have used all of its powers, the Court spoke of "special administrative competence," and "experience and insight denied to others."¹⁴ Finally, in the last paragraphs of the opinion, the majority expressly stated that it did not intend to trammel the Commission's powers.¹⁵ With no apparent hesitation, however, the majority opinion also said that "had the Commission . . . promulgated a general rule of which its order here was a particular application, the problem for our consideration would be very different." It concluded that some standards of conduct were required to support the findings and that such standards originated in Congressional provisions, judicial precedents, and general standards promulgated by the Commission itself under its rule-making powers.¹⁶ Whether intentionally or otherwise, this list of alternatives did not include ordinary administrative discretion, so prominently discussed in earlier parts of the opinion. Since language can thus be found to support either position, the Supreme Court decision is not of much help in attempting to arrive at the present state of the law.

An examination of subsequent Supreme Court decisions is perhaps more illuminating. Two years after deciding the *Chenery* case, the Supreme Court in a per curiam decision by an evenly divided court affirmed a circuit court of appeals decision upholding an SEC order based upon a factual situation strikingly similar to the *Chenery* case.¹⁷ The circuit court had held that the SEC's order was conclusive because supported by substantial evidence, that the corporation bore the burden of proving to the Commission that it did not come within the provisions of the Holding Company Act, and that it was irrelevant that the standards imposed by the Commission were based only upon events which might happen and not upon those which had actually occurred. It was the duty

¹³ SEC petition to the Supreme Court for writ of certiorari, October Term, 1945.

¹⁴ SEC v. *Chenery Corp.*, 318 U.S. 80, 92 (1943).

¹⁵ *Ibid.*, at 94.

¹⁶ *Ibid.*, at 92.

¹⁷ *Pacific Gas & Electric Co. v. SEC*, 324 U.S. 826 (1945). The Pacific Gas & Electric Company had filed an application with the SEC under the Public Utility Holding Company Act for an order declaring it not to be a subsidiary of a registered holding company. The statutory standard involved was the presence of a "controlling influence" by the holding company over the utility. The Act did not elaborate further on this standard, leaving it to the Commission to give it meaning in the cases coming before it. The SEC held that the utility bore the burden of convincing the Commission that no such "controlling influence" existed, and had failed to do so.

of the Commission, not the courts, it concluded, to make inferences, and these inferences were conclusive when a reasonable man could possibly have made them.¹⁸ Three recent Supreme Court decisions by a divided court involving orders of the National Labor Relations Board are of similar import.¹⁹

While it is somewhat dangerous to generalize from one administrative agency to another, it is submitted that these decisions disclose a far more fundamental split among the justices on the whole question of administrative discretion than is apparent from either Mr. Justice Frankfurter's subtleties or from the SEC's arguments in the instant case.²⁰ The Commission contends that the Supreme Court split four to three in the *Chenery* case merely because the majority wanted the SEC to indicate which of its powers was being exercised and to clarify the grounds upon which it was acting, while the minority held that this formality had already been observed.²¹ This hardly seems tenable. It is much more likely that the SEC is hoping that changes in Court personnel, plus the passage of time, have led to a new alignment on the Supreme Court.²² Where the line will eventually be drawn as to the amount of discretion that will be permitted administrative bodies is at present a matter of conjecture. The issue, however, is more clearly drawn than analysis of the litigation in the *Chenery* case would indicate.

¹⁸ *Pacific Gas & Electric Co. v. SEC*, 127 F. 2d 378 (CCA 9th, 1942).

¹⁹ In *Republic Aviation Corp. v. NLRB*, 324 U.S. 793 (1945), it was held that the Board had the power to use its special administrative experience as a basis for its orders; and since it was the Board's duty to interpret and apply the Act's general language to the various cases arising under it, if the Board made clear the theory which had led it to act as it did, the Court would not lightly upset the order. In *Phelps Dodge Corp. v. NLRB*, 313 U.S. 177 (1941), quoted by both the majority and minority in the *Chenery* case, it was held that the Board had been entrusted by Congress with the duty of adapting means to ends through the empirical process of administration, and that courts must be careful not to enter the allowable area of the Board's discretion; the Board must, however, disclose the basis of its order, giving clear indication that it had exercised the discretion with which Congress had empowered it. In *Virginia Electric & Power Co. v. NLRB*, 319 U.S. 533 (1943), the Court, speaking through Mr. Justice Murphy, affirmed a Board order on the grounds that courts must give considerable weight to administrative determinations, and that such determinations should stand unless it could be shown that the order was a patent attempt to achieve ends not fairly designed to effectuate the policies of the Act.

²⁰ See Pritchett, *The Divided Supreme Court, 1944-1945*, 44 Mich. L. Rev. 427 (1945). Professor Pritchett has made a detailed analysis of the manner in which the justices have split into groups on various issues. In the *Phelps Dodge* case (1941) Frankfurter and Reed agreed in a majority decision, Murphy, Black, and Douglas concurred in part and dissented in part; and Stone and Hughes joined in an opinion dissenting in part. The *Chenery* case (1943) had Frankfurter, Stone, Roberts, and Jackson for the majority, Black, Murphy, and Reed dissenting, and Douglas not participating. The *Virginia Electric* case (1943) had Murphy, Black, Douglas, Reed, and Rutledge for the majority, Frankfurter concurring in a separate opinion, and Roberts, Jackson, and Stone dissenting. The *Pacific Gas* case (1945) was decided by a four-to-four split, in a per curiam decision, Douglas taking no part. In the *Republic Aviation* case (1945) only Roberts dissented.

²¹ Note 13 *supra*.

²² Since the *Chenery* decision in 1943 there have been three new appointments to the Supreme Court, and two of the members then sitting are no longer on the bench. See Pritchett, *The Divided Supreme Court, 1944-1945*, 44 Mich. L. Rev. 427 (1945).

It is generally said that the nature of a legislative act is one of general application and prospective operation whereas a judicial act applies specifically and operates retroactively.²³ In applying the Holding Company Act, the SEC exercises both types of functions, for it has the power to issue orders in deciding specific cases, a so-called quasi-judicial function, and the power to promulgate rules and regulations, a so-called quasi-legislative function.²⁴ Carried away by the analogy, courts have been prone to declare that since administrative orders are retroactive in effect, their validity must be determined by the same strict rules governing judicial decisions.²⁵ This has meant, in many cases, that orders have had to be based upon previously formulated and promulgated standards of conduct which gave specific notice to all concerned. Behind this attitude is the traditional American distrust of all government administrative agencies, and the belief that Congress and the courts are the only appropriate agencies for devising and applying standards of conduct.²⁶ This attitude and these restrictions ignore the fact that administrative agencies are *sui generis* and not courts of law, and that they have been created by Congress for the specific purpose of making ad hoc rulings under a statute in cases where there may well be no specific precedents. Flat rules and standards amenable to mechanical application cannot be promulgated by legislatures in certain fields. Administrative agencies are created precisely because complex and technical fact situations such as arise under the Holding Company Act require highly specialized personnel to deal with them. Only to the extent that administrative agencies are permitted to exercise the necessary discretion can the legislative will be carried out.²⁷

It is submitted that the Court of Appeals in the instant case, while perhaps properly construing Mr. Justice Frankfurter's opinion, leaves little, if anything, of administrative discretion to the SEC. When an administrative agency can only apply a specific statutory provision, a specific judicial precedent, or a specific commission regulation to the facts before it, its discretionary powers are severely curtailed. The very essence of administrative discretion lies in the utilization by a group of specialists of their special competence and experience

²³ See *Prentiss v. Atlantic Coast Line Co.*, 211 U.S. 210, 226 (1908); *San Diego Land & Town Co. v. Jasper*, 189 U.S. 439, 440 (1903); Fuchs, *Concepts and Policies in Anglo-American Administrative Law Theory*, 47 *Yale L.J.* 538, 545 (1938).

²⁴ In fact, the Commission can decide specific cases only by order. It is interesting to note, however, that Section 11 (e), which was cited by the Supreme Court majority as granting to the SEC power to promulgate new general standards of conduct, permits the Commission to use "rules and regulations or orders" in promulgating such standards.

²⁵ See *Assigned Car Cases*, 274 U.S. 564, 583 (1927); *ICC v. Louisville & N.R. Co.*, 227 U.S. 88, 91 (1912); *Chicago M. & St. P. R. Co. v. Minnesota*, 134 U.S. 418, 457, 458 (1890).

²⁶ See *State v. Whitman*, 196 Wis. 472, 220 N.W. 929 (1928); Dicey, *The Law of the Constitution*, c. 12 (4th ed., 1893); Frankfurter, *Foreword to a Discussion of Current Developments in Administrative Law*, 47 *Yale L.J.* 515, 517 (1938).

²⁷ See *McLean Trucking Co. v. United States*, 321 U.S. 67, 87 (1944); Dickinson, *Administrative Justice and the Supremacy of the Law* 13 (1929); Fuchs, *Concepts and Policies in Anglo-American Administrative Law Theory*, 47 *Yale L.J.* 538, 546 (1938); Cooper, *Administrative Justice and the Role of Discretion*, 47 *Yale L.J.* 577, 580 (1938).

in applying a general statutory provision to a particular set of facts. An administrative decision which is both rational and supported by substantial evidence should not be upset merely because it is not based upon traditional precedents or specific legislative provisions.

Appeal and Error—Appealable Interest—Right of Landlord Not Party to Dram Shop Proceeding to Prosecute Appeal—[Illinois].—The plaintiff was injured in a tavern by the acts of an intoxicated person. Section 14 of the Illinois Liquor Control Act¹ gives to the party injured in such circumstances the right to sue the tavern keeper and property owner separately or jointly. The plaintiff elected to sue only the tavern keeper, and he obtained a judgment. Pursuant to Section 15 of the Liquor Control Act,² the plaintiff then sued to subject the building in which the tavern was located to the payment of the judgment. The owners, non-residents, had that action removed to the federal district court, where it is now pending, and filed a petition with the Illinois appellate court for leave to appeal the original judgment. The appellate court dismissed this appeal on the plaintiff's motion.³ On appeal to the Illinois Supreme Court of the appellate court's dismissal of the property owners' petition to appeal the original judgment, *held*, the property owners have no appealable interest in the original judgment. Judgment affirmed. *Gibbons v. Cannaven*.⁴

At common law the only mode of removing a cause from an inferior court to a superior court was by writ of error.⁵ The writ of error was available to anyone who was a party to the record, was injured by the judgment, would be benefited by a reversal, or was competent to release errors.⁶ An additional method of review under certain restrictions, the right of appeal, was created by statute.⁷ Prior to the Civil Practice Act, under Illinois statutes, a person not a party to the record could not maintain an appeal,⁸ although he might have been able to do so under the writ of error. Section 81 of the Civil Practice Act eliminated the distinction between the writ of error and the right of appeal.⁹ This merger

¹ Ill. Rev. Stat. (1945) c. 43, § 135.

² Ill. Rev. Stat. (1945) c. 43, § 136.

³ *Gibbons v. Cannaven*, 325 Ill. App. 337, 60 N.E. 2d 254 (1945).

⁴ 393 Ill. 376, 66 N.E. 2d 370 (1946).

⁵ *Bowers v. Green*, 2 Ill. 42 (1832).

⁶ *People v. Whealan*, 353 Ill. 500, 187 N.E. 491 (1933); *White Brass Castings Co. v. Union Metal Mfg. Co.*, 232 Ill. 165, 83 N.E. 540 (1908); *People v. Harrigan's Estate*, 294 Ill. 171, 128 N.E. 334 (1920); *People v. Lowrer*, 254 Ill. 306, 98 N.E. 557 (1912); *People v. O'Connell*, 252 Ill. 304, 96 N.E. 1008 (1911).

⁷ *Veach v. Hendricks*, 278 Ill. App. 376 (1935).

⁸ *People v. Franklin County Bldg. Ass'n*, 329 Ill. 582, 161 N.E. 56 (1928); *National Bank v. Barth*, 179 Ill. 83, 53 N.E. 615 (1899).

⁹ Ill. Rev. Stat. (1945) c. 110, § 205. "The right heretofore possessed by any person not a party to the record to review a judgment or decree by writ of error shall be preserved by notice of appeal."